

## WHY RUSSIA WILL CONTINUE TO DISAPPOINT

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Russia has more natural resources than any other country – perhaps as much as 30 percent of the world’s total – and a well-educated population. So, why is it not rich?

The short answer is that it is still plagued by high levels of corruption and lacks the institutions to take good ideas and turn them into globally competitive products. When is the last time you were in a store and saw a product “made in Russia,” like those made in China, Japan, South Korea, and Brazil, etc.?

Russia consistently runs a positive balance of trade, but its exports are primarily oil, gas, metals, wood, other natural resources, and military products. As a result, its GDP goes through wild swings based on international commodity prices. The Russian economy grew rapidly from 1999 to 2008, in large part due to the global demand for commodities, and in particular oil and gas. But in the last couple of years, the Russian economy has been in a deep recession because of the drop in the price of oil and economic sanctions imposed as punishment for its military adventurism.

Russia also has an on-going demographic problem with a flat or even falling population, estimated to be about 144 million. During the boom times in the early 2000s, Russia attracted many immigrants from the former Soviet Republics which largely offset the declining native Russian work force due to

a low birth rate. But as the economy fell into recession, the number of immigrants has greatly declined. Russia females, on average, live about ten years longer than their male counterparts, largely because of widespread alcoholism and smoking by Russian males. Yet, women have a retirement age of 55 while men can retire only at age 60. These low retirement ages drive many of the most productive workers out of the labor force, which adds to the costs of dependency.

In the early 1990s, during the transition period, I was an economic advisor to several senior Russian government officials, including the first non-communist prime minister, the late Yegor Gaidar. Subsequently, several of us set up joint ventures with Russia entities, in part to teach them how a real capitalist economy operates. Because of on-going problems with the Russian physical and legal infrastructure, and because of the pervasive corruption, we ended up moving our operations, including our most skilled Russian scientists, to the U.S. in one of our companies. In another joint venture, we ended up selling the business to our Russian partners because of their inability to follow international legal, management and accounting standards. Russia has made considerable progress in the rule of law and property rights protections since those early days of transition, but corruption is still very widespread, which has the same effect as a tax on the productive and honest. Russia ranks 119th out of 166 countries on the Transparency International global corruption index. By contrast, neighboring Finland ranks number 2, and the U.S. number 16. On the World Bank measure of ease of doing business, Russia now ranks 51, while the U.S. is number 7, and Singapore has the top spot of number 1, out of 189 countries.

Russian universities produce one of the highest numbers of engineers and scientists, and yet they create relatively few world-beating high-tech companies. During the communist period, there was no way for a Russian scientist with a transformative idea to create a company to turn that idea into products that millions would buy. Those who came up with new ideas would receive an “authors’ certificate” rather than a patent. “Authors” were provided with a 50 ruble payment, but no royalties or ownership of the idea, no matter how important. At the time, there could be as many as four “authors” for any new idea – each of whom would receive the 50 rubles. As one would logically expect, most authors’ certificates had four authors – the person who thought of the idea plus three of his or her family or friends.



Even in a country like the U.S., it is not easy for an innovative patent holder to obtain the capital and build the structure of a new enterprise around the idea, or even license it. And the U.S. has more venture capital firms and the developed infrastructure than anywhere else for taking new ideas and turning them into goods and services people want. Other developed countries, such as Switzerland, realize that their future prosperity is dependent on innovation. The Swiss MIT, called ETH, where Albert Einstein and many other scientific Nobel Prize winners studied, has a program to help its students and faculty create new enterprises from their ideas.

It takes some time for a culture to change from a top-down government directed society to a bottom-up entrepreneurial society. Russia continues to export capital, for reasons of both safety and opportunity, and export many of its best and brightest scientists and engineers. The Russians, of course, are well aware of the problem, but they still default to centralized planning in attempting to create a Russian Silicon Valley, as they are now doing in the city of Skolkovo. The communists during the USSR days also set up several science cities which were of little use.

Despite the limited Russian success in creating an entrepreneurial culture and institutions, they do produce world-class technology in a few areas, most of it military related. Their large rocket engines are arguably the best in the world, and the U.S. has been dependent on these engines for the last few years. They are also able to produce highly sophisticated military aircraft and submarines – no small achievement. Before the collapse of the Soviet Union, the Russians and Ukrainians were the second largest producer of civilian aircraft in the world, but that industry almost died with the USSR. Their airframes were very rugged, but their avionics and engine efficiency was a generation behind that of the West. They largely missed the opportunity to form joint ventures with foreign companies to provide state-of-the-art avionics and engines combined with Russian airframes. So they are just now, a quarter of a century later, trying to rebuild a civilian aviation industry which will be tough given the global competition.

Russia has a relatively small and highly manageable government debt-to-GDP ratio unlike all of the major developed countries. Russia also wisely went to a low 13 percent rate flat income tax system a decade and a half ago. They also have a relatively low corporate tax rate of a flat 20 percent. But

their sales tax rate at 18 percent and social security tax rate of 30 percent are very high. On the positive side, they have kept government spending under control and in most years run a surplus.

Russia also set up national reserve funds during the period of high commodity prices, to cushion the periods of low commodity prices. The rate of depletion of these funds and their considerable foreign exchange holdings will depend on domestic political pressures to spend on an added social safety net, and whether or not there is a major recovery in oil prices. Given the advances in fracking technology and the new discoveries of major oil and gas fields throughout the world, it is unlikely that oil and gas prices will return to the levels whereby Russia can again accumulate surpluses and also have sufficient funds to invest in new gas and oil infrastructure. As would be expected, it is reported that there has been underinvestment in oil and gas expansion and replacement, and increased mismanagement since the oil and gas companies were largely renationalized a decade ago.

Over the long run, commodity prices tend to fall relative to other prices, as production technologies improve. Russia relies primarily on commodities for its income, and to date has been largely unsuccessful in broadening the economic base of the economy. So the open question is, where are the sources of growth for the next couple of decades?

In 1992, the ruble had collapsed, and the currency was almost worthless. Yet, I was amazed that the subways continued to run, and the electricity remained on. The workers who provided these basic services continued to show up at work, even though they could buy very little with their paychecks. There were virtually no riots in the streets as would be expected in most places. Instead, the Russians faced this extreme hardship with quiet desperation. Women stood for long hours outside of the subway stations trying to sell a pair of boots or a frying pan in order to buy some food which was in very short supply. Within weeks, spontaneous free markets began to emerge – even though, after 70 years of communism, virtually no one had any experience with a market economy. The economy was dollarized with considerable help from the U.S. and the European countries – but it was the individual perseverance of the Russian people that enabled them to get through several very tough years.

Real incomes are now several times higher than they were at the end of the communist period, and poverty has been greatly reduced. Russia has enough going for it – incredible quantities of raw materials, a highly educated work force, and a functioning market economy, which should keep it as

a slowly growing middle-income economy over the next few decades. But Russia is also unlikely to experience the high growth rates of the 1999-2008 period because they give little indication that they are going to seriously deal with the corruption and the lack of the rule of law, and create the venture capital institutions and markets that are necessary.

Russia will likely continue to disappoint, not because it will become an economic disaster, but because it ought to be high-growth developed country. Yet, it is unlikely to make those few remaining steps to fulfill its potential.

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