Incentives & Institutions

The Transition to a Market Economy in Russia

ILLUSTRATIONS BY
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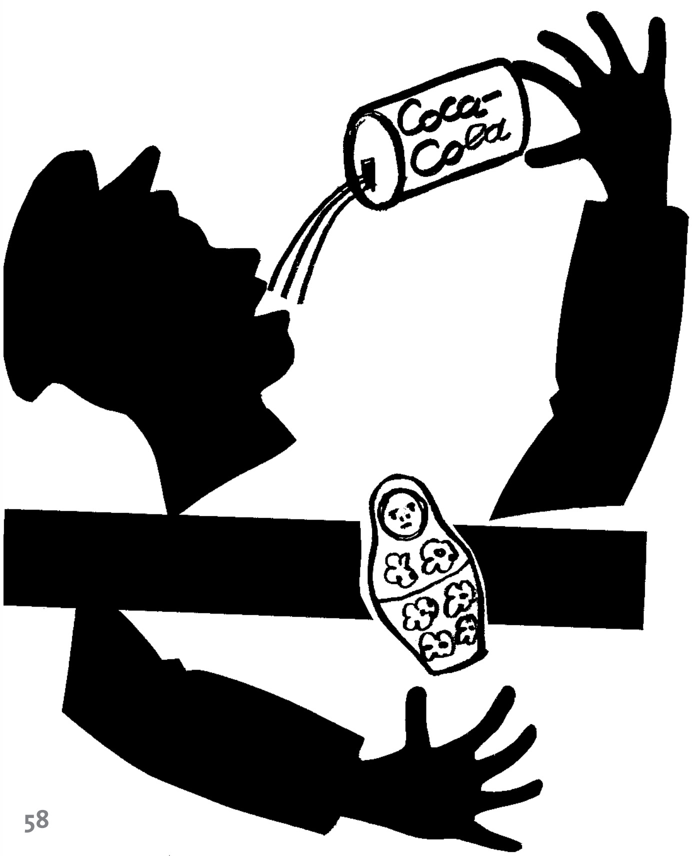
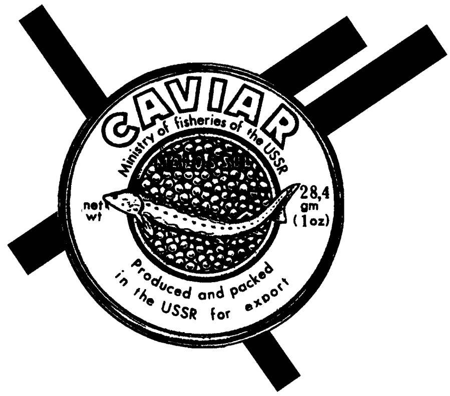
Remember The Grand Bargain? That's right, the 1991 proposal by Graham Allison of Harvard's Kennedy School of Government and Grigory Yavlinsky, a flashy young Russian academic who was at home in modern economics at a time when his peers were still wondering how Marx would have raised grain yields in Belarus. ¶ Allison and Yavlinsky briefly made headlines with a plea for a deal in which the West would spend hundreds of billions of dollars to make Russia safe for capitalism and democracy. It was brushed aside by the Bush administration, which was more worried about budget deficits than about tidying up the corpse of the Soviet Union. However, Yavlinsky lived to fight another day; he heads Yabloko, the only surviving political party in Russia that is committed to transforming the motherland into something resembling a civil state. Yavlinsky is far from the seat of

BY SERGUEY BRAGUINSKY AND GRIGORY YAVLINSKY power, but remains influential in the West as one of the few Russian reformers who has not been compromised by the endless intrigue – and opportunities for personal profit – of post-Soviet, post-Yeltsin politics. ¶ Yavlinsky wrote *Incentives and Institutions* (Princeton University Press) with Serguey Braguinsky, a Russian economist who teaches at Yokohama City University in Japan. It's an unusual book, a mix of theory and hard-won policy lessons that reflects the bitter disappointments of Russia's first-generation post-Soviet reformers. But unlike many of their liberal colleagues, Braguinsky and Yavlinsky have not retreated to apathy. Indeed, the contrast between their dark image of a contemporary Russia run by organized criminals and their optimistic assessment of the prospects for a fresh start is quite striking. ¶ More striking yet, they offer a genuinely novel approach to reform – one inspired by game theory. They seek a social contract in which the fruits of more efficient economic organization can be used to bribe the malefactors to embrace competition and democracy. ¶



Is it convincing? Probably not to the cynics among us, who are not far behind the Russians themselves in writing off The Bear as a lost cause. But the two economists do offer an alternative to a sad status quo in which the West effectively pays the Russian government to keep its saber-rattling confined within the old borders of the Soviet Union. —*Peter Passell*

Russia faces a watershed. Communism is no longer an option. But will Russia become a quasi-democratic oligarchy with corporate, criminal characteristics, or will it take the more difficult and painful road to becoming a Western-style democracy with a market economy?



Russians will make this fateful choice – and Russians will be its principal victims or beneficiaries. But the consequences for others who share this shrinking globe should not be underestimated. Contrary to the widespread view that Russia is now essentially irrelevant, this vast country will be important because of its location between the East and the West, its possession of weapons of mass destruction, its natural resources and its potential as a consumer market.

Unlike previous choices in recent Russian history, this one will not be made on a single day by a coup or by an election. Rather, it will evolve through myriad decisions made by Russia's millions of people – leaders and ordinary citizens alike – over the coming years. Nevertheless, the route chosen will be no less important than the rejection of Communism in its effect on our children and grandchildren.

RUSSIA'S ROBBER BARONS

The Russian economy today shows signs of evolution toward Western-style capitalism on the one hand and the consolidation of corporatist, criminal-style capitalism on the other. Until summer 1998, the conventional wisdom in the West assumed the former, and thus saw a Russia progressing fitfully toward a successful market economy.

Russian reformers did manage to lower inflation and to stabilize the currency – though the fix was only temporary, as the events of late 1998 and early 1999 proved. Some of the newly established and privatized corporations that operate with international sensibilities and ambitions are making their way to the top. Some regions of the country have received favorable international credit ratings, and a handful of Russian companies were able to float bonds in the international market before the government defaulted on its debts in August 1998. And while it occasionally suspends promised outlays because Russia failed to meet tax collection targets or deviated from promised reforms, the International Monetary Fund always seems to find a reason to reinstate its largess.

However, for all the boasts of economic success, most signs suggest the economy is moving toward a "corporatist," monopoly-dominated market and toward a state marked by lawlessness. Markets are driven by large and small oligarchs, whose goals of increasing their personal wealth conflict with the goals of increased economic productivity and a better life for the majority. Freedom of the press and other civil liberties have been suppressed. Laws are frequently ignored or suspended, and the constitution is only obeyed when it is convenient. Corruption is rife from the streets to the halls of power. Personalities, contacts and clans count for more than institutions and laws.

Hence, far from creating an open market, Russia has consolidated the role of a semi-criminal oligarchy that was already largely in place under the old Soviet system. In the wake of Communism's collapse, this *nomenklatura* – members of the former Communist Party ruling class – stand in the way of an open competitive economy. They cannot begin to answer the important social and economic questions, for they exist solely to promote their own power and prosperity.

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Those who believe that the capitalism of the robber barons will eventually give way to a benign market economy, as occurred in the United States at the turn of the 20th century, are mistaken. The United States already had an established middle class with a strong work ethic, and it did not have the legacy of 75 years of Communist rule and 750 years of czarist totalitarianism before that.

The American tycoons bullied, stole and bribed – but they also invested in their own country. They built railroads and large-scale industrial enterprises where none had existed. They extracted the country's mineral wealth to feed their industrial revolution. Russia's robber barons, by contrast, stifle their homeland's economic growth by investing their plunder abroad. Russia has no middle class, and its oligarchs consume all they import.

With the big boys – they are all male – fighting over the shrinking economic pie, the government has been unable to create economic conditions in which the majority can thrive. The problem is not only that most Russians are worse off than they were before the economic transition began, but that they have little prospect of becoming better off.

The European Bank for Reconstruction and Development recently ranked Russia as the most corrupt major economy in the world. Graft, from illegal book deals in Kremlin corridors to rigged bids for stakes of privatized companies, permeates the country. Recent polls by the Public Opinion Foundation show that Russians believe the best way to get ahead is through contacts and corruption. When asked to select the criteria needed to become wealthy in today's Russia, 88 percent picked connections and 76 percent chose dishonesty. Only 39 percent said hard work.

Anyone who attempts to start a small business in Russia encounters extortion demands from organized criminals – what Russians call their Mafia. So there is no incentive for individual enterprise: better to stay home and grow potatoes at your dacha. A crime-ridden market can support the current level of consumption – which for the majority means near-pauperhood – for some time. But it cannot create the basis for real progress.

THE ECONOMIC TOLL

Even a casual look at the data should have convinced observers that something was deeply wrong with the Russian economy long before the crisis of 1998. Seven years of transition had failed to deliver the results that Russian reformers and their Western well-wishers expected. The conventional path, emphasizing the freeing of prices, privatization of state enterprises and macroeconomic stabilization, simply did not work.

By the summer of 1998, Russia's industrial output had fallen almost 60 percent from its peak. Large industrial enterprises were running at just 10 to 40 percent of capacity. Investment in fixed capital assets has fallen even faster than output, running at 20 percent of its peak rate. By no coincidence, the average age of capital equipment in Russian industry was 14.7 years in 1996 – twice as old as in the 1970s.

Deindustrialization is progressing rapidly, with the share of machinery manufacturing reduced from 24 percent of Gross Domestic Product to just 12 percent. The textile industry, fully 12 percent of industrial output in 1990, has been virtually wiped out. Though smaller in absolute size than before the fall of Communism, the resource-extraction sector now accounts for almost 50 percent of what remains of industrial output.

Things do not look any better from the firms' perspective. Far from representing a giant step toward efficient ownership, the privatization program was a grandiose failure. Suffice it to say that six years into privatization, half of the privatized firms were losing money and had piled up unpaid bills amounting to 25 percent of GDP. Today, barely 30 percent of transactions between industrial firms in Russia are settled with money; the rest are settled by barter or through default.

In contrast, the service sector now accounts for more than 60 percent of the country's GDP. And alternative estimates put the share even higher than the official numbers suggest. Indeed, a closer look at the seemingly flourishing private sector in services, trading and banking reveals that we are dealing here not with the germs of a new institutional form, but rather with a vehicle for financial freeloading. Much of the activity does little more than add transaction costs to the resource-extraction sector, dissipating value rather than adding to it.

Moreover, despite the introduction of sophisticated computer-based trading systems, a meaningful capital market does not exist. About 1,500 banks of various kinds were operating in Russia before the financial collapse of August 1998. However, instead of mediating flows of loanable funds between households and firms, they extended short-term commercial credit to businesses (primarily export-import companies) and to the government. Almost all real business investment in Russia is financed from retained profits, and only 3 to 4 percent of all loans provided by the banking system from 1994 to 1998 had terms of a year or more.

These economic failures have had dire consequences for the day-to-day life of ordinary Russians. Real incomes have fallen by a third, and living standards in most regions have deteriorated to levels not seen in many decades. Government attempts to curb inflation resulted not only in tremendous wage and pension arrears, but also in the government's failure to pay its own bills for goods and services. This led to total disarray in payments between enterprises, with up to 75 percent of bills either paid in kind or with promissory notes that cannot be cashed. Government pension and wage payments were cut by 60 percent or more in real terms, yet the government is still unable to collect enough revenue to cover its shrinking obligations.

Indeed, combined tax receipts of the federal and local governments have fallen to less than 20 percent of the country's GDP. Meanwhile, external debt has skyrocketed. And domestic debt, which was next to nothing a decade ago, has reached almost 15 percent of GDP.

This list of economic woes can be easily extended. However, the basic message should be clear enough: the economic and social crisis cannot be written off as a temporary recession. Most alarming, there are almost no signs of recovery. Hence, it is extremely important to understand why the outcome of what was widely regarded as the correct course for reform has been so dismal, and what can be done now to put things straight.

AN ALTERNATIVE VISION OF RUSSIAN TRANSITION

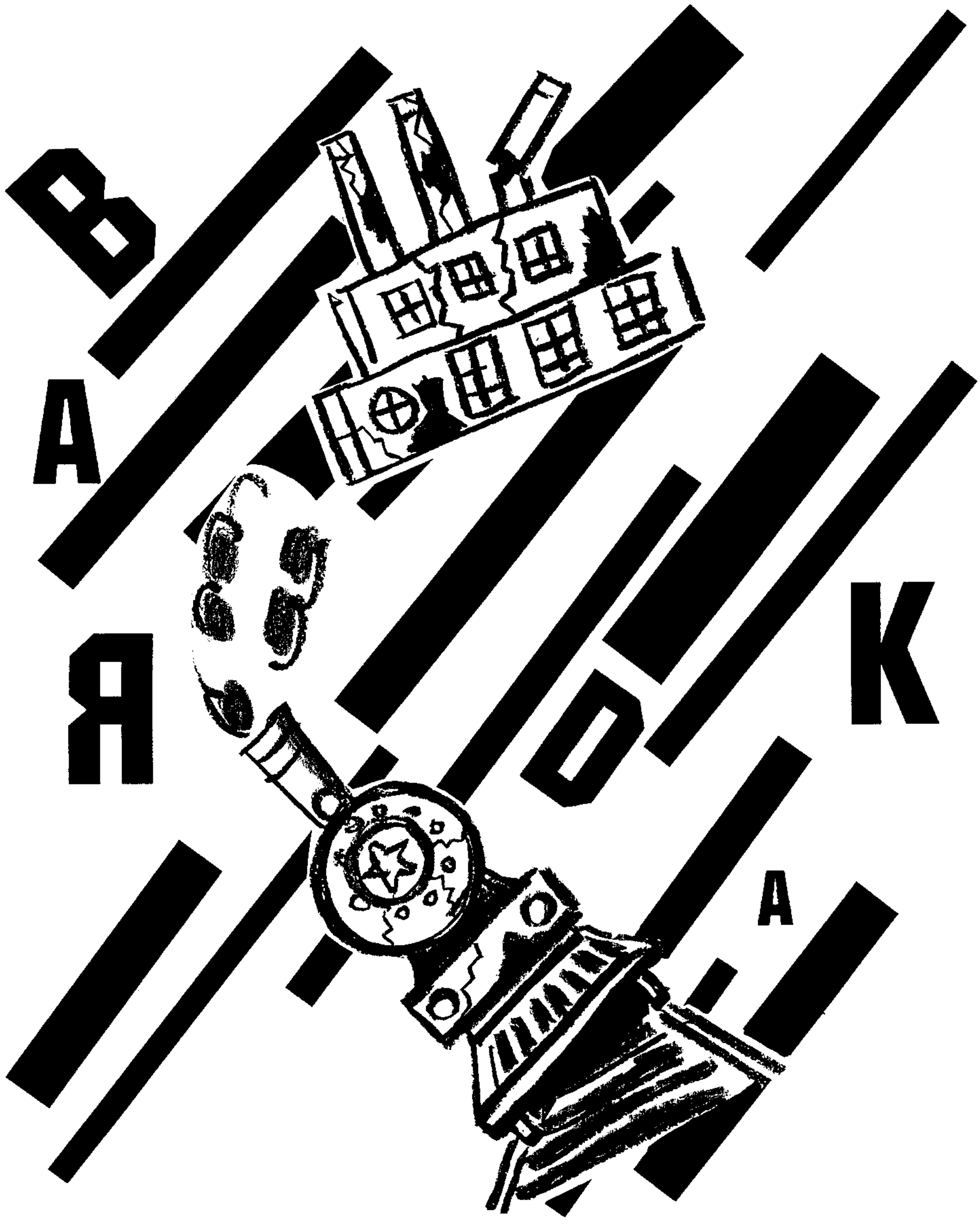
Russia's departure from totalitarianism is the only instance among major countries in the 20th century that may be defined, in the words of the American economist Mancur Olson, as a transition that is "entirely internal and spontaneous." Germany, Japan and Italy were defeated in World War II and occupied by the Allies. Besides, each of those countries had had some experience with democracy and with a free-market economy prior to the war. The latter is also true of the countries of Eastern Europe. And in any case, their totalitarianism was not spontaneous, but the result of Russian occupation. And while China is well on its way to a successful transition to free markets, it can hardly be regarded as a democracy.

The spontaneous nature of the Russian transition is probably beyond dispute. However, analysts have yet to grasp the implications. Indeed, it is still the conventional wisdom that economic reform can be imposed from above, with consumers and producers switching seamlessly to profit-seeking behavior in free markets.

All the broad transition plans, beginning with Yavlinsky's own *500 Days: Transition to the Market Economy* (Pantheon Books, 1991), made this linear view of reform the starting point. We still believe that if reform had proceeded under a well-defined institutional framework (as was still in force in the former Soviet Union when *500 Days* was written), such an approach might have been warranted. However, after the collapse of the Soviet Union, hopes for a success along those lines faded. Many of the subsequent programs of transition were more or less complete and ingenious. But all such programs – those developed under the auspices of the government, the IMF or the World Bank being no exception – seem to have one feature in common: not one has ever been implemented.

We find it particularly hard to understand how those economists and politicians who tried to convince the public that the collapse of the Soviet Union was inevitable could at the same time believe they would be able to control events thereafter. The approach that envisages a top-down, straightforward transition from socialism to capitalism suffered a fatal blow when the Soviet Union, with all its formal institutional structures, was dismantled overnight.

Dismantling those structures did not mean that reform could start anew on a blank slate. On the contrary, it just meant that coercive power and leadership functions were transferred to the lower-tier institutions that had survived the collapse of communism.



Those surviving institutions dictate the structure of incentives faced by economic agents, and largely invalidate attempts to mimic Western free markets by decontrolling prices, privatizing property, stabilizing macroeconomic variables and opening the economy to trade and investment.

The implications of this vision of failed transition are profound. On the one hand, we are led to re-examine the institutional structure of the Communist system in order to understand those elements that carry on after the system's formal collapse. On the other, it is no longer safe to assume that transition will bring Russia closer to a conventional market economy. Indeed, the incentives built into the transition environment are leading to a system that is almost as remote from a free-market economy and polity as the previous Communist system was.

THE FALLACY OF THE HISTORICIST APPROACH

The still widely accepted assumption that the Russian transition will inevitably lead to an open society is, at best, premature. The reasoning behind this assumption represents nothing but the "spell of Plato," or the historicist approach, to which the British philosopher Karl Popper strongly objected. The assumption that Russia must be heading in the right direction is blinding the Russian government and its Western advisers, and preventing the much-needed change of policies. Whenever developments do not fit the optimistic assumptions, the typical reaction is to explain away uncomfortable facts as aberrations.

Ironically, this approach is similar to the way the Soviet Union coped with adversity. When it finally became impossible to ignore the inefficiencies of the Socialist system, the ideologues claimed they were just temporary difficulties encountered along the correct path.

The dismal end of this self-deception is still fresh in our memories. But the arguments that are advanced nowadays to reassure the world that the transition is on track represent nothing so much as a replacement of the idea of the historical inevitability of socialism by the idea of the historical inevitability of capitalism. What is emerging in Russia resembles a market economy and a democratic political system no more than socialism in the former Soviet Union resembled its blueprint in the works of Marx, Engels and Lenin.

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WHERE ARE WE?

Taking an honest look at what has happened in Russia since the collapse of the Communist system, we are forced to admit the following. First, as discussed above, the collapse of Communism was the logical end of a lengthy and largely spontaneous process in the Russian society itself, which had started at least 40 years earlier. This legacy is shaping the process of transition.

Second, incentives intended to transform the Russian economy into a Western-style free-market economy have had unanticipated consequences. New rules and new institutions were imposed on the old structures of economic and political power, which not only survived the collapse of Communism by force of inertia, but assumed almost unchallenged control over the post-Communist scene.

Hence, the economy was not freed from old Soviet-type monopolies; rather, these monopolies were freed from most institutional restraints. The emerging power system relies on control over mineral resources, energy and the government pork barrel. And by virtue of its control over wealth, that emerging system also largely controls the political system and its mass media. Ordinary citizens, disillusioned by this turn of events, are inclined to apathy and nihilism.

Third, and most fundamental, the collapse of Communism has led to the entrenchment of an elite that is blocking further movement in the direction of a conventional market economy. The two most important factors behind this lock-in are insiders' markets and Russia's natural wealth. Investment in restructuring and long-term growth is stymied by absence of both long-term capital markets and reliable means for protecting property rights.

This system is kept afloat by an abundance of natural resources. Revenues from raw-material exports grease the wheels of short-term trading and what economists call "rent seeking" – gaining wealth by taking it away from someone else rather than by creating it. The parallel economy of insider trading and easy short-term profits in the resource extraction sector thus complement each other.

This last reality is very important. In a country poorly endowed with natural wealth, a crisis of economic transition would be resolved one way or another within a relatively short period. But in a resource-rich country like Russia, the issue of survival does not immediately arise. Instead, institutional chaos allows plundering of natural wealth, which can be used in part to maintain a bearable standard of living for the downtrodden majority.

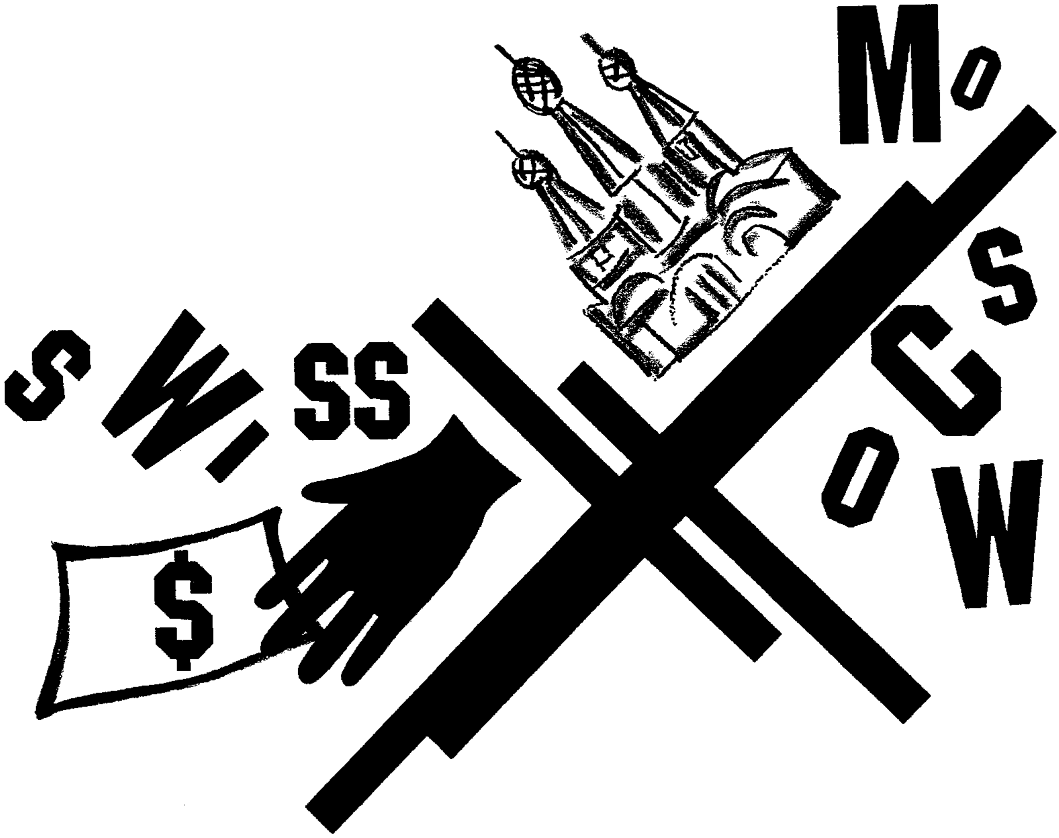
A prolonged industrial stagnation results, during which no long-term investment is made. The political system stagnates, too, while successive weak governments survive by catering to the interests of the powerful groups that control the natural resources. The opportunity to pillage thus not only attenuates the sense of crisis, but redirects the ambitious and talented into unproductive rent seeking.

The lavish assistance the West provided to Russia during its initial phase of transition had similar consequences, temporarily relieving pain but not curing the disease. Thus, paradoxically, the uniquely favorable opportunities provided by rich natural resources and the good will of the international community have led to worse, not better, economic performance.

THE NEED FOR A NEW SOCIAL CONTRACT

Although the concept of the social contract goes back several centuries, it has only acquired precise meaning with the development of game theory – a branch of economics that analyzes interactions in which individual economic actors understand that their behaviors affect the behaviors of others. By one enlightening definition, a social contract represents an implicit self-policing agreement between members of society to coordinate on a particular equilibrium in "the game" of life. Each more or less complicated social game can lead to many possible outcomes, or equilibria. A particular equilibrium comes about through repeated interactions of players – businesses, interest groups, consumers, workers – according to the law of the survival of the fittest.

Consider the social decision to drive on one particular side of the road. If half of the vehicles travel on the left and half on the right, the probability of collision is equal for both types. However, if (by pure chance, perhaps) slightly more than half of the drivers choose one of the sides, those who travel on the opposite side will face a higher probability of collision and will be driven out of existence in the long run. The environment thus adopts those individuals who are better fit for it, even though no conscious choice might be involved. In the case of traffic rules, there is no intrinsic efficiency or inefficiency in the



choice of a particular equilibrium. But in many other cases the efficiency of the outcome largely depends on the choice made.

A coordinating authority (a government, for example) can greatly reduce the costs of establishing the equilibrium in a social game – in the traffic case, simply by requiring that all traffic must travel on the right. It is very important to understand the role of the coordinating authority. Formal rules cannot create any new equilibria that are not already present in the structure of the underlying social game itself. What government can aspire to do, however, is to shift the actual equilibrium from a prevailing less efficient one to a more efficient latent one through social coordination.

To be meaningful, a social contract has to be self-policing: the government may foster traffic rules by its coordinating announcement, but what ultimately enforces the convention is the implicit understanding that one is much safer on the road if one adheres to that rule than if one ignores it. Formal arrangements that are not based on such implicit agreements and are not self-policing are usually not worth the paper on which they are written.

The history of post-Communist transformation in the former Soviet Union presents an almost endless list of examples of laws, decrees and other products of institutional zeal that remained irrelevant to the real-life game. This is not to deny, of course, that the formal establishment of a social institution can make a lot of difference, especially in the long term. But the success of a newly introduced institution will depend crucially on the strength of the social interests it helps to organize and on its relative position in the hierarchy of incentives of private agents.

THE SOCIAL CONTRACT IN RUSSIA, PAST AND PRESENT

For centuries, the social contract in Russia was a strictly paternalist one in which all (or almost all) members of the society were guaranteed some minimum welfare in return for absolute obedience in carrying out the orders of their superiors. Although Communist rule dramatically changed the structure of power in the former czarist Russia, it did not alter this basic arrangement.

Indeed, the socialist revolution represented a reaction to attempts to introduce a new form of the social contract in which the ruled would rely more on their own initiative and less on the benevolence of the rulers. Those attempts started in Russia around 1861, when serfdom was abolished. And they continued, albeit with reversals, right up to the Bolshevik coup in 1917.

The Bolsheviks reintroduced almost all the elements of the old social contract, even including de facto serfdom. Ordinary citizens were freed from both the right to make decisions for themselves and the responsibility for choices. This type of social contract was self-policing and, indeed, the only one possible under the Communist system.

However, in their desperate attempts to create a modern industrial economy and a strong military machine, the Communist rulers propagated education and failed to prevent information about Western society and its living standards from penetrating Russia. More significantly, they failed to prevent the incentives given to their officers from coming into deep conflict with the goals of the system. Some cheating had always been present. But under Communist rule, the cheaters gradually dominated the system. The old social contract insuring bread and stability in return for obedience was thus corrupted from the inside and was finally cast off.

The demise of the old social contract has not yet led to a consensus about the form the new social contract should take. There is a growing sense among ordinary people that the paternalist relationship with the state has ended for good, and that they will have to rely on their own devices. The conspicuous failure of the government to provide even the most basic public goods adds strength to that perception.

On the other hand, a great many Russians still expect a return to some form of paternalism, characterized by the absence of the need to assume personal responsibility for one's own well-being. And the rulers themselves, though no longer providing the ruled with a decent standard of living, still cherish the hope of retaining most of their totalitarian powers. This mismatch between reality and expectations, characteristic of ordinary people as well as their government, is the main impediment to a new consensus about the new equilibrium of the social game.

Even that part of the population that initially welcomed the opportunity to become self-sufficient and wholeheartedly accepted responsibility for themselves is becoming disenchanted with the government. Many elements of the old social contract have been left intact just to promote the personal interests of government officials, who need a legal basis for predatory activities. People favoring a new social contract thus find themselves sliding ever deeper into the underground economy. They look inward to small circles of friends and colleagues, and reject any sense of obligation to a broader community.

Another part of the population, especially those who find it difficult to cope with the demise of paternalism, has escalated its unrealistic demands on government and falls into apathy when they are not met. Thus, while Russia's return to the old social contract is highly improbable, alienation among various social groups is impeding the development of a new consensus.

Gilding this poisonous lily, the oligarchs have exploited the current chaos by expropriating more assets and making their own contract with the government to enforce their rights to ill-gotten property. It is this (and only this) group that is currently being serviced by the government, and on which the well-being of government officials and the continued existence of the government itself depend.

We can thus distinguish several layers of the social game in contemporary Russia:

- The old, largely dismantled totalitarian contract that the bureaucracy still tries to exploit to its selfish ends.
- The emerging new social contract of self-reliance and freedom of economic activity, which lacks an adequate institutional backing.
- The exclusive corporate contract used by the oligarchs to share the economic spoils with the government.

This segmentation of the social game results in a corresponding segmentation of the society, precluding the establishment of a stable equilibrium. Paradoxically, business as usual is unsatisfactory for the vast majority, yet the equilibrium is fairly stable.

WHAT IS TO BE DONE?

The provision of a clear blueprint for a new social contract is the most urgent task of any government that hopes to reform the Russian economy and polity. A meaningful agenda must be based on an understanding of (and sympathy for) the struggles of ordinary people in the current Russian environment. All previous reforms in this country, starting with Peter the Great and ending with the recent attempt at transition to a market economy, have been conducted by arrogant rulers oblivious to the needs of ordinary citizens. And all those reforms have failed for precisely that reason.

Top-down reform fails to stir real change in the ways the majority live and behave. Without bringing about the motivated participation of the people, no reform policies, whether radical or gradual, ideological or technocratic, will have any hope for success.

A new protectionist (in Popper's benevolent sense of the term) state would need to empower citizens to operate in a competitive market while protecting them from interests that benefit from corruption and rent seeking. This does not boil down simply to more government intervention, or less. The state must become more interventionist in some cases, and less interventionist in others.

A separate challenge is to create conditions in which the state does not assume unreasonable responsibility, but never reneges on the promises it does make. Later in the book, we consider incentive mechanisms through which ingredients of the new social contract can be introduced. The first and most important is democracy itself. The development of democracy implies not only holding elections for the president and members of parliament, but also promoting constitutional changes to achieve a better division of power among the executive, legislative and judicial branches. A trustworthy news service, an independent judiciary and fully developed political parties are also indispensable.

However, democracy at the national level is just the first of the incentives needed to foster the transition to a new social contract. Both political power and financial resources should be decentralized. Russia will be doomed to instability and underdevelopment as long as 80 percent of the nation's money remains concentrated in Moscow. Local initiatives and entrepreneurship should be encouraged if the fruits of economic growth are to be shared. Self-responsibility implies self-organization and self-governance, and this principle should be extended to the very bottom layers of administration.

The second element of the new social contract is the introduction of rules to create a true market economy. There must be a decisive break with the past, when administrative power stood above the law. Individual businesses should be regulated by legislation, not by government officials or local barons who are often not easily distinguishable from gang leaders. In particular, the power of oil and gas tycoons, who appropriate huge profits using the country's natural resources, must be curtailed. Their activities should be made transparent, and they should be held accountable to law.

The present system of economic management, where insiders run most large enterprises, must be radically reformed. In particular, the hybrid collective enterprises born of the old state enterprises – whose management styles smack of the Soviet era – should be eliminated. Open accounting that meets international standards is a prerequisite to controlling corruption. Competition must be promoted by removing the red tape and excessive regulation that stands in the way of small- and medium-sized businesses.

Without bringing about the motivated participation of the people, no reform policies, whether radical or gradual, ideological or technocratic, will ever have any hope for success.

Such proposals may seem drearily familiar, and doomed to fail. The novelty of our approach is the explicit focus on incentives mechanisms. We envisage the establishment of new power-sharing schemes and the creation of commercial services that would give businesses and government officials opportunities to reorganize relationships on their own.

Another task, which does not constitute an element of the social contract in itself but would be extremely important in bringing about a more favorable equilibrium of the social game, is a tangible economic recovery. It is extremely difficult to persuade people to take chances on radical change when they face economic decline.

Russia's GDP in 1997 was estimated at just over $450 billion (about $3,000 per capita). Even the official purchasing-power estimates from Goskomstat, the Russian statistics-gathering agency, put the figure at just $4,200 per capita – an unbelievably meager level for a country that was the world's second-ranked superpower only 10 years ago. For the new social contract to possess any serious appeal, people should become reasonably convinced that prosperity is a realistic prospect.

The positive spillovers created by such an environment would play a very important role in changing present-day incentives. The measures envisaged involve, in particular, a departure from uncritical acceptance of the original macroeconomic stabilization policies still haunting the Russian government – especially the IMF-led approach to reforms.

Unregulated prices, low inflation rates and a stable currency are absolutely necessary. In Russia, however, these are not sufficient conditions for economic recovery. What we propose here is by no means simple Keynesian-style economic stimulus. Our alternative would establish a new mechanism for monetary growth in which new funds would flow into the expansion of the real economy.

their long-term welfare and limit the scale of corruption.

Pressure groups will resist not only a democratic change of power, but also any attempt to codify a new, competitive form of the social contract. However, we believe that a successful shift to a new social contract would generate sufficient growth to compensate the direct losers. After all, it serves nobody's interests – not even those of the oligarchs – to risk a bare-knuckles collision with the have-nots.

Democratic change at the top is crucially important to the introduction of an arm's-length relationship between the government and the oligarchs.

Last, but not least, the Russian transformation faces the cold reality that almost everything that has to be done can only be done by an effective and motivated government. But the Russian government, by and large, is a captive of oligarchic pressure groups that oppose change. Rather than deplore this situation, we are inclined to create incentives for the government to change itself. As Popper noted, "It is not at all easy to get a government on whose goodness and wisdom one can implicitly rely. If that is granted, then we must ask... how can we so organize political institutions that bad or incompetent rulers can be prevented from doing too much damage?"

We consider devolution of power an extremely important part of the new social contract. Democratic change at the top is crucially important to the introduction of an arm's-length relationship between the government and the oligarch. But it is possible to establish effective incentive schemes for government employees, which will both increase

We have reason to believe that many business leaders, as well as bureaucrats and even politicians, are receptive to the voice of reason. The problem for them, just as for the majority of ordinary people, is that an uncoordinated attempt to move to more efficient rules of the game is likely to be unsuccessful.

A Russia that works for its citizens and plays a constructive role in the world's economy and politics will be a Russia that has chosen well. Its new economic and political system would naturally include many idiosyncratic features, but still would fit the mold of a Western market economy and democracy. We do not think the Western system is ideal: its problems are numerous and well known. But given the current status of Russian society, we would be delighted to face problems of the same kind.

THE COMPLEXITY OF THE TASK

The fundamental task of this transition is to create, for the first time in Russian history, a system driven by private initiative. The basic flaw in the current debate is the implicit assumption that the transition to free markets can be decreed from above. Understanding how democracy and free markets work is necessary, as is the political will to get from here to there. But they alone are not sufficient.

The deeper problem is creating incentives that give both the private sector and the government itself a strong stake in the success of the transition. The zeal of elite reformers cannot replace motivated behavior from below. But a good government can and should create conditions under which individuals exercise private initiative in the direction of progress.

Some of the measures contemplated here are far-reaching and controversial. Accordingly, we would like to emphasize that change should be approached with caution. If social engineers can be compared to doctors treating a patient, we should always remember the key principle of the Hippocratic oath: first, do no harm.

The reader will notice that our proposals envisage a period of coexistence between new and old institutions. That is, new forms of government and new elements of institutional infrastructure will first be introduced on a pilot basis, without any attempt to replace the existing system. The ultimate test for our proposals will thus not be through scholarly debate, but through competition among alternative institutions.

ENFORCING PROPERTY RIGHTS

It has become a commonplace that almost no productive activity is possible without well-defined ownership rights. After the collapse of state planning, Russia did find substitutes for delineating property rights and enforcing them. But the current ad hoc arrangement, which relies on private enforcement teams or bribes to the police and other government officials, is highly inefficient.

In fact, it is the inefficiency of this parallel enforcement of ownership rights that offers the best hope for the success of the reforms we propose. If the government can offer economic agents more reliable and more efficient means of enforcing property rights and contracts, the new official system can be expected to gradually replace the existing unofficial one through the sheer logic of competition. In other words, if economic agents cannot be forced to abandon the parallel economy infrastructure, perhaps they can be bribed out of it.

In developed market economies, enforcement of both property rights and contracts is provided by the government and paid for with taxes. Such a solution in Russia is not possible today. Widespread tax evasion has left the government without sufficient revenue to pay even the meager salaries it promises to law-enforcement officers. Thus, many of the officers accept bribes. And even those who are honest often have no choice but to rule in favor of the stronger party, because otherwise the ruling would have no chance of being implemented.

The Russian government has repeatedly stressed its determination to raise tax revenues. But in Russia, distrust of the government makes it impossible to establish an effective, once-and-for-all social contract in the Western mold. The government could perhaps coerce more revenue from businesses. In the longer term, though, that would be counterproductive.

We offer a very different – and, we think, more realistic – solution to this problem. The contract between the business sector and the government should take a more explicit form in which businesses would know exactly what services they are paying for – just as they do today when contracting with private enforcement teams or offering bribes to government officials. Our proposed Federal Property Protection Service (FPPS) would create top-down incentives for government to protect private ownership rights, while creating incentives from below to organize along the lines of a conventional market economy.

INCENTIVES-BASED PUBLIC ENFORCEMENT

With the popular perception of the state as yet another bloodsucker – and an especially vicious one to boot – neither passionate appeals nor draconian penalties can be expected to change the tax collection situation. We are thus led to consider second-best alternatives: if the state could offer economic agents a more reliable and more efficient system of protecting property rights and implementing contracts, it could win back their enforcement business.

The Federal Property Protection Service would enter markets now protected by the fragmented Mafia rings. It would have the legal authority to enforce property rights among businesses that purchase its services. We believe the FPPS would eventually be able to dominate the enforcement market, imposing common rules for the economic game.

Firms would have much stronger incentives to switch from their own Mafia gangs to the new federal agency than to switch from one private enforcement gang to another. In fact, the Mafia rings themselves are likely to split, with at least some part of the government apparatus and politicians currently associated with private enforcement teams finding it more profitable to switch to cooperation with the new service.

Specifically, contracting with the FPPS would result in an increase in the value of the firm because (1) the management would be able to retain a much larger share of profits than it can currently, and (2) the risks that raise firms' internal "discount rates" would decline. The first follows from the reality that the FPPS would be able to provide protection services at lower costs, while the second is due to the fact that the FPPS's size and its association with the state make it less likely to renege on its obligations in the future.

Thus, by employing the natural advantage of its economies of scale, the new unified federal structure can reasonably be expected to succeed in driving the gangs out of the protection business. It is worth noting that scale economies alone would result in a considerable reduction in waste in the Russian economy. Indeed, even with an unchanged market structure, replacing the private Mafias with the FPPS would reduce the cost of protection, increase the value of the firms to their owners and expand the planning horizon.

The positive effects would not be limited to those just outlined. For in sharp contrast to the Mafia rings, the FPPS would have no independent interest in preventing the consolidation of small, inefficient firms.

SOME PRACTICAL ASPECTS OF THE FPPS PROPOSAL

We initially envisaged the creation of the FPPS by a special law, with all shares owned by the government. Private payments could take the form of annual or monthly fees. In return, the federal service would guarantee protection from intimidation, speedy arbitration of contract disputes and effective implementation of its rulings. The FPPS would, in turn, have the right to conclude contracts with the police and other law-enforcement agencies to make its promises credible.

To ensure an arm's-length relationship with individual businesses, we envisioned that the FPPS could only make agreements with self-organized national, regional and local associations of industrialists, wholesalers, retailers and bankers. Moreover, a non-exclusivity provision in the law establishing the FPPS would guarantee every business the right to join at least one association contracting with it.

While no doubt desirable, however, these latter provisions would make it problematic to finance the FPPS. In particular, an established local monopoly might be better off paying more to a private Mafia for protection from competition than paying less to the FPPS but facing the prospect of erosion of its monopoly. In the worst case, the new commercial public-enforcement system would turn out to be almost as impotent as the present tax-based one.

Hence, it might be more prudent to allow the possibility that the FPPS would, at least initially, be inclined to serve monopolies. However, that does not automatically mean the scheme would be no better than the status quo. A more unified market, with monopolies operating at optimal scale, is likely to represent an improvement over the present state of affairs, in which consolidation on efficiency grounds is hindered.

Consider a simple example. Each region in the Russian Federation currently maintains a vodka monopoly. The interests of those monopolies are typically vested with regional governments and protected by informal enforcement agencies, with the result that high prices and inefficiencies persist in many regions. With the FPPS, the federal authorities would take the side of more efficient producers and retailers and would have the means to protect their interests. Thus, more efficient businesses would be able to guarantee themselves an opportunity to compete in larger markets, driving out the less efficient monopolies.

The same principle applies to conflicts between insiders and outside investors in battles for control of large industrial enterprises. Here, too, the highest bidder (freed from the necessity to pay the gangs) would likely be the one with more funds to commit to restructuring the business and raising its efficiency.

There are several additional reasons to believe that enforcement of predatory local monopolies would decline under the FPPS. First, the whole enforcement process would be taken out of the obscure byways of the parallel economy and moved into the public domain. This would focus attention on a single, well-defined institution – rather than on multiple, elusive private enforcement rings. Corruption is already an election issue. But with the FPPS, individual officials could be held politically accountable.

Second, the legal design of the FPPS could create incentives for rank-and-file enforcers that would motivate them to extend their protection to as many competitors as possible and to reject offers from entrenched monopolies. For example, their bonuses could be made dependent not just on total revenue, but also on the number of contracts they secure, with severe penalties in cases where only one or two contracts were signed in each particular domain of operation. In fact, the FPPS could be explicitly assigned the roles of promoting entry into new markets and fostering the opening of credit lines.

To this effect, a special division could be created within the service that would specialize in registering new businesses and facilitating their admission to the associations with which the FPPS contracted. Another division of the FPPS could serve as a go-between in providing accounting, auditing and legal services – especially for small businesses. The enforcement arm would, of course, effectively protect those businesses from intimidation, demolishing one of the largest of the barriers to competition that plague the Russian economy today.

Perhaps most important, the FPPS would neutralize the basic source of power of entrenched local monopolies in the present-day Russian economy. An effective system of overlapping jurisdictions, together with checks and balances among its various divisions and regional offices, should render the FPPS much less susceptible to bias in cases where the interests of different contracting parties collide.

Indeed, the FPPS could develop into an effective mechanism for settling disputes, one not much different from the mechanisms of lobbying and logrolling in even most law-abiding countries. It is, after all, not the presence of those inevitable conflicts of interest, but the nature of private enforcement itself, that makes such conflicts virtually irresolvable – and is the true culprit responsible for entrenching local monopolies in Russia.

Its own monopoly over protection services might lead the FPPS to charge prices above its cost. This, together with the likely bias toward protecting other monopolies, might give rise to concerns that the superior efficiency of the FPPS would backfire, leading to greater entrenchment of monopolies. A constitutional enforcement mechanism based on taxation and a well-defined and properly functioning legal system would, of course, be less susceptible to such problems.

However, one should not lose sight of the limits imposed by current realities. Today, if police officers accept bribes from the Mafia, it is extremely difficult to call them to account since there is no direct link between the taxes paid and the quality of enforcement provided. With a quasi-private FPPS, the agency would only be able to survive by offering a superior combination of price and quality.

The likely monopoly fees collected by the FPPS should not exceed the extra value it provides. Thus, the benefits of the new system would likely spill over into the general population in the form of higher tax revenues and more effective government. Establishing the FPPS as a temporary institution, to be replaced by more conventional tax-based government, could provide an additional safety valve.

What would happen if a business that purchased services from the FPPS had a dispute with a business that didn't? The first business would have the right to call on the FPPS for help. However, favoritism toward the FPPS's own clients would present no problem, since the basic idea is to induce all businesses to become FPPS clients.

In fact, one important justification for discrimination against businesses that do not hire the FPPS is to introduce the taxpaying culture into Russian business life. The reason the New York government is so harsh with unlicensed taxis (while Moscow's is so lenient) lies in different attitudes toward the problem of tax collection.

The FPPS would represent a first practical step toward introducing the taxpaying culture into the Russian chaos – one that initially relied on economic incentives. Once most of the Mafia retreated, the FPPS could be transformed into a more conventional mechanism for general public law enforcement funded by taxes.

It cannot be overemphasized that the success of the proposed scheme would depend on how the new institution was staffed and supervised by the government. In this sense, the maintenance and enhancement of the democratic political system, including a free and independent press and an independent judiciary, is a crucial prerequisite.

Even more important, none of our proposals could be successfully implemented as an isolated measure in an unchanged political environment. Only by combining all, or at least most, of the policy measures proposed can we be sure that the changes would attain critical mass and that launch the society toward a new social contract.

INSIDERS' CONTROL AND TRADE UNIONS

Under the old totalitarian system, Communist Party rule provided an institutional mechanism for supervising the activities of state-owned enterprises. The collapse of this control and the absence of alternative means to check the behavior of insiders represent a major problem for the economy in transition. Hopes that commercial banks and financial-industrial groups could provide effective corporate governance have so far been unfulfilled. We think strong trade unions could help to fill this gap.

With the significant exception of coal miners' unions, organized labor is virtually nonexistent in Russian enterprises today. This is not surprising in light of the fact that unchallenged corporate control by insiders deprives most industrial workers of the opportunity to earn a living. Here, as in the case of enforcing private-property rights, we encounter what is basically a coordination problem. If the workers could control what the insiders do, they would probably be able to earn a living at their own official workplaces, which in turn could limit malfeasance.

Thus, the promotion of a strong trade union movement is likely to create another social force with a stake in normalizing the rules of the market game. In particular, trade union control would make it much more difficult for managers of previously state-owned enterprises to beat the system.

For example, in one Moscow factory that we studied in some detail, the leader of the trade union took the initiative in a successful campaign to oust the corrupt incumbent manager and his friends. The new management, appointed from the outside, did express some concern over a possible future clash of "class interests" with the strong union, but enthusiastically praised the union's role in saving the enterprise from total collapse.

Organized labor can also be expected to function as a strong countervailing force to intimidation by gangs. Indeed, if union-organized vigilance by workers were combined with the establishment of a FPPS, we could expect the Mafia's rather speedy retreat to its natural sanctuary in gambling and prostitution.

Promoting organized labor would likely meet opposition because of fears that trade unions would become one more powerful interest opposed to the much-needed restructuring of Russian industrial enterprises. However, we believe that those fears are not well founded. The most important task for Russian society now is to institutionalize the

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process of bargaining and logrolling. Whenever we can succeed in bringing this process out of the shadows it is likely to result in increased, not diminished, efficiency.

More specifically, the main problem for these enterprises is the lack of incentives for insiders to maximize the long-term value of their firms. Ordinary workers, who do not have access to the profits, are likely to have a greater stake in the future performance of their enterprises in order to preserve their jobs. We believe the need to respond to union demands would thus discipline the management. A similar effect was observed in postwar Japan, where the promotion of a trade union movement was a cornerstone of the policies introduced by the American occupation forces in their effort to change the structure of the Japanese economy.

THE IMPORTANCE OF ECONOMIC GROWTH

As we have shown, an environment of growth is vital to the success of economic restructuring because only economy-wide growth can provide adequate incentives. We can expect a decisive breakthrough in Russia only when investors are convinced that they can expect high profits from producing for competitive markets. And honest profits will remain elusive as long as the economy is stagnant. Note, too, that economic growth is a prerequisite for the social stability that makes prosperity possible.

The Russian economy has been in serious decline since 1992, and the cumulative effect has been more severe than the effect of the Great Depression. So far, the collapse has not led to much open unemployment, in part because of the ample opportunities for malfeasance and rent seeking in which some of the wealth of the newly rich new Russians has trickled down into demand for domestic goods and services.

However, those sources of income are now attenuating, and the Russian economy is in danger of sliding into mass unemployment. Thus, a resumption in investment and the growth of manufacturing, the only way to create stable jobs and sources of income, will become vitally necessary in the next few years.

Under the present structure of incentives, the government is needed to jump-start the process – that is, to move a rent seeking economy from its bad equilibrium. The dismal results of Russian reforms so far can largely be blamed on the failure of reformers to grasp this fundamental point.

Proponents of shock therapy argued that macroeconomic stabilization and other measures envisaged in their reforms would by themselves create the preconditions for growth; they thus saw relatively little problem in the temporary fall or stagnation of output per se. It is true, of course, that economic growth would be hollow – and perhaps even detrimental to the transition to a market economy – if it were attained without structural change. But there is a vicious circle involved: meaningful growth is impossible under the old system, yet the absence of growth itself leads to further entrenchment of this old system.

We believe that the vicious circle could be broken on the side of economic growth. To this end, we propose several government policies to promote investment in priority industries, which could be carried out relatively independently of the overall economic environment. The success of those policies would give a powerful boost to the process of systemic change, raising the prospects for the success of the other measures envisaged in our design for reform.

It is extremely important to bear in mind the danger of overreaching. One fundamental reason for the failure of every growth-promotion policy tried so far is that Moscow spread its resources too thinly. Individual projects were funded with just 20 to 30 percent of their budgeted cost, and most of the money was thus wasted on unfinished work.

However, growth-promotion policies of this type were extremely efficient in enriching certain government officials, as well as bankers and other captains of the Russian economy. We would call a halt to this practice of spreading resources thinly. The government should concentrate on the most important strategic goals. Moreover, those projects that are undertaken should be financed from new revenue sources. The tax base is already vastly overburdened.

The government should also make sure that its most motivated officials – those with a proven reputation for integrity – monitor and supervise each project, at least for its initial years. Additional projects should be undertaken only as the success of previous ones brings the government new revenues and expands its means of effective monitoring.

INDUSTRIAL POLICY AND PRIVATE INCENTIVES

Economic growth should be promoted through strategic industrial policy, in which the government specifies priority industries and provides both cash and access to wider markets. The immediate choice of projects should be made with a view to the prospects of getting access to non-inflationary financing (especially foreign direct investment), as well as to the importance of the industries in terms of technological multiplier effects and new job creation.

The initial focus for industrial policy in Russia should be the country's oil and gas industry, which tops the list of industries with the largest potential export competitiveness. However, this should not be understood simply as developing new oil and gas fields with the goal of increased extraction, exports and government revenues. The purpose of the government policy with respect to the oil and gas industry should be to make sure that investment not only leads to expansion in the energy industry itself but also stimulates the reconstruction of related industries.

A key component in this strategic industrial policy is the full implementation of the 1996 law on product-sharing agreements (PSAs). Under that law, oil and gas developers pay an agreed-upon share of their output in lieu of taxes, and are free to dispose of the rest as they wish. If enough direct investment can be attracted into oil and gas, the effects would be felt far beyond the energy sector.

The PSA law also mandates competitive bidding for contracts to supply equipment and do construction work. Some analysts argue that Russian suppliers, among them former military factories in regions hit hard by the transition, would have a good chance of winning those contracts in a competitive market. This could provide the opportunity for the big push needed to reverse the current economic decline, with the steel, machine-building and construction industries among the major beneficiaries.

The incentives could break the current vicious circle in which enterprises are cheating the government of taxes while the government is trying to compensate by squeezing firms for all the profits it is able to track. Since the tax rate is fixed in kind for all projects covered by the PSA law, all financial transactions can be made transparent. It is important, of course, that Russian suppliers of equipment and construction services for PSA projects should also be able to elect a PSA-type taxation system. The parties to PSA-related transactions would then have less incentive to hide their revenues.

It would make sense for the government to provide firms that have succeeded in becoming internationally competitive suppliers to the energy industry with an exemption from their tax arrears, thus reducing incentives to hide profits that might be seized to pay the back taxes and assuring stable tax revenues in the future.

The PSA projects would also show other previously state-owned enterprises that the new system offers better opportunities than the existing system, which is based on barter transactions and IOUs. A vicious circle will be replaced by a positive one.

Note that this new system would not be created as a compulsory replacement for the old one. Rather, a range of relationships between the government and oil and gas developers would coexist, with competition determining which one predominates. The use of bargaining to set tax rates may not seem particularly appealing. However, we must again stress that such bargaining was firmly entrenched in the Russian economy long before the collapse of planning. Our proposal would simply make the bargaining process explicit.

Unfortunately, the initial effects of the PSA law have been mixed. The benefit to the Russian economy so far appears to have been limited to lump-sum payments to the federal and regional governments, which have been used to finance current expenditures, such as pensions and salaries for government employees.

The use of bargaining to set tax rates may not seem particularly appealing. However, we must again stress that such bargaining was firmly entrenched in the Russian economy long before the collapse of planning.

It is difficult to make even a good law work in the Russian environment, which is generally hostile to competitive activity. As we have stressed, only the concerted implementation of the whole complex of measures aimed at changing incentives can possibly lead to favorable results. Once the overall environment begins to change, perhaps the federal government should take a more interventionist stance, including a local-content provision specifying the share of tools, equipment, and other products and materials that ought to be supplied by domestic firms.

In any case, it is important that Russia not squander its mineral wealth just to cover its budget deficit. The country should use the PSA revenue to create new enterprises in manufacturing that possess high international competitiveness.

Among other industries that might feature prominently in the initial phase of the industrial policy, we would be inclined to single out construction engineering, textiles and wood processing as well as auto, aircraft and furniture manufacturing. Naturally, this list should be reviewed as conditions change. The important thing is that the government can do more, even with its current limited means, to create incentives for restructuring and industrial growth.

TAXATION AND THE STATE OF EXPECTATIONS

We attach special importance to the implementation of PSAs in the energy industry because we believe that the product-sharing scheme of taxation developed in the oil and gas industries ought to be applied in a much wider context. The key incentive-related point is that firms taxed under this scheme are free to disburse all the profits left after meeting their obligations under the PSA – and are thus freed from the need to conceal sales and revenues. The hide-and-seek game played by businesses and the government not only causes budget problems but also raises transaction costs in the private sector. The change from taxing net income to taxing a share of output would greatly simplify the rules of the game for both sides. Competition among local and regional authorities to attract new investment should limit the share accruing to the public sector to a reasonable level.

PSA-type taxation need not be introduced as a compulsory reform; the current system could just be supplemented. Firms that would like to switch to the new system would negotiate their tax payments with the authorities, using, for example, the average amount of taxes actually paid over the past few years as a benchmark. If no agreement were reached, the sides could go their own ways and the existing tax system would apply. If an agreement were reached, though, the firm's management would be free of government harassment, while the government would have an assured flow of revenue.

The key feature of this mechanism is that it should be more attractive than the existing tax system for both government and business. The proposed new scheme is only superficially similar to the current system of selective preferential treatment adopted by the Russian government, which amounts to arbitrary granting of tax- and customs-duties exemptions. This has led to widespread corruption and the waste of resources in rent seeking, with none of positive effects that our scheme would bring.

Today, the firms that receive preferential tax and customs treatment may not be financially strained at all – though they cannot reveal their wealth for fear of a public outcry. Their bargaining with the government also takes place in the form of insider negotiations behind closed doors. Under our scheme, the choice of the fixed operating license fee has nothing to do with the (officially announced) financial position of the firm, so firms that come to agreements with the government would have no incentive to conceal their revenues. True, the bargaining procedure would waste some resources, but nothing on the scale of the current system. Future breakups or mergers of firms would present no difficulty if successor companies were contractually obligated to honor their agreements.

As shown earlier, expectations are likely to play a significant role in determining when and if post-Communist producers switch from the parallel economy to competitive markets. Hence, no measure that would increase confidence in the future, however small its immediate effects, should be neglected.

The government should commit itself to a realistic and credible long-term policy in which each industry knows its place in the list of priorities. Reducing the level of uncertainty would in itself help restructuring by diminishing the need for businesses to keep all their options open.

FINANCING LONG-TERM GROWTH

The present-day Russian banking system and financial markets do not perform the function that they ordinarily perform in a market economy – that is, channeling private savings into real investment. Russia's capital markets are as insider-oriented as the rest of the economy is. Hence they cannot provide Russia with an effective risk-sharing mechanism.

Each investor is forced to assume large stakes in a limited number of projects, with the inevitable outcome that only projects involving the prospect of a quick return are undertaken. Those projects are mostly limited to operations with government bonds, or to financing foreign trade and currency-exchange operations. Since the fall of the Soviet Union, long-term loans to the nonfinancial sector have constituted barely 3 to 4 percent of the total extended by commercial banks.

Our proposed initiatives would not require any immediate changes in the capital markets. In particular, they would not require a crackdown on speculative financial operations. Instead, they would be aimed at creating flows of new investment money, through newly established competing financial institutions. If the new investment projects prove themselves lucrative enough, existing flows of money will also be attracted to the new system and away from inefficient short-term operations.

Our proposal here consists of two parts. In the first, we would establish a new State Insurance Fund, in which the government would deposit money on behalf of its employees receiving special incentive pay. The money would be borrowed from the central bank. And it would be frozen in deposit form for at least 10 years – curtailing the immediate inflationary consequences from increased claims on the central bank.

The asset side of the fund would be principally composed of a long-term loan to another new state-sponsored financial institution, the State Development Bank, whose sole function would be to invest in the long-term development of Russian manufacturing. The investment guidelines would be periodically reviewed together with government priorities in industrial policy. For instance, if the initial priority for industrial policy is to revamp enterprises supplying equipment to foreign investors, that would also become the priority for the development bank's loans.

It is important that the initial investment capital be financed from new sources, so that the development bank would not have to compete with other savings vehicles and pay extremely high interest rates. In fact, the development bank should have no concern whatsoever about the level of short-term interest rates in the Russian financial market.

What makes this scheme different from direct financing by the state is the independence of the development bank. When the financing of restructuring is provided directly, the process is vulnerable to rent seeking. With an independent State Development Bank in charge, there is hope. Of course, skilled professionals of high integrity would have to be in charge, and foreign experts, especially those with experience in similar governmental and quasi-governmental institutions, should be invited to serve as executives. The accounting and auditing standards should correspond to the highest international standards.

With each successful project, the State Development Bank's position in the financial market would presumably become stronger. This would allow it to join in financing projects with private lenders, and it could thus foster the shift of private banking in Russia from its present role as a source of short-term funds to its proper function of financing industrial development and economic growth.