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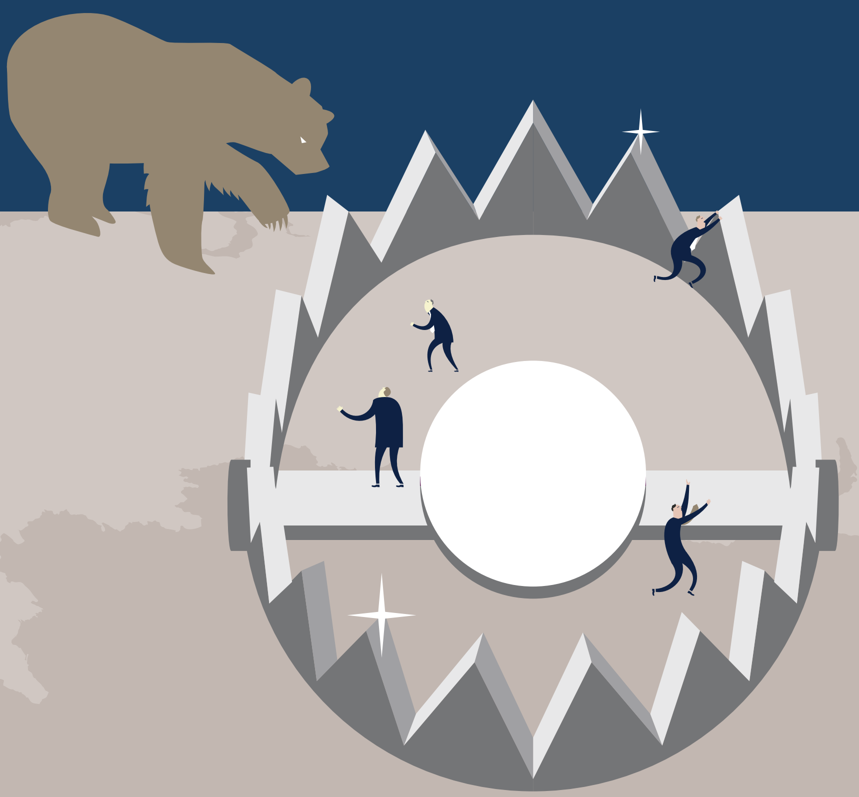
PROSPERITY IN DEPTH: RUSSIA

Caught in the Bear Trap



By Clifford G Gaddy
and Barry W Ickes

2013 LEGATUM PROSPERITY INDEX™ RANKING: RUSSIA

61/142

THE LEGATUM INSTITUTE

Based in London, the Legatum Institute (LI) is an independent non-partisan public policy organisation whose research, publications, and programmes advance ideas and policies in support of free and prosperous societies around the world.

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PROSPERITY IN DEPTH

To complement the annual Legatum Prosperity Index, we regularly commission specialists—economists, political scientists, journalists—to provide additional analysis of selected countries. In each case, the Prosperity in Depth papers represent highly original work by distinguished experts that adds depth and insight to the statistical analysis of the index.

FOREWORD

There are no two ways about it: Post-Soviet Russia has been a deep disappointment to those who imagined it would make the transition to social democracy in a decade or two. Russia is badly run (it ranks 115th out of 142 countries in the Governance sub-index on the Legatum Prosperity Index), short on liberty (114th on Personal Freedom) and, for a high income country, downright dangerous (98th on Safety and Security).

You've probably read the conventional explanations: Russia never had a chance to evolve a middle-class society with a vested interest in personal and market freedom; an unbroken history of authoritarian government left citizens yearning for strong leaders inclined to play the paranoia card; abundant oil (and other natural resources) bred corruption and made it easy for the beneficiaries to resist change. Clifford Gaddy, a senior fellow at the Brookings Institution, and Barry Ickes, an economist at Penn State University and director of PSU's Center for Research on International Financial and Energy Security, buy into the third, "curse of oil" theory—but with twists that offer a very different perspective on why Russia's economic problems are inherently so difficult to solve.

Free markets drive manufacturers to produce efficiently and in locations that offer the lowest cost environments in terms of inputs, transportation and weather. But Russia was only industrialised after its capture by the Communist Party, which never allowed markets to determine what was made or how, and dispersed industry across the great sprawl of Russia for reasons of security and empire building. Hence, most post-Soviet industries only survived privatisation with a lot of help from their friends. In particular, the privatised oil and gas industries provide energy at far below the open-market prices, allowing businesses that are far from markets and lack efficient technology to stay afloat.

But why would the oligarchs sacrifice profits to this end? Because the Kremlin and its local agents want it, and in Putin's Russia they have ways of being persuasive.

For Ickes and Gaddy, then, the big question is whether there is any reason to believe that Russia could, or will, escape what they call the bear trap. Oil in Russia—as in so many countries—both sustains a reasonable standard of living and prevents the sorts of social, economic and political change needed for genuine prosperity.

Peter Passell, Editor

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OIL WORKER

Caught in the Bear Trap

All those who have been proposing remedies for Russia's ills have failed to properly diagnose the disease.

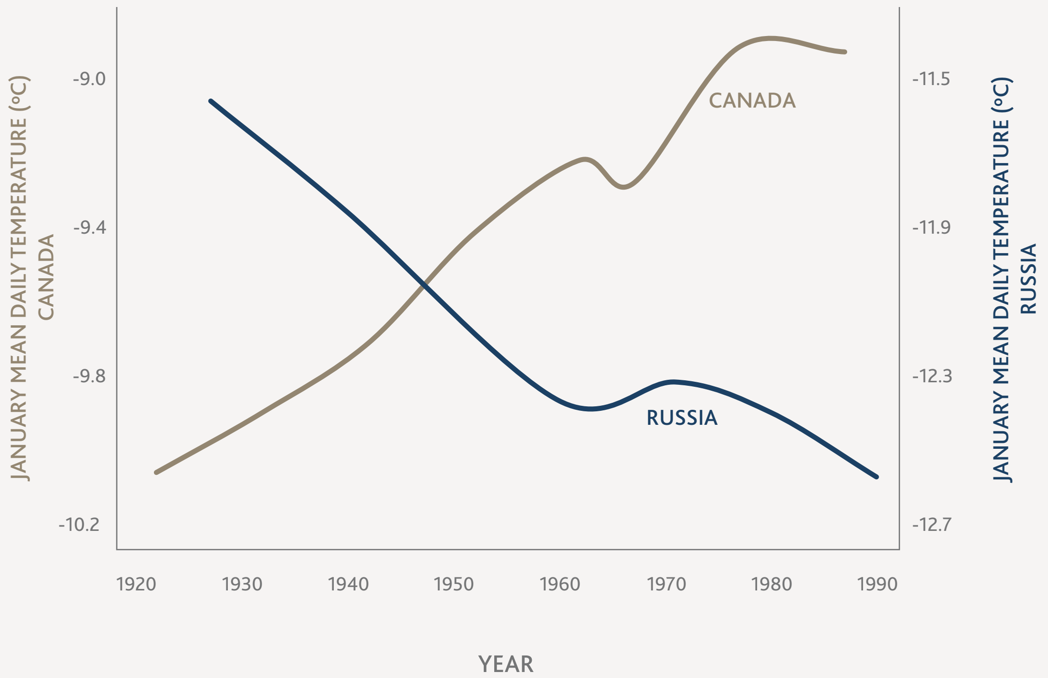
Russia has followed an odd path in the two decades since the demise of the Soviet Union. At the beginning of the 1990s, insiders and outsiders alike were optimistic about its prospects for a successful transition. Blessed with unsurpassed natural wealth, Russia had developed its human, industrial and scientific resources to the level of a superpower during the Soviet period. So once freed of the burden of the Cold War and the backward Soviet economic system, the thinking went, Russia would surely prosper.

This promise remained unfulfilled in that first post-Soviet decade, however. Radical programmes of privatisation and liberalisation didn't yield a bonanza in productivity. Reform followed reform, but the economy nonetheless shrank. Thereafter, its leaders focused on stability, abandoning efforts at modernisation. The economy boomed.

Why did Russia grow but not modernise? And why do Russian leaders (and the IMF and World Bank) still put forth plans today for the same reforms that they did at the beginning of transition, some 20 years ago? The main reason, we argue, is that nearly all those who have been proposing remedies for Russia's ills have failed to properly diagnose the disease.

The problem is not their competence as professionals. It's that the therapies they recommend are being directed at the wrong patient. Russia does, indeed, suffer from corruption, weak institutions, lack of rule of law and myriad other factors usually cited by development experts as obstacles to growth. But these are in large part symptoms of more basic maladies dogging Russian society. And policies that deal with symptoms alone will be no more effective than they have been since the collapse of the Soviet empire.

POPULATION-WEIGHTED AVERAGE NATIONAL TEMPERATURES: CANADA AND RUSSIA



NOTE: Degree day is a quantitative index demonstrated to reflect demand for energy–either for heating or for cooling. A mean daily temperature (average of the daily maximum and minimum temperatures) of 65ºF/18ºC is the base for degree day computations. Heating degree days are summations of negative differences between the mean daily temperature and the 65ºF/18ºC base; cooling degree days are summations of positive differences from the same base. Degree days are then population weighted to more accurately reflect temperature-related energy consumption. See www.cpc.ncep.noaa.gov.

THE SOVIET LEGACY

The fundamental error stems from thinking that Russia is like other nations. It is typical, of course, for countries to argue "we are different"—not least when they are trying to resist IMF efforts to make them tighten their belts or challenge incumbent interest groups. But Russia really is different in important respects.

For one thing, its huge land mass and extreme climate pose unique problems. For another, it must cope with legacies of industrial structure and economic culture from the Soviet period that differ fundamentally from those of other countries at the same stage of economic development. It's no wonder, then, that one-size-fits-all prescriptions have failed.

Politics—the priorities of the leaders and their emphasis on ideology and security—is a vital part of the Soviet legacy. Stalin (and his successors) did not want the Soviet Union to remain a

Russia spent the Soviet period handicapping itself. It was setting "bear traps" that today block its path to modernisation.

"raw materials appendage" of the capitalist West; the goal was to industrialise to reduce its dependence on a largely hostile world. And owing to abundant natural resources (and a willingness to demand extreme sacrifices from ordinary citizens), the Soviet Union did manage to develop a full range of industries that were minimally dependent on the outside world.

But because the Soviet planning system was characterised by opaqueness and prices set by bureaucrats, rather than markets, the true cost of investments made to realise the goals of the communist leadership was not generally recognised. The result was a vast network of interdependent enterprises that were very inefficient compared to their counterparts in market-based economies.

One big reason for the inefficiency of Soviet industry was its location. Factories—and the cities and infrastructure to support them—were built in impossibly remote and cold locations. Of course, one might object, how else could it be? Russia is, after all, the largest and coldest country on earth.

But geography is not fate. The mere existence of forbidding territory does not mean that it has to be home to cities of over a million, or the site of giant manufacturing plants. Other economies face parallel issues. Canada has its northern provinces; the US has Alaska. Consider, though, the difference between how those countries populated their inhospitable regions and what Russia, especially during the Soviet period, did with its Siberian and Far Eastern provinces.

Alaska has 710,000 residents, while Canada's Northwest territory and Yukon territory together are home to a mere 79,000. In terms of relative shares of total national population and territory, Eastern Siberia and the Russian Far East are roughly 15 times more densely populated than their Canadian and American counterparts. Russians complain that their eastern regions are under-populated. But consider: if Eastern Siberia and the Russian Far East had followed the American and Canadian pattern, they would have barely one million residents in total, instead of their current 15 million living in extremely cold places that are exceedingly far from markets. Conversely, a "Sovietised" Alaska—one populated in the Soviet manner—would have a population of 13 million!

The costs associated with cold temperatures and vast distances between factories and markets are like a tax on growth. In the case of Russia, much of the extra burden was self-imposed. Over the course of several decades, Moscow's central planners moved millions of people eastward from European Russia, into remote and far less productive regions. By contrast, during the same period Canadians were clustering along the US border, in warmer climes that were nearer to markets and high-quality transportation.

Thus for reasons of ideology, leadership paranoia and grandiose planning, Russia spent the Soviet period handicapping itself. It was setting "bear traps" that today block its path to modernisation.

The implicit assumption in cross-country studies of economies is that climatic and spatial differences average out, so they can safely be ignored. But the legacies from the Soviet period are too large to ignore. Much of measured investment, then and now, is devoted to coping with climate. The same goes for the extra costs

Understanding the failure of cost pressures to alter the economic landscape is key to unlocking the mystery of the Russian economy.

for a transportation infrastructure to overcome distance. Thus, while it appears that Russia's troubles are largely due to low productivity caused by organisational problems and corruption, Russia's most important hurdles are the widely ignored structural handicaps that have persisted since the Soviet period.

But why do these legacies persist, two decades since the Soviet system imploded? Understanding the failure of cost pressures to alter the economic landscape is key to unlocking the mystery of the Russian economy.

ECONOMIC RENTS AND THEIR MANAGEMENT

At prices for inputs that reflected opportunity costs, most Soviet manufacturing enterprises were value destroying; that is, the goods they produced were worth less than the world free-market value of the inputs used in their manufacture. In the long run, such activity can only continue if valuable inputs can, in fact, be exploited to subsidise the value-destroying production. For Soviet Russia, this was the surplus from cheap-to-exploit natural resources - what economists call resource rents.

In terms of employment, Russia's value-producing resource sectors are small. They consist mainly of the oil and gas extraction, and mining industries. Meanwhile, the value-destroying sectors—everything from machine building to the defence industry to light industry—are vast. Thus, the Russian economy came to resemble an inverted funnel: there was a narrow sector of oil and gas (the neck of the funnel) and a broad base of industries that could not survive without a constant flow of value from the narrow neck. The ever-increasing demand for the rents to sustain the system was akin to an addiction.

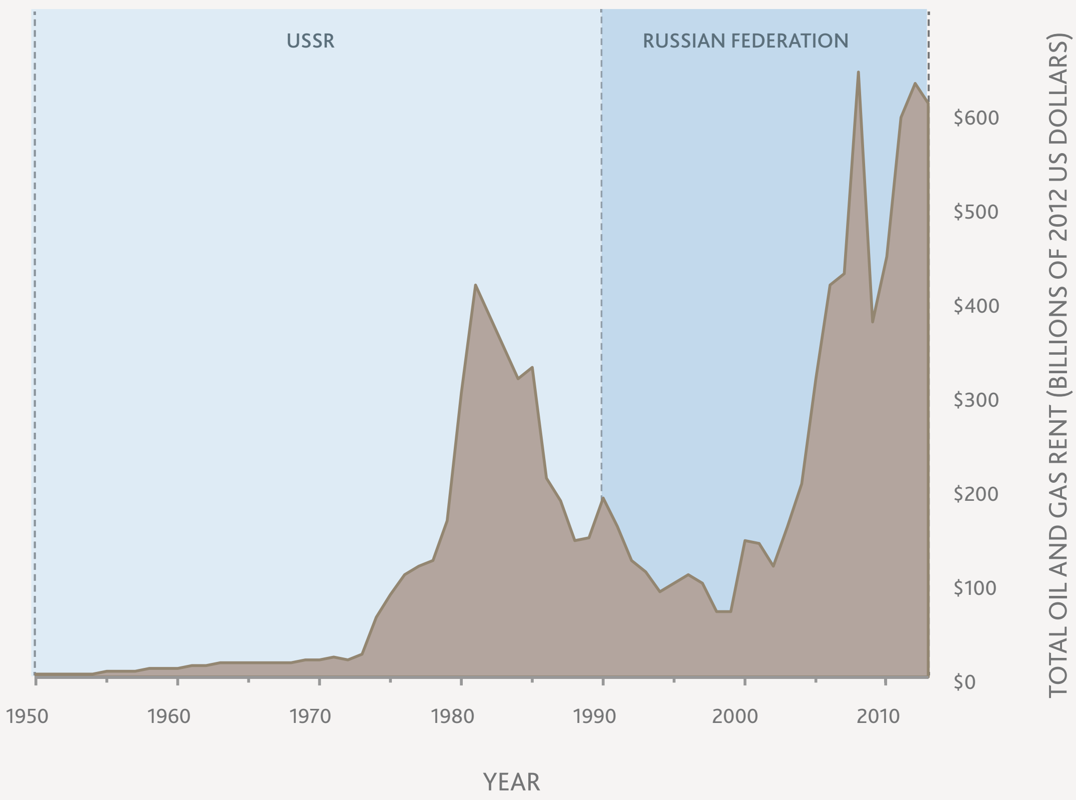
The amount of rent available and the mechanisms by which it is distributed constitute the essence of the political economy of a resource-abundant economy. In the case of Russia, we can focus on oil and gas rents, which generate the lion's share of total resource rents.

The rent-addicted structure of the Russian economy was shaped in three epochs. The first was the 1970s through the beginning of the 1980s, when rising rents associated with the growth of western Siberian production and, more importantly, higher oil prices in the wake of the Arab oil embargo permitted the structure to be built. The second was the subsequent two-decades-long decline in rents that threatened the very survival of the structure. The third is the current one, which began at the end of the 1990s.

Rents soared to levels that surpassed even those of the 1970s. Oil and gas rents in the USSR had averaged roughly 11 percent of GDP. Between 1999 and 2012, that figure (now calculated for the Russian federation alone) ballooned to 33 percent of GDP. Not quite Persian Gulf levels, but you get the idea.

The ebb and flow of oil and gas rents also provides a lens through which to view recent Russian history. The rise in rents in the 1970s saved the Soviet system. It allowed the economy, which had run out of steam, to continue to operate and even to increase investment in Siberia and the far eastern provinces. It also made it possible for the regime to purchase legitimacy through a deal with the broader society to provide welfare, or at least jobs. And it offered the means to

ECONOMIC RENTS 1950–2013



exercise "soft power" in relation to the Warsaw Pact countries, trading oil and gas for manufactures at prices that favoured their allies.

The decline in resource rents that began in the early 1980s eventually led to the collapse of the USSR and the Soviet system inside Russia. The decade ending in 2010 is often seen as a period of recovery from Russia's 1998 financial crisis. But a longer view suggests that the years since 2000 represent a recovery from the rent crisis that really began in 1986. The later part of the Soviet era and chaos of transition, including the Gorbachev (1986-1991) and Yeltsin (1992-1999) years, are a period of shrinking rents and, as a result, growing political and social tensions. Only since 2000 has Russia again enjoyed the luxury of rising rents.

This long rent drought heightens the puzzle of how the addicts survived. The collapse of communism destroyed the old system of centrally planned rent flows that supported deeply inefficient enterprises. And the ongoing decline in available rents tightened the squeeze after 1990. How, then, could these enterprises have survived the shock? To answer this question, one needs to understand how the rents are controlled and distributed—that is, the rent management system.

CHEREPOVETS STEEL MILL BY THE RIVER SHEKSNA, RUSSIA

Every resource-abundant economy has some kind of system to control the flow of rents. From the standpoint of the leaders of the economy, its function is to channel rents to their preferred uses and to prevent their dissipation or diversion. If the management system is weak, then rents will be appropriated by various stakeholders near the source of production. If it is centralised and robust, rents will flow upwards to the leadership.

In the Soviet period, direct dissipation was limited. Rents could not be transformed into consumption on anywhere near the scale on which they were produced. Nor could rents be shifted easily to private accounts abroad. Rather, those who controlled the flow and wanted to appropriate some for personal gain were limited to semi-legitimate activities. Party leaders and economic planning officials, as well as plant directors, could enjoy a better standard of living than ordinary citizens on the perquisites of office. But most of the rents were channelled to the production of things that enhanced the leadership's stature and authority, as well as the legitimacy of the Soviet state.

This meant, above all, goods produced by heavy industry in giant enterprises—symbols of Soviet accomplishment since the rise of Stalin. The more metal, energy, and transportation services the plants consumed, the greater the power, prestige and privilege their directors enjoyed.

The priority users of the equipment produced in such plants were agriculture and defence because they were so well-suited to serving the interests of the self-perpetuating elite. And by no coincidence, farming and the military in the Soviet Union were two of the most wasteful sectors in the entire Soviet economy. The goal of the managers was not to produce the most food for a given amount of inputs or to present the most fearsome military for given numbers of men and weapons, but to demand as much equipment (and support as many jobs) as possible. So, in a way, the real function was to be just that—costly and wasteful.

The production structure that evolved (and this included not just factories, but cities and the USSR's infrastructure of power plants, canals and railways) followed the same principle of cost-enhancement. The system, therefore, had to be fed with ever-more resources to offset the value destruction. This is the essence of rent addiction, and it is the economic legacy of post-Soviet Russia.

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FROM CHAOS TO ORDER

When the USSR collapsed, the Soviet rent management system collapsed with it. The post-Soviet Russian government, however, had nothing to replace it with. Reformers had a long list of reforms to implement, especially the triad of enterprise privatisation, market liberalisation, and macroeconomic stabilisation. But they did not recognise the crucial role of rent management in the economy.

They weren't alone. One can read through the literature on the problems of reforming the Soviet economy in the 1980s and find precious little about the energy sector. The importance of resource rents to the Soviet system and the implications of their decline were not on anybody's radar at the time. Hence, in terms of planning reforms, the creation of a new system to manage rents—other than letting the market decide—was not on the agenda.

This omission had important implications for the path of reform. Rent addiction enabled by resource abundance had bequeathed to Russia an industrial sector dominated by enterprises that just weren't viable in a market economy. The entire Soviet economic system had been dedicated to masking the true nature of these enterprises: Planners simply commandeered inputs and allocated them to manufacturing plants, regardless of the true

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cost. And they shipped off the output to customers, regardless of true demand. The accounts were more or less balanced—that is, financially unviable plants at least broke even—by systematically underpricing resource inputs and overpricing manufactured goods.

Post-Soviet reformers, however, did not see unviable enterprises; they saw inefficient enterprises. There's a big difference. If inefficiency is the problem, it can be remedied by changing incentives, or as economists like to say, "getting the prices right". For instance, eliminating "soft" budget constraints—the expectation that enterprises in financial difficulty will be bailed out—would force these enterprises to change. They would reduce staff, change management practices, design new products and seek new markets. If they didn't, they'd go bankrupt.

Privatisation, of course, would alter the incentives of management. If an enterprise is fundamentally unviable, however, changing incentives can't save it. The amounts of money that would have to be spent to make the enterprise competitive in the market could never be justified by the expected return.

The reformers did acknowledge that there were cases of true non-viability. But they believed that they were relatively few in number. If we divide Russian enterprises into two categories, those that did not want to adjust and those that simply could not adjust, then the basic assumption of the reformers was that the ratio of "won't adjusters" to "can't adjusters" was high. Hence, credible reforms to eliminate subsidies, along with privatisation, would induce the behavioural response that would lead to improvements in efficiency.

The problem is that the proportion of "can't adjusters" was much higher than the reformers, presumed due to their failure to take into account the consequences of pervasive, long-standing rent addiction. And imposing hard budget constraints in such an economy had unintended consequences.

Faced with threats to their very survival, and recognising the futility of demanding subsidies from a government that was determined to eliminate them, the enterprises fought back from below. While directors of these enterprises had very little by way of assets that could make them competitive in the market, they did have other assets to protect themselves from the market; their "relational capital". Banding together in the networks created in the Soviet years, they swapped goods with one another without exchanging money. They also colluded with local and regional governments against the centre.

On paper (but only on paper) it looked like a real economy, where profits were being earned, taxes remitted and wages paid. But it was a virtual reality. Behind it all, and making it work, were transfers of real value from the resource sector—in particular, from the natural gas giant, Gazprom (oil prices were historically low at this time and the share of resource rents produced by oil producers was at a historic low for Russia). Two other major monopolies—the national electric power company and the railroads—played auxiliary roles as value distributors.

The transfers took place in an opaque fashion by underpricing fuel supplies or through barter of one sort or another. Enterprises did not produce positive value-added. Nor, however, did they perish at the hands of the market. Indeed, they were like zombies seeking a meal, perpetually hungry for rents in the form of cheap

MOSCOW CITY COMPLEX UNDER CONSTRUCTION

fuel and for buyers who would pay more than market prices. In short, reform led to adaptation, though not in the direction that reformers had intended.

But why would those who controlled the resource companies transfer resources to the losers at less than their market value? They did so in self-defence, in an effort to avoid losing all of their property.

To grasp this point, we need to understand the nature of one of the centrepieces of Russian reform, mass privatisation. In that programme, all Russian adults were issued shares in the nation's state-owned enterprises. Here, an analogy is useful. Think of mass privatisation as a special kind of lottery. Imagine that prior to privatisation, the value of shares in enterprises is unknown. Only after the privatisation takes place will values be revealed. Privatisation, then, created both winners and losers.

Now, suppose it turns out that there is only one winning ticket; Gazprom shares. In such a scenario, there would be overwhelming political demands to reverse the privatisation. To prevent this, the lucky owners of Gazprom needed to share the wealth by giving the other tickets value. And this, in effect, is what happened during the 1990s in Russia. The newly rich resource producers transferred income to the worthless industrial enterprises in order to keep the latter afloat.

ULYANOVSK, RUSSIA

This is the bottom-up rent management system that developed without central planning in the low-rent years of the 1990s. It was replaced towards the end of the decade (just before resource rents exploded in the wake of rising global oil prices) by a variant created and managed by Vladimir Putin's government.

Putin's system combines strong state influence with private ownership of enterprises. The particular role of private owners in this system begs explanation. Most of the companies in Russia's core industrial sectors had been privatised in the 1990s, and have remained private entities. The only significant exception is the oil company, Yukos, which was effectively re-nationalised after the arrest in 2003 of its owner, Mikhail Khodorkovsky, who had challenged Putin's system. The lucrative metals and mining sector is also almost entirely in private hands.

Contrary to conventional wisdom, the Russian leadership under Putin is not hostile to private ownership, even to ownership of vital

During the 1990s the newly rich resource producers transferred income to the worthless industrial enterprises in order to keep the latter afloat.

sectors of the economy. The highest priority for the Putin regime with respect to private owners is to ensure that they continue to support the rent distribution system that serves the interests of the regime. For the rent-producing companies—whether state-owned or private—the most important requirement is that they directly support the production and supply chains linking the enterprises inherited from the Soviet economy.

Suppliers of material inputs (fuel and energy, metals, components) and services (rail and pipeline) are required to serve the machine-building enterprises. The prices of virtually all these critical inputs are set to transfer value to the rent addicts. Those very same input suppliers are then obliged to purchase the machinery and equipment produced with the implicit subsidies.

Note the method behind this (seeming) madness. Rather than collecting oil and gas rents exclusively as formal taxes, and then redistributing some of them to addicted enterprises, energy producers provide much of the transfer directly. This is either in physical form (as below-market-price inputs) or in money (as excessive payment for orders) to the equipment manufacturers, or via intermediate production sectors that serve the oil and gas industry, such as transport, infrastructure construction, the electric power sector, and the processing (refining) industries.

The supply chains can thus be regarded as rent distribution chains. They are mechanisms to disperse rents from resource producers (the narrow end of Russia's inverted funnel economy) to its broad base.

The distribution of rent through production is the most important way rents from natural resources are shared in today's Russian economy. And it is all informal—it is not written into law and it does not show up on a government budget. Oil and gas rents thus form the currency of power in which corporation owners (the oligarchs), top government officials, and governors of the most important regions are on nearly equal footing. They are, in effect, rent management division heads in the gigantic enterprise that ought to be known as Russia, Inc.

The system combines the virtues of stability (by ensuring that rent is distributed to the regions, cities and plants with the most clout) and efficiency (by ensuring that the private owners of rent-generating industries have strong incentives to maximise profits and thereby create more rents). In effect, it preserves the ownership rights of the oligarchs in exchange for sustaining legacy manufacturing enterprises.

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AN OIL-FUELLED BOOM

The post-Soviet rent-management systems channelled rents to addicts and thus preserved the legacy of the old system. Yet, despite the backwardness of this old structure, the Russian economy has performed well in many respects since 2000. Indeed, during the decade preceding the global financial crisis, Russia was, by some measures, the fastest growing economy in the world, ahead of China, Brazil and India.

Today, Russia's GDP per capita, measured by the World Bank in terms of purchasing power, exceeds $23,000—more than double that of China or Brazil and very close to that of Portugal. Even measuring income by the World Bank's Atlas (adjusted exchange rate) method, puts the country in the high-income category.

But the quality of Russia's institutions and objective measures of societal welfare present a very different picture. For example, according to the Legatum Prosperity Index, Russia ranks just 115th among countries in Governance and 98th in Safety and Security. The adult mortality rate—the probability that a 15 year old will die before reaching age 60—is almost three times higher than in Turkey, a country with roughly the same per capita income. Likewise, when measured in years of schooling, Russia's level of human capital appears to be as high as that of Switzerland or Japan. But this measure does not take into account the quality of education or the way it translates into labour productivity.

The gap between the appearance of affluence and the problematic reality has much to with resource abundance. And this dependence on resources to generate so substantial a portion of GDP is both a source of concern and an opportunity.

The worry is that Russia's resource abundance is temporary, and that the industrial structure is not viable without its massive rent flows. Fear of excessive dependence on resources has long been the bugbear of Russian leaders, and, ironically, the reason the legacy of the Soviet industrial base weighs so heavily on the economy and polity.

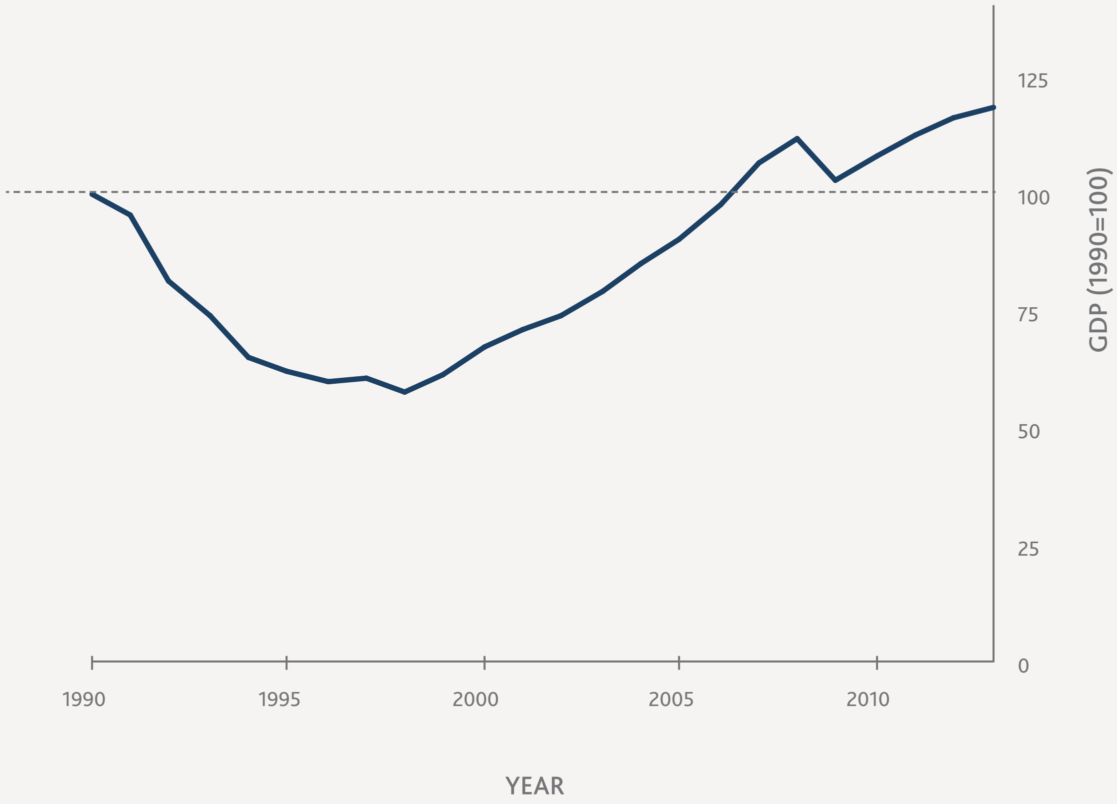
The opportunity, of course, is that the trillions of dollars' worth of rents still available through resource extraction could smooth the inevitable bumps on the road to market reforms and a more sustainable growth trajectory. It's not surprising, then, that there is widespread recognition of the need for reform, even if there is no consensus on how to implement change.

The obvious question that follows: Why has so little changed since the Soviet meltdown? We think the primary reason is that modernisation is out of reach as long as the bear traps are in place. Yet, most of the advocates of economic reform seem to ignore the looming presence of these barriers to growth.

THE MODERNISATION DILEMMA

Russia's oil-fuelled economic growth in the decade leading up to the global financial crisis in 2008 lessened the urgency to reform. Resource wealth could conceivably sustain growth for a few more years, albeit at a slower pace than before 2008. But this would require substantial increases in oil and gas prices, which isn't a likely scenario. It also assumes that Moscow will manage fiscal and monetary policies effectively and

RUSSIAN GDP PERFORMANCE 1990–2013



ensure that adequate funds are invested in resource development—both of which become more difficult with the passage of time.

However the stresses are felt, Russia's future will continue to be shaped by resource rents. While it may be fashionable to talk of economic diversification within the existing industrial system, it's hard to imagine a scenario in which Russia could prosper without a large and well-performing oil and gas sector. And that will only be possible if the energy industries are freed from the obligation to share rents through the rent distribution chains.

Even in the best-case scenarios for oil prices, Russia faces many constraints on growth. Among them are its demography—notably, an unhealthy (and shrinking) working-age population—which will be almost impossible to stretch over the coming decades. Dealing with the other obvious weaknesses of the economy—outmoded plant and equipment, inadequate and aging infrastructure, and weak market-economy institutions—might appear to be straightforward. But spending serious sums on solving these problems is unlikely as long as the rent distribution system must feed its vested constituencies. Given the way power is shared in Russia, investment will tend to reinforce the non-competitive structure of the economy.

To be modern, Russia needs democracy. But a democratic Russia cannot become modern because the majority of Russians have a vested interest in an economic structure that prevents modernisation.

Russia's dilemma is that any serious attempt to convert the economy into something resembling a modern Western (non-oil) economy would require dismantling the rent distribution system. But this would be highly destabilising in social and political terms as the number of enterprises and the population supported by it is simply too large. Given the climatic and locational realities that burden the rent addicts, cutting them loose is unimaginable. And creating a transparent taxation and distribution system that would put incentives in place for a more efficient spatial distribution of the population would require political reforms that are even farther beyond the horizon.

There will still be scope for some productivity-enhancing reforms. Both the sectors that create the rents (oil and gas), the ones that transmit the rents in the form of below-cost pricing (transport, electric power and infrastructure construction), and the ones for whom the entire rent-sharing system works (heavy manufacturing) can be reformed within limits. But changes that would disrupt the rent distribution chain or negate its purpose by forcing unviable enterprises to shut down or to restructure supply chains to minimise costs face formidable barriers.

Some analysts hold out hope that Russia's need for foreign direct investment (and the technology and organisational capital that accompanies it) will force reforms that would otherwise be off limits. But this isn't likely. The volume of foreign investment may well increase in coming years, given the siren song of its oil and gas rents and the imperative for modern technology to sustain production. Multinational corporations may even help to re-tool Russian manufacturing enterprises and introduce progressive business practices.

But foreign firms will not be allowed to undermine the rent distribution chains. The priority will continue to be support for the enterprises inherited from the Soviet system, with their legacies of poor location and organisation. To put it another way, efficiency-enhancing investment, technology and organisation will be permitted only if it reinforces the viability of the status quo.

Russia is in a trap. To be modern, it needs democracy. But a democratic Russia cannot become modern because the majority of Russians have a vested interest in an economic structure that prevents modernisation. Today's Russia is not Singapore or South Korea. It will not work to use anti-democratic methods to force modernisation. The changes required would cause such disruption and discontent that the extended brutal authoritarianism needed to sustain it would wipe out all traces of modernity. It would isolate Russia from the rest of the world, as well as drive out its best people.

Russia's post-Soviet adaptation works well enough to be self-sustaining—in the medium term, at least. But it works too well in the sense that too many Russians have too much to lose in risking change. The bear trap has very strong jaws, indeed.

RUSSIA

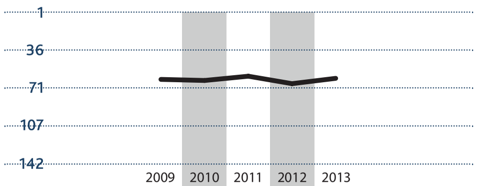
OVERALL RANKING: (TOTAL 142)

61

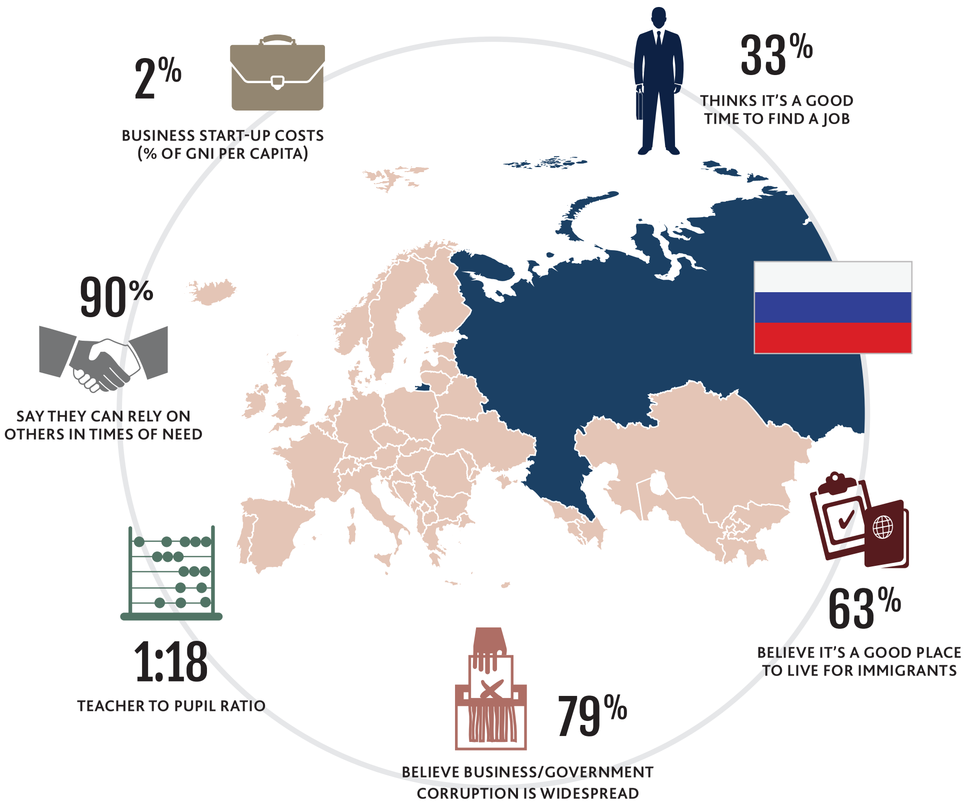
EUROPE RANKING

Norway	1
Switzerland	2
Sweden	4
Denmark	6
Finland	8
Netherlands	9
Luxembourg	10
Ireland	12
Iceland	13
Germany	14
Austria	15
United Kingdom	16
Belgium	17
France	20
Spain	23
Slovenia	24
Malta	25
Portugal	27
Czech Republic	29
Italy	32
Poland	34
Estonia	36
Cyprus	37
Slovakia	38
Hungary	41
Lithuania	43
Latvia	48
Bulgaria	49
Croatia	53
Greece	54
Romania	55
Belarus	58
Russia	61
Ukraine	64
Montenegro	71
Serbia	76
Macedonia	79
Azerbaijan	81
Albania	83
Georgia	84
Moldova	89
Armenia	95
Bosnia-Herzegovina	97

PERFORMANCE



- Russia has moved up four places to 61st in overall Prosperity since 2009.
- Over the last five years, the country has risen ten places to 26th in the Education sub-index, due to increases in net primary enrolment rate, and secondary education per worker.
- The Personal Freedom sub-index has declined ten places to 114th since 2009, as a result of decreases in civil choice and tolerance towards minorities.



DATA IN FOCUS:

SUB-INDICES

Rank	Sub-index / Indicator	Year	Data	Global Av.
50	**ECONOMY**			
	5 year growth rate	2011	2.9%	2.7%
	Confidence in financial institutions?* (% yes)	2012	39.9%	59.5%
	Satisfaction with living standards?* (% yes)	2012	43.4%	58.2%
47	**ENTREPRENEURSHIP & OPPORTUNITY**			
	R&D expenditure (% of GDP)	2011	1.2%	0.8%
	Mobile phones (per 100 ppl)	2012	183.5	103.9
	Will working hard get you ahead?* (% yes)	2012	59.5%	81.0%
115	**GOVERNANCE**			
	Confidence in the government?* (% yes)	2012	54.1%	51.5%
	Confidence in the judiciary?* (% yes)	2012	29.0%	52.1%
	Government effectiveness [1]	2011	-0.4	0.04
26	**EDUCATION**			
	Gross secondary enrolment rate	2009	88.6%	79.3%
	Satisfaction with education quality?* (% yes)	2012	53.1%	66.3%
	Perception children are learning?* (% yes)	2012	49.1%	70.2%
44	**HEALTH**			
	Self-reported health problems?* (% yes)	2012	32.7%	23.9%
	Hospital beds* (per 1000 people)	2006	9.7	3.1
	Satisfaction with health?* (% yes)	2012	60.6%	78.2%
98	**SAFETY & SECURITY**			
	Human flight [2]	2012	5.4	5.3
	Safe walking alone at night?* (% yes)	2012	43.8%	62.8%
	Property stolen in past 12 months?* (% yes)	2012	8.9%	16.5%
114	**PERSONAL FREEDOM**			
	Civil liberties [3]	2012	3	4.7
	Tolerance for ethnic groups?* (% yes)	2012	57.8%	68.0%
	Satisfaction with freedom of choice?* (% yes)	2012	60.9%	71.7%
62	**SOCIAL CAPITAL**			
	Volunteered time in past month?* (% yes)	2012	17.6%	20.1%
	Donated to charity in past month?* (% yes)	2012	6.1%	28.3%
	Helped strangers in past month?* (% yes)	2012	33.6%	47.9%

NOTES: [1] *Gov. effectiveness: values range from -1.66 to 2.25, higher values indicate higher effectiveness.* [2] *Human flight: values range from 1 to 10, higher values indicate higher levels of human flight.* [3] *Civil liberties: values range from 1 to 7, lower values indicate lack of civil liberties. *Survey data are taken from Gallup World Poll.*

BUILDING A MORE PROSPEROUS WORLD THROUGH LIBERTY AND RESPONSIBILITY

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ISBN 978-1-907409-30-1

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NOVEMBER 2013