An Assessment of Putin's Economic Policy

Anders Åslund*

Fate is not necessarily fair.[1] Some people are born with a silver-spoon in their mouth, and some just happen to be in the right place at the right time. Vladimir Putin should go down in history as one of the lucky ones who happened to be in the right place at the right time, as Talleyrand said about Lafayette, but accomplished little that was positive.

The cause usually precedes the effect, and that is all the more true of a monumental metamorphosis such as the change of an economic system. Putin's luck was that he was anointed president by President Boris Yeltsin in 2000, soon after Russia's transformation to a market economy had been sufficiently completed so that the country had reached high economic growth of 6.4 percent in 1999.

Russia was reformed in the 1990s

The 1990s formed Russia's heroic decade. Boris Yeltsin announced his market reforms in October 1991. Chief reformer Yegor Gaidar liberalized prices and trade, rendering Russia a normal market economy by 1994. Anatoly Chubais, Minister of Privatization, privatized so successfully that no less than 70 percent of GDP pertained to the private sector by 1997 (EBRD 2007).

Because of extraordinary political resistance by rent seekers, ranging from old state enterprise managers to novel oligarchs, Russia had an average budget deficit of 9 percent of GDP from 1993 until 1998. According to the World Bank, Russia's business subsidies amounted to no less than 16 percent of GDP in 1998, but they were of little or no social benefit. The lasting excessive budget deficit inevitably caused Russia's horrendous financial crash in August 1998 with both a default on treasury bills and a huge devaluation. Half of Russia's banks went out of business. Many foresaw the end of Russia's market experiment. In reality, however, Russia's financial crash completed the market transformation. It taught the Russian elite the importance of macroeconomic responsibility. Since 2000, Russia has had a sound budget surplus. The crash had multiple fortuitous effects.

First, the default forced vital fiscal reforms upon the country. As financing out of tax revenues was no longer available, the budget deficit had to be eliminated. From 1997 until 2000, the government slashed public expenditures by 14 percent of GDP. Russia's political inability to balance its budget disappeared because the only alternative was hyperinflation, which nobody wanted. All arguments about the impossibility of reducing public expenditures fell by the wayside. Now most subsidies were abolished, which also leveled the playing field for Russian business.

Second, the financial crash reinforced central state power and weakened the regional governors. The federal government could undertake a radical centralization by shifting revenues from the regions to the federal government. Federal revenues almost doubled as a share of GDP from 1998 to 2002, while total state revenues were close to constant. With the devaluation, foreign trade taxes, which were valued in foreign currency, increased sharply. The federal government could finally insist on cash payments, which eliminated barter.

Third, the government of Yevgeny Primakov continued the tax war on the oligarchs that the reformers had launched in 1997–98, and the newly strengthened state could beat the weakened oligarchs. The government started applying the tax laws to big enterprises, especially the oil and gas companies, which had previously enjoyed individually negotiated taxes. A new aggressive bankruptcy law imposed hard budget constraints on enterprises. As a result, arrears of pension and state wages dwindled, and the

* Peterson Institute for International Economics.
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monetization levelled the playing field. Consequently, many enterprises changed ownership, which revived them. Typically, old managers were forced to sell to young hungry entrepreneurs at rock-bottom prices.

The financial stabilization, monetization, and devaluation were the main catalysts behind Russia's high and steady growth of nearly 7 percent a year from 1999. All the main requirements of economic growth that Gaidar (1999, 210) had formulated were finally in place: "macroeconomic stability and low, predictable rates of inflation, an open economy plus access to promising markets, clear-cut guarantees of property rights and a respectable level of financial liability, high levels of individual savings and investments, and effective programs to aid the poor and to maintain political stability".

Putin's early reforms

At this moment an obscure official named Vladimir Putin entered the stage. He is often praised for these achievements, but the financial stabilization was undertaken in 1998–99 before he became prime minister, and Russia was already growing fast. Putin arrived at a laid table.

When Putin became president in 2000, he continued the "second generation" market reforms that had been formulated in 1996–97, and thanks to his newly-won parliamentary majority he could legislate them as Yeltsin never could. The three years from 2000 to 2002 were characterized by progressive economic reforms. Most impressive was the comprehensive, radical tax reform. The progressive personal income tax, peaking at 30 percent, was replaced with a flat income tax of 13 percent as of 2001. The corporate profit tax was reduced from 35 to 24 percent in 2001. Far more important was that most ordinary business costs became deductible, leveling the playing field. Social security contributions were cut from a flat rate of 39.5 percent of the payroll to an average rate of 26 percent. Tax collection was unified in one agency. Small-scale tax violations were decriminalized. The tax reforms reduced the threat to businessmen posed by tax inspection.

Russia finally woke up to its need for small and medium-sized enterprises. They had been depressed by a maddening array of red tape and bureaucratic harassment. In 2002, registration, licensing and standardization were simplified, and inspections were restricted. This broad effort at deregulation improved the situation, and the amelioration has proved sustainable. The number of officially registered enterprises has steadily increased by more than 7 percent a year, and by 2006 the total number of registered enterprises in Russia had reached almost 5 million, quite a respectable number. Still, the patriarchic surveillance system remains in place, and more radical deregulation is needed.

The privatization of agricultural land was the last ideological barrier to abolish. This was done when, on July 24, 2002, the Duma finally legalized the sale of agricultural land. It was a compromise, requiring each region to adopt a law to make the federal law effective. As a consequence, communist regions could withhold agricultural land from sale, while more liberal regions allowed the sale of land. In practice, private ownership of agricultural land developed only gradually, and good connections with regional governors were vital for land purchases. Yet, this last communist taboo was also broken. By 2002, Putin had established himself as a credible authoritarian reformer in the line of General Augusto Pinochet and Lee Kuan Yew.

Putin opts for re-nationalization and corruption

In 2003, however, Putin's economic policy changed track. He ousted his reformist Prime Minister, Mikhail Kasyanov, and chief of staff, Aleksandr Voloshin, relying ever more on his cronies from the St. Petersburg KGB. His reforms, which were only half-way done, came to a screeching halt. The signal event was the confiscation of the Yukos oil company. In 2003, Yukos was Russia's largest and most successful company, but Putin clamped down on it ruthlessly and lawlessly, engineering its confiscation. He did so for primarily two reasons. He wanted to emasculate its main owner, Mikhail Khodorkovsky, the most independent and outspoken of the big businessmen, and Putin's collaborators wanted to seize Yukos' lucrative assets cheaply. Repeatedly, Putin met with foreign portfolio investors to reassure them that Yukos would not be confiscated, expropriated or nationalized, after which he did exactly that.

The Yukos affair started a wave of re-nationalization. State enterprises have been buying big, successful private companies either at a high prices in voluntary deals, accompanied by rumors of sizable kickbacks, or the sales are forced and the prices are low. No economic rationale is evident in any single case. The most likely purpose of re-nationalization is corruption, while ideological motives are conspicuously absent. Two of the most aggressive predators, the oil company Rosneft and the bank VTB, sold their shares to private foreign investors in large international initial public offerings (IPOs) in London in 2006 and 2007, respectively.

The Russian re-nationalization has had a limited, but negative impact on the economy, which is most evident in the current stagnation of oil and gas production, but also in banking, and machine building. Fortunately, two-thirds of the Russian economy is still in private hands, including the metals, retail trade, and construction sectors. The aggregate indicator that has suffered the most is investment, with Russia's official investment ratio remaining rather low despite the economic boom. Liberal leader Boris Nemtsov (2007) commented upon the re-nationalization: it is offensive that under Putin the state has taken on the role of plunderer and racketeer with an appetite that grows with each successive conquest. But the greatest calamity is that nobody is allowed to utter a word in protest regarding all this. "Keep quiet", the authorities seem to say, "or things will go worse for you. This is none of your business".

In 2004, the international oil prices took off, filling the Russian state treasury and boosting its international reserves. Russian exports started skyrocketing, mainly because of the rising commodity prices. The consequence in Russia, however, was not a higher growth rate but aggravated repression, corruption, re-nationalization, and all economic reforms stalled. For Putin, the high international oil prices became a license to be as authoritarian and corrupt as he really wanted to be. During his last five years in office, President Putin has not undertaken any reform worth mentioning.

Putin has effectively condoned corruption among his friends, and it is hardly an exaggeration to say that everything is for sale in Russia. People pay bribes to enter university, to escape military service, to stay out of prison, and to land a good job. Until the late 1990s, the selling of top offices was not an issue, but by 2004 it had become endemic.

Until October 2007, Putin maintained impressive fiscal discipline with budget surpluses every year from 2000. Then, all of a sudden, he seems to have lost his nerve. In the midst of rising inflation, he abandoned that achievement as well, boosting public expenditures. By May, inflation had surged to 15 percent. The Russian government needs to return to its prior excellent fiscal policies to cool the economy down. In addition, the Central Bank needs to adopt inflation targeting, allowing the exchange rate to appreciate with the large currency inflows.

When Putin became president in 2000, he promised that Russia would join the World Trade Organization by 2003, but it is not likely to join even in 2008 because Putin has allowed various protectionist interests to override Russia's national interest. This stands out as one of his most spectacular failures.

No less than *Time* magazine praised Putin as their man of the year 2007 for the stability he had brought to the country, but what stability? Russia's murder rate has been higher under Putin than under Yeltsin and is currently four times higher than in the United States. The change is real but only in its presentation thanks to the ubiquitous censorship that Putin has imposed. What remains of Putin's economic legacy is only that he was lucky to reap the benefits of the arduous but productive reforms his predecessor instigated in the 1990s (Milov and Nemtsov 2008).

Russia: No longer normal

In 2004, *Foreign Affairs* published a seminal article by Andrei Shleifer and Daniel Treisman. They argued that Russia was a "normal country": "Russia was in 1990, and is today, a middle-income country with GDP per capita comparable to Argentina in 1991 and Mexico in 1999. Almost all democracies in this income range are rough around the edges: their governments suffer from corruption, their judiciaries are politicized, and their press is almost never entirely free. They have high income inequality, concentrated corporate ownership, and turbulent macroeconomic performance. In all these regards, Russia is quite normal". Steven Fish (2005, 130) noted that Russia was "just as corrupt as one would expect it to be, given the prominence of natural resources in its exports". The oil revenues are obviously a cause of Russia's authoritarianism and corruption, but both have become quite extraordinary.

Russia has gone through three major developments in the last eight years. First, Russia's GDP has grown by 27 percent a year measured in current US dollars. Second, the country has moved from being partially democratic to authoritarian rule by Freedom House (2007) standards. Third, it has stayed equally corrupt according to the measurements by the World Bank (2007), the European Bank for Reconstruction and Development (2007) and Transparency International (2007), while corruption has abated elsewhere (see also Anderson and Gray 2006). In these regards, Russia is no longer normal but extreme. Many draw parallels between Russia and China, but even today, after 30 years of high economic growth, China's GDP per capita at current exchange rates is merely one quarter of Russia's. Unlike Russia, China is still a developing country. It is more authoritarian than Russia, but according to Transparency International' assessment, it is less corrupt.

By the measures of the outstanding political sociologist Seymour Martin Lipset (1959), Russia is too rich, too educated, and too open to be so authoritarian. The faster Russia grows, the greater this contradiction becomes between an increasingly obsolete political system and a swiftly modernizing economy and society. This contradiction is likely to be untenable in the medium term. No modern society can function without reasonable information or checks and balances. A Russian president cannot make decisions of high quality about everything, after having abolished all feedback and concentrated so much decision making in his own hands. During President Vladimir Putin's reign, the Russian regime became too rigid and centralized to handle crises, which always occur. Therefore, this regime can hardly be very stable.

Russia has become an outlier. At present, Russia's GDP per capita measured in purchasing power parties, that is, standard of living, is a respectable one-third of that of the European Union. Only eight countries in the world are richer than Russia and still not democratic, namely Singapore and seven small oil states (World Bank 2007; Freedom House 2007). Authoritarian rule is usually a means of the rulers to hide and sustain their corruption. According to Transparency International (2007), the only country that is both richer and more corrupt than Russia is Equatorial Guinea. That is hardly a standard worthy of a great, historic European nation.

Russia has long distanced itself from the upper middle-income countries, Argentina and Mexico, with which Shleifer and Treisman (2004) associated it. Russia has grown faster, but it has become more authoritarian and corrupt. The conclusion is not that authoritarianism and corruption are good for development, but that Putin has been lucky. He has been drowned in oil money, so that he could make Russia as authoritarian and corrupt as he really wanted to. No large state with an educated population has managed to maintain authoritarian rule or stay so corrupt at Russia's level of economic development. Therefore, it seems natural for Russia's dictatorship to collapse in the near future, as happened even in countries with strong authoritarian traditions, such as Taiwan and South Korea.

The structural reasons to expect such a change in Russia in the near future are many. First, opinion polls show that Russians are as upset as any other nation about corruption and they have more of it. Information about corruption is abundant. Only fools do not believe that the government aims at the promotion of corruption. Second, the mismanagement of the large state corporations and apparent kickbacks of up to 50 percent on major infrastructure projects are outrageous. Russia's corruption might be the greatest in world history in terms of the absolute amount individuals receive and the relative share of the kickbacks. Claims that Putin and his close friends have stolen billions of dollars from the state or private businessmen abound, but so far Putin has never reacted, which is evidence that he approves of such activities (Milov and Nemtsov 2008). Third, incredibly but fortuitously, Putin decided to resign as president, although he stays as prime minister, which grants Russia an ambiguous dual power structure. But in Russia, power rests in the Kremlin, where the president sits. Not surprisingly, President Dmitri Medvedev has started his term by launching an anti-corruption campaign.

A state that is as corrupt as Russia is not strong but dysfunctional and thus weak. Corruption poses a systemic threat to the Russian state, notably the quality of education and health care. Is the Russian state able to carry out any major infrastructure project? The country suffers a desperate shortage of qualified labor because much of the education has been debased by corruption, and the government has made no attempt to clean it up. Russia can no longer afford this corruption that contributes to the current inflation crisis.

Russia needs to restart its reforms

It would only be fair to let President Putin himself make an assessment of Russia's current state of affairs. On February 8, 2008, one month before the end of his second term, he gave a speech to the State Council that appeared like an annual address to the nation, entitled: "On Russia's Strategy of Development until 2020".

The President bragged at length about "everything that was done during these eight years", but he seemed unaware that it boiled down to one single achievement – an economic growth of 7 percent a year, but that growth record puts Russia in twelfth place among 15 former Soviet republics since 1999 (Åslund 2007a; EBRD 2007), in spite of its abundant oil revenues, which is not very impressive. With imports increasing by 35–40 percent a year, and energy production stagnating, Russia's current account surplus is likely to disappear within two years, given that oil prices can hardly continue rising in the midst of a Western economic slowdown.

Putin's unproductive two-term presidency leaves a huge backlog of reforms that can no longer be ignored. Russia badly needs to restart serious market reforms. Putin's greatest failure is that male life expectancy has not reached more than 61 years of age, which he rightly called "a shame". Russian men are drinking themselves to death, and an effective anti-alcohol policy is the nation's greatest need, but Putin has not lifted a finger. All state systems are in crisis: health care, education, law enforcement, and the military. Russians are greatly upset over the miserable state of the ailing public health care system. Substantial reform plans were drawn up in 1996–97, but Putin has failed to implement them, only increasing funding somewhat. Such a wealthy country can no longer make do with a third-world health care system.

Russia suffers from a stark shortage of skilled labor, although its youth try to invest in own human capital. According to UNESCO's comparative statistics, two thirds of Russian youth attend higher education, more than in Europe, but the education they receive is largely of poor quality, because the public education system is malfunctioning. As in health care, corruption and vested interests of the bureaucracy cause these ills. Cures have been tested in limited experiments. Standardized national tests should be made compulsory and the only criteria for acceptance to higher education. All oral exams should be prohibited as sources of corruption. Both universities and hospitals need substantial financial independence being financed by the state for their services, not for their mere existence. They should become independent foundations, being accountable to a board of trustees. Finally, Russia's public infrastructure has been so neglected that Moscow's traffic has repeatedly come to a complete halt for six hours.

In his speech, Putin acknowledged that "the state apparatus is to a considerable extent a bureaucratized, corrupt system, which is not motivated to support positive changes or dynamic development". Indeed, to impede Russia's corruption requires democratization, which has reduced corruption in Ukraine (Transparency International 2007).

One of the hallmarks of Putin's second term has been the re-nationalization of big, healthy, successful private companies. Now even Putin, the main author of this policy, realizes that he has gone too far: "a private company, which is motivated by the results, if often better at management than a civil servant, who does not always have even a perception of what efficient management amounts to or what a result is". A grand task is to rein in re-nationalization and reverse it. Russia can neither be an efficient market economy nor a democracy as long as the state is dominated by a few state monopolies. These monopolies must be broken up, not consolidated. It should also prohibit Russian state corporations from borrowing funds in the West, which they use for harmful re-nationalization.

The proudest economic reform of Putin's first term was the tax reform, which decriminalized most tax violations and reduced the powers of the arbitrary tax authorities. Alas, through the Yukos affair Putin erased many of these achievements, and now anew he had to emphasize "the need for a simplification of the tax system to minimize the opportunities of arbitrary interpretation of the legislation". His call for a lower tax burden drew applause.

It is true that Russia's growth in the last nine years has been substantial and beneficial, but it is all the more striking for the many problems that have accumulated because of the near absence of structural reforms after 2002. President Dmitri Medvedev badly needs to re-launch Russia's reforms. The current global economic slowdown tests the quality of economic policy throughout the world. Russia is likely to escape the first onslaught because of high energy prices, but when they moderate Russia will also be probed.

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