This long-time Russian economist believes the economy is embedded in oligarchic, oligopolistic rigidities that the Putin government is not about to undermine. This is true despite its efforts to control the Yukos oil empire. Moreover, the government does not even consider alternative fiscal or monetary policies, much less industrial policies. One result is that wages comprise an unusually low share of gross domestic product.

The Russian economy today is a form of oligarchic capitalism with a high degree of concentration and monopoly in most basic industries, an underdeveloped banking system, weak government stimulation of the economy, and a shrinking social security infrastructure. Such a system tends to rely on excessively high profit margins, hinders technological progress, promotes inflationary pressures, creates high income inequality and mass poverty, and prevents the rise of a numerous and stable middle class. The result is an extremely narrow domestic market, excessive dependence on high-priced exports of mineral resources, decay and stagnation in the manufac-

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turing and high-tech arenas, and a lopsided and unstable growth of the economy in general. A major reason for these developments is the neoliberal model of market reforms and a running of the economy that turned out to be perfectly suited to the vested interests of an extremely narrow group of oligarchic capitalists centered on fast self-enrichment. This paper suggests a list of reforms needed to improve the situation. These reforms are based on institutional and evolutionary economic theory.

In a book I coauthored with John Kenneth Galbraith, *Capitalism, Communism, Coexistence* (Houghton Mifflin, 1988; subsequently translated into Russian, French, and other languages), Galbraith and I argued that the centrally planned economy of Russia would slowly transform into a mixed system combining competitive market mechanisms with active state intervention and a well-developed social security infrastructure. Basically, we were following the concept of socioeconomic convergence between capitalism and communism, a concept that was first suggested by Jan Tinbergen and John Kenneth Galbraith and was popular in the West in the 1970s and 1980s.

My own view at that time was that the Soviet system would slowly introduce many essential features of the market economy while retaining certain features of central planning, which concerned, in particular, long-term capital investment and the determination of basic macroeconomic proportions. I still believe that such a course was best for my country, because in the long run it permitted the optimal combination of the best and most efficient features of both capitalism and socialism and, in the short and medium term, would have helped avoid deformation and destruction imminent in shock transformation into capitalism.

However, the political forces that came to power after the forced resignation of Mikhail Gorbachev and the dissolution of the Soviet Union pursued a different strategy that led to the prolonged, deep economic crisis of 1992–98, which reduced Russia’s gross domestic product (GDP) by more than 40 percent. Even today after four years of economic recovery, the pre-reform level of GDP has not been restored.
More important, the Russian economy, as it emerged in the last decade or so, can be likened to an inertial system moving along a trajectory that in the long run is self-destructive but extremely difficult to change.

**Russia's Inertial Economic System and Its Prospects**

The principal institutional features of this system are as follows:

- the prevalence of oligopoly and monopoly over competition;
- the dominance of oligarchic financial-industrial groups together with a relatively weakly developed banking industry;
- the close fusion of the business oligarchy with the state while the role of the latter in guiding the economy remains very weak;
- an excessively high share of gross profit in GDP and inappropriately high inequality in the distribution of income and wealth;
- an excessively large share in GDP of the shadow sector—corruption and organized crime.

These features of the system have given rise to certain negative regularities in the behavior of economic agents, as well as in macroeconomic dynamics.

For instance, the prevalence of oligopoly and monopoly has created a typical orientation of businesses to maximize profits not so much by increasing output and sales but more by maintaining inordinately high profit margins, that is, markups of price over cost. Average profit margins of even 20 percent in the manufacturing industry are considered too low to warrant large long-term investments, while the principal capital-generating sectors of the economy (all of them export-oriented industries, such as oil and nonferrous metals) are operating at profit margins as high as 50 percent.

Such a behavioral mode had already emerged in the early 1990s when output was either falling or stagnating while high inflation was rampant. In such an environment, increasing production was sense-
less, and the only rational tactic was to maximize short-term profits by raising prices. In the practice of those years, cases of companies trying to beat competitors by underselling were extremely rare if not totally unknown. On the contrary, every possibility and pretext was used to raise prices, even when it was perfectly feasible to increase output by squeezing competitors out of the market. This was the rule for big and even middle-sized concerns, which dominated both national and regional markets and used noneconomic means, often sheer force, to eliminate rivals. That was also one reason, besides corruption and the spread of organized crime, that small business never grew in importance in the Russian economy.

After the financial crisis of 1998, the overall competitive power of domestic producers in the internal markets improved due to the drastic devaluation of the ruble, and it became possible to reduce competition from imported goods. This opening, for the first time since privatization, allowed profit maximization by increasing output, not simply by marking up prices. But even in these more favorable circumstances, firms took care to raise output in such a way as to avoid reducing profit margins. Naturally, this activity helped to prolong inordinately high inflation and led to a fairly fast loss of competitive advantages created by devaluation.

In foreign economies, the prevalence of oligopoly and nonprice competition often strongly stimulates qualitative changes in the utility of goods and induces the quest for new products, thus creating market niches that bring at least temporary rents or super-profits. In Russia, however, this mode of behavior has not become typical. The old rule under which oligopoly and monopoly put a brake on technical progress and product differentiation still prevails.

This does not mean that Russian companies wholly avoid exploiting new niches in principle. They do so willingly but only, as a rule, when new products have already been created abroad, and all that remains is to adapt them to the Russian market. Typical instances are the quick spread of cell phones and Internet networks. But there are practically no examples of new products of domestic origin, save in the defense area. Even large and potentially strong companies in the
automobile and civil aircraft industries, where regular model changes are a must, have not been able to achieve a competitive advantage and expand output of new products to satisfy available demand.

One of the reasons for this failure is the strong reluctance to invest capital on a long-term basis in modernizing production equipment and building new plant. In fact, as Western experience shows, regular changes in technologies and products necessitate continuous large expenditures repayable only on a medium- and long-term basis. Most Russian companies, even large ones in possession of necessary capital resources, do not have a long-term strategy of that sort. In more than a decade of existence, Russian capitalism had not built a single brand-new large plant (that was not started in Soviet times) and has satisfied its production needs mainly by exploiting existing underutilized capacities or formerly discovered and developed mineral resources.

Even in such a highly profitable sector as oil and gas, new capital construction has been practically limited to export-oriented pipelines built and financed by the state. Only in recent months, private oil companies have expressed their intention of participating in the construction of new pipelines with an export orientation (from Siberia to Murmansk for export to the United States and to Daqing in China and the Far Eastern port of Nakhodka for export to Japan). The only large, new hydroelectric dam—the Burei dam, started in Soviet times—was put into operation last year with great fanfare by the state-owned electric power monopoly, with President Putin on hand to mark the event.

Similar results in terms of stagnant technical progress and skewed capital investment are the result of the dominance of oligarchic industrial and financial groups. As a rule, these groups were created by capitalists who earned their first tens of millions in murky financial and other speculative operations. Their principal interest was not in developing and modernizing production but in capturing the most profitable, formerly government-owned assets and using them for personal enrichment. In most cases, these were oil and metals concerns primarily with an export orientation, which after being cap-
tured by a few financial groups were reorganized as oligopolies. Today only five leading concerns—Yukos, Sibneft, LUKOIL, BP-TNK, and Surgutneftegaz—control 80 percent of the Russian oil industry. Only two concerns—Rusal and SUAL—control 95 percent of the aluminum industry. Only one concern—Norilsk Nickel—controls practically all the production of nickel and palladium.

In most groups, banks were the initial main source of primary capital accumulation that was used to buy at bargain basement prices the profitable mineral resource companies. After these new super-profit bases were taken over, they—instead of the banks—became the group centers. As for the banks, particularly after the 1998 financial crisis, they were mostly bankrupt and lost their importance as the principal source of profits. They now became auxiliary links servicing and coordinating the cash flows of companies composing the groups. This arrangement precluded the normal development of the banking sector as a public utility industry serving the economy at large rather than limited groups of insider clients.

The following is a description of the operations of the MDM Bank, which is part of an oligarchic group and closely related companies. It is typical of other banks. “Normal banking business has been absent in the bank during recent years. Loans were issued mainly to group insiders while the bank itself played the role of the exchequer for companies belonging to the group, helping optimize their cash flows for tax purposes. Well, if there is a Russian bank that did not engage in such activities, let it first throw a stone at MDM” (an anonymous insider as quoted by Gazeta.ru, March 15, 2003).

At a certain stage, such narrow bank specialization might satisfy the short-term interests of the principal shareholders of the groups’ companies. However, it is already coming into conflict with their longer-range interests, for instance in maximizing market capitalization with a view to selling off to foreign investors. The latter would not be greatly interested in buying closed institutions with a limited number of active clients and a narrow deposit base. That is why some groups have been acting to increase their banks’ retail business and local branch networks, opening up financial accounts to
the public and separating normal commercial banking business from offshore and other money-laundering operations. These developments are essential for attempts to list shares of Russian banks on international stock exchanges and thus lay the basis for boosting their market capitalization.

It is clear that normalization of the Russian banking industry could well proceed without necessarily integrating it into foreign banking empires. The groups' leaders should be vitally interested in expanding their credit activities to a much wider range of companies beyond their own insider groups. They should be particularly interested in promoting loans to medium-size and small businesses, increasing consumer credit and mortgage loans. But these areas are slow to develop. Short-term profit maximization still largely determines narrow group servicing as the top priority.

This phenomenon is not confined to the largest centrally located banks. Regional and local banks have been following the same model by orienting their operations to the immediate needs of their principal stockholders and their companies. Thus, smaller oligarchic financial and industrial groups have become widespread at the regional and local level. Having one's own bank is extremely advantageous for local tycoons who may have difficulty in finding access to funding by the larger banks in Moscow or St. Petersburg. Living is easy under one's own roof.

Economic development is also impeded by the close fusion of the business oligarchy with government structures at all levels—central, sectoral, regional, and local—while government stimulation of macroeconomic activity remains extremely weak. Contemporary market economies know two different models of interrelationship between business and the state. In one model, the government acts in the interests of the business class as a whole. By keeping equal distance from all principal business groupings, the state can act in the interests of the entire system and help maintain its stability. If the system deviates from equilibrium and enters a recessionary phase, the state will help correct emerging imbalances even if its corrective activities conflict with the interests of some groups of the business elite, and induce the economy to return to equilibrium.
In the second model, the state is largely dependent on one or a few influential oligarchic groups. Since overall stability often conflicts with the interests of these groups, the role of the state as the means to correct imbalances and disproportions is necessarily weakened. Governments in this case tend to lag behind private interests rather than lead them. This trait can negatively affect general economic conditions and preclude economic development at full capacity and top feasible speed.

In reality, none of the two models usually exists in its pure form. In current market economies, both models are usually intertwined. But as a rule, it is easy to see which one of them prevails.

In Russia, their interrelationship is not straightforward. Some spheres are so strongly dominated by oligarchic groups that central and regional authorities are unable to influence their activities. Under Boris Yeltsin, not only was his “family”—a closely related group of businessmen and government officials—for all practical purposes subservient to a few oligarchs, but most of the government bureaucracy was subordinated to various business groups and acted in their interests. At times, the state resembled a manger for clans of businessmen and corrupted officials, interlocked with organized crime.

Vladimir Putin proclaimed equal distance of the state from the oligarchs and declared his intention to act as arbiter vis-à-vis the business elite. It looked like the former direct fusion of the central authorities with concrete oligarchic groups was coming to an end. However, the Yeltsin-period meetings in the Kremlin with selected business leaders became even more regular, as did attempts to coordinate policy with the principal organizations of big business. On the other hand, there were clear signs of the president’s proximity to certain new business groups that played second fiddle under Yeltsin but now would like to use their newly acquired influence to capture profitable and not yet privatized chunks of government assets.

These battles proceed with mixed results. The Mezhprombank group (allegedly close to Putin) was unable to gain control over the Slavneft oil concern, which (with the support of former prime minister Mikhail Kasianov) was won over instead by the Alfa group led by Mikhail...
Fridman and Viktor Vekselberg. But Alexei Miller, whom Putin named to run Gazprom instead of former boss and tycoon Rem Viakhirev, managed together with other men from St. Petersburg to consolidate control over the gas monopoly. The same group decisively squeezed rivals out of another manger—control over armaments exports. It also looks like the electric power industry might eventually be taken over by people close to Putin. And the outcome of the Kremlin’s attack against Khodorkovski’s Yukos at this point seems bound to be the merger of that company or a large part of it into a large new oligarchic group of banks and companies controlled by Putin and his loyalists.

It turns out that the government-arbiter model is closely intertwined with rivalry inside the government for redivision of property and high profit niches. But it is evident that Putin is not out to destroy the dominance of oligarchic groups. Rather, he is integrating his own sphere of business interests into the prevailing oligarchic structure. This approach is also consistent with the neoliberal model of economic policy, according to which the state should only care for creating a generally favorable atmosphere for economic development by conducting reforms in the interests of business, while minimizing its active intervention in the economy. This model serves as the basis of economic policy for Putin’s government and in principle precludes any active role of the state in correcting existing imbalances and restoring macroeconomic equilibrium.

One has to bear in mind that the liberal model is more or less successful in economies that grow evenly, without large fluctuations, and do not suffer from large structural imbalances. In such economies, the role of government intervention can be indeed minor because the market mechanism tends to spontaneously correct small, temporary imbalances and fluctuations. However, the same model when applied to the Russian economy of today is not practical and is even harmful.

One of the two largest structural imbalances in the Russian economy is its undue dependence on exports of energy and raw materials, while other sectors, including manufacturing, are relatively undeveloped.
and stagnant. The basic reason for this imbalance is the skewed distribution of gross profit in the economy, which tends to be continuously reproduced and has no spontaneous mechanism for self-correction. In normally functioning competitive markets, prolonged large deviations of sectoral profit rates from the macroeconomic average are not possible. If profitability in one sector substantially exceeds the average, capital tends to flow into that sector until profitability there is equalized. This mechanism does not work if inter-sector flow of capital is inhibited by economic, natural, or other barriers. In the case of oil and nonferrous metals in Russia, these barriers do exist. Oil deposits are captured by a narrow group of companies that use natural and geographical factors to close entrance to new competitors.

Equally important is the reverse effect. Since the gap in profitability remains, excess capital created in the energy and raw materials sector fails to find its way into other sectors where profitability is much lower. A vicious circle is created, a trap that normal forces of competition cannot overpower.

In the competitive model, super-profits gained from the natural rents of mineral resource exploitation are partly or wholly appropriated by the land’s owner. In Russia, as in many other countries, private ownership of land is recognized, but the state still retains ownership rights to land that lies above the deposits of oil, gas, metal ores, etc. Exploitation of mineral resources by private companies is subject to licenses granted by the state. The latter therefore has the title to all or most of the mineral rent—above-normal profits earned by private leaseholders. In the early 1990s, licenses for these purposes were granted at bargain basement prices, that is, practically for free. But this is not necessarily a final decision. If the government decides to extract a much larger share of the rent than it collects today, it has all the rights to do so. The exact share to be taxed is a matter of economic expediency, that is, determined by the need to equalize sector rates of profit as much as possible and as is practical. Even the neoliberal-minded current government seems to agree that movement in that direction is essential. The major impediment is not so much
technical issues of rent taxation, but rather the active opposition of oligarchic groups that so far considered themselves the owners of the nation's mineral resources and do not wish to share their excessive incomes with other sectors of the economy.

The government attack on Yukos involves partial redistribution of oil rent to the state budget, but it solves the problem as an individual company case, not as an industry rule. Other oil companies continue to appropriate their excessive rent from oil, at least for now.

The refusal or delay in resolving this issue serves to impede Russia's economic development. GDP growth rates depend on growth of its sector components. If half or more of capital investment continues to go into energy and raw materials, then the overall growth rate of GDP will be determined by growth in that sector. But because it is export-oriented, its growth rate will be tied to growth in foreign demand, that is, to average growth rates of the world economy. In that case, one can well forget the need to expand at much higher rates, as demanded by President Putin.

Faster rates of GDP growth are only possible under quick expansion of manufacturing, which is oriented toward domestic markets and is not restricted by average growth rates of the world economy. And the only means to accelerate growth in manufacturing, as noted, is to rechannel excess capital created in the "rent" sector into other branches of the economy. Accomplishing such redistribution without active government intervention is impossible. But the state can perform this maneuver only if it eliminates in deed, not only in words, its dependence on oligarchic groups that have saddled the "rent" sector.

But even apart from resolving this crucial issue, the role played by economic policy in Russia is extremely weak. The government is practically refusing to use any active forms of fiscal policy. For instance, such well-known ways of stimulating growth as government purchase of goods that are temporarily in poor demand or government-financed investment in infrastructure are completely ignored by the authorities. Even in tax policies—the only fiscal sphere where evidence of government intervention is seen—the state acts very indecisively and
Menshikov considers short-term fiscal objectives to take precedence over long-term needs to stimulate economic growth.

Practically absent is any trace of active monetary policy. The principal government economic activity is to promote so-called structural reforms that are centered on privatizing those parts of the economy that are still run by the state. In the process, control by oligarchic groups is strengthened even more while the stimulatory role of the state is further diminished. At the same time, the role of government in reforming such crucial spheres as the banking industry and capital markets is close to zero.

Neither has the Russian government used the powerful weapon of industrial policy to help develop competitive domestic manufacturing and high-tech industries. The industrial structure remains fixed despite quantitative growth, and neither business nor the government shows an interest in promoting the "new economy," that is, computers and informatics. In terms of technical progress, the country is completely stagnant.

A major result of oligopolistic and oligarchic dominance in the economy is the permanently excessive share of gross profit in GDP and consequently the continuously low share of wages and salaries (labor income). Apart from the major sector imbalance cited above, this is one of the principal reasons for the narrowness of the domestic market and the impossibility of fully utilizing all capital generated inside the country. Even if the sectoral imbalance were to be corrected, the remaining disproportion between gross profit and labor income would preclude accelerated economic growth.

With gross profit exceeding 40 percent of GDP, the share of labor income (after deducting net indirect taxes) stands at only 43 percent. This explains why personal consumption expenditure is less than half of GDP. Together with the average share of gross capital investment at 16 percent, this is only 66 percent of GDP. In other words, total output can be fully sold domestically only if government purchases and net exports amount to 34 percent of the total. Because government purchases on the average take out another 16 percent, a full 18 percent has to go to net exports. This is only possible if an
exorbitant proportion of fuel and raw materials is sold abroad at high prices.

It is unrealistic to believe that this condition will remain for long. A better decision is to slowly but surely increase the share of labor income and consequently of consumer expenditure in GDP. This should help expand domestic markets for products of Russian manufacturing.

The low share of labor income in GDP is another way of saying that distribution of income in Russia is extremely unequal and that inequality has sharply increased in the last decade. The gap between the top and lowest income quintiles of the population reached 6.4 times by 2000 as compared with only 2.6 in 1991. In the same period the Gini coefficient increased from 0.26 to 0.39. Regional and sectoral differences in average personal income are extremely large, making Moscow look like a relatively booming oasis surrounded by a provincial Sahara of widespread poverty, most of it permanent and self-reproducing. A quarter of the population is living below the official poverty level, and another 45 percent can be considered on the brink of poverty. According to the latest surveys by retailer research organizations, 60-75 percent of the population spend practically all their disposable income on food. Only 15-20 percent, at the most, enter the definition of a middle class, reducing effective consumer purchasing power to a very small minority.

To put the issue into an international perspective, compare Russian figures on GDP composition with relevant U.S. data for the decade of 1989–99 (see Table 1).

In the United States, with more normal shares of gross profit and labor income, the total share of personal consumption and gross capital investment is as high as 82 percent. Since government purchases account for 18–19 percent on average, practically the whole national output is sold inside the country, while a relatively small export share is fully compensated by adequate imports.

Increasing the share of labor income and reducing the share of gross profit would allow the Russian economy to be relieved of its undue dependence on external markets and create a solid foundation for sustained economic growth oriented mainly toward the domestic
Table 1

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<tr>
<td>Gross profit</td>
<td>40.7</td>
<td>34.9</td>
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<tr>
<td>Labor income</td>
<td>42.9</td>
<td>57.2</td>
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<tr>
<td>Personal consumption</td>
<td>49.7</td>
<td>66.8</td>
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<tr>
<td>Gross capital investment</td>
<td>15.7</td>
<td>14.9</td>
</tr>
<tr>
<td>Personal consumption and gross investment</td>
<td>65.4</td>
<td>81.7</td>
</tr>
<tr>
<td>Government purchases</td>
<td>16.5</td>
<td>18.9</td>
</tr>
<tr>
<td>Net exports</td>
<td>18.1</td>
<td>-0.6</td>
</tr>
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Sources: Russian Statistical Yearbook (Moscow: Goskomstat, 2002); Economic Report of the President of the United States (Washington, DC: GPO, 2000).

market. There is no need to decrease the share of capital investment, which is large but structurally disoriented. A larger share of gross profit should be spent on modernizing and expanding productive fixed capital with the aim of reducing the capital-output ratio and increasing economic efficiency of investment.

Making this turnaround within the bounds of neoliberal economic policy is hardly possible, at least not in the short- or mid-term perspective. It is therefore easy to project the direction of further economic development in Russia in the absence of necessary corrections.

1. The economy will continue at best to grow at moderate speed that would not permit a substantial reduction of the current gap between Russia and industrial nations of the West in per capita GDP and living standards. In the worst case, a drastic fall in oil and raw materials prices will put a brake on growth and make the income gap even larger, not smaller.

2. Technical progress will continue to stagnate, and most Russian industries will remain noncompetitive in world markets. Russia will not be able to escape from its current position on the periphery of the world economy and will retain its extreme dependence on the industrial world for at least one or two de-
cades. It is quite possible that control over key economic assets in the country will be captured by foreign transnational companies.

3. At average growth rates and with a further decline in the state’s share in GDP, the sphere of redistribution of income will become even narrower and the conditions for financing education, medical care, science, and art will become even worse.

4. At the same time and for the same reasons, it will become impossible to maintain Russia’s military potential at levels necessary to guarantee its national security. Russia’s role as a global power would further diminish due to its economic and military weakness.

Such a perspective is not one to the liking of the Russian elite or the majority of its population. The question arises as to possible alternatives.

**Possible Alternatives and Policy Solutions**

To find alternatives to Russia’s economic inertia means determining ways to change the current mechanism described above.

*Maximalist* ways that have been suggested amount to destroying the very foundations of monopoly and oligarchic control and making the state a truly independent and active agent helping to form long-term economic processes in both the various industrial sectors and the economy at large. These suggestions include renationalizing some key industries and operating a large government-owned sector within the framework of a mixed economy, which would largely retain the principal contours of private entrepreneurship and a market economy.

It is the consensus of most Russian economists that retaining and expanding the market is necessary for maintaining equilibrium at the micro, meso, and macro levels. But it is also admitted that while markets are necessary to maintain long-term proportions, they are not in a position to correct major structural imbalances when the
latter tend to become too large and rigid. To make the necessary adjustments, the state should play a more active role. But a substantial number of economists would argue that large-scale renationalization at this point would be destabilizing from a political, social, and economic perspective.

A more realistic approach would be to try to tackle the same issue by avoiding a wholesale breakdown of oligopolies and oligarchic groups and instead placing certain adequate limitations on their activities. This outcome is possible if the state is transformed into a truly independent power that would be able and willing to induce oligarchs to adhere to certain clearly defined rules of economic behavior and refrain from attempts to unduly impose their will on formulating policies.

In practice, even this minimalist approach could lead to a sharp confrontation with forces within the elite that are closely connected to the oligarchs and are defending their interests. It is no secret that most of the leading newspapers in the country belong to oligarchic groups and that at least some electronic mass media are under their strong financial influence. Some political parties fighting for seats in the parliament are known to be financed by big business. Its strong influence can be also seen at the level of important provincial governors and big-city mayors. Fighting for meaningful anti-oligarchic reform in these conditions is extremely difficult.

Yet, it is quite possible and indeed indispensable to educate the elite and the populations to see realistic alternatives to current economic policies and the dire need for them to be implemented in the national interest. One has to bear in mind that there is no unanimity on these issues at the top of the government. For instance, Vladimir Putin made quite a sensation three years ago in his State of the Nation address to parliament when he suggested redistributing mineral rent to other sectors of the economy. Following the president's initiative, some taxes were indeed raised on oil companies, but these changes were relatively minor and did not resolve the major imbalance issue.
In the past two years, the government, while remaining under strong pressure from the oil lobby, has officially recognized the need to improve the oil and raw materials imbalance in the economy. A project was suggested to reduce taxes for manufacturing industries while retaining them at current levels for the oil and raw materials industries. This shows some movement in the right direction, but the rate of change is small, practically close to zero.

Of late, the authorities have been raising the issue of reconsidering some of the results of privatization in the early 1990s. The issue became nonacademic when billionaire Yukos shareholders Mikhail Khodorkovski and Platon Lebedev were arrested in 2003 and brought to trial on charges of illegally appropriating government-owned assets and gross tax evasion. But, as mentioned above, the drive against Yukos is still an exception and does not signify a drastic break with neoliberal policies.

One of the neoliberal dogmas is that the state should not be involved in the economy. This may be true in countries where business is active in areas that are particularly crucial for maintaining a healthy economy. But in Russia this is not the case. For instance, the major structural imbalance between mineral resources and manufacturing would not have occurred had the government retained ownership of the largest oil companies instead of selling them practically for free. Had that happened, the issue of taxing mineral rent would not have emerged as a major structural problem. It is not true that privately run oil companies show a better performance than government-owned concerns. A careful comparison of financial reports of privately owned Yukos and Sibneft with that of government-owned Rosneft shows practically similar rates of reported net profitability. There is nothing particularly new in terms of products or technology that private concerns have introduced in the enormous Soviet-built oil industry since they took over. The same is true of the aluminum or nickel industries.

But that is ancient history today. The most pressing problem is how to make the state the major recipient of rent earned on its oil properties. This could be done by keeping the private oil companies running as they are but changing ways in which their incomes are taxed.
A recent suggestion to tax excessive rent incomes is worth considering. A tax on mineral rent (i.e., super-profit above economic or industry average) is one obvious solution. For instance, any profit exceeding the average of 20 or 25 percent of gross revenues should be considered a super-profit and taxed at, say, 50 percent or more compared with the current normal profit tax rate of 24 percent.

Another proposal is to introduce special taxes on capital gains of the oligarchs and on their dividends transferred out of the country. The dividend proposal is straightforward and provoked by two recent dividend payments of $1 billion each by Sibneft oil company, which is obviously pure mineral rent that has not been taxed by the government and is way above the company's needs for domestic investment. Ninety percent of Sibneft shares are known to belong to Roman Abramovich. The point is that the $1.8 billion paid out to this gentleman was officially taxed at only 4 percent under the existing more than liberal tax laws. That in itself is socially unfair since the flat personal income tax rate is set at 13 percent.

In addition, the money is being spent outside the country, including Abramovich's $300 million acquisition of the Chelsea soccer club in Britain, purchase of a $90 million luxury yacht allegedly registered in the Bahamas, and ordering of a new Boeing 767 for his personal use. Large dividends in excess of $10 million should be taxed at a minimum of 50 percent and, when transferred abroad, at an even higher rate of, say, 75 percent. This would be a fair means of returning at least some of the mineral rent appropriated by the oligarchs due to lax taxation in former years.

The capital gains tax proposal is a trickier affair. For instance, in the case of Yukos, which in 1995 was bought for a meager $300 million and saw its market capitalization rise to a maximum of $33.1 billion by early August 2003, the capital gain for the major stockholders who own above 70 percent of the total is enormous. The reasoning is that it can be taxed only if turned from paper into cash profits. However, there is an interesting precedent. In the UK, following Margaret Thatcher's privatizations, a rule was set obliging the new owners of the privatized companies to pay a tax of 38 percent on
the capital gain in market value of their shares in the period between their initial acquisition and a certain future date. This precedent could also be used in Russia to help return part of the oligarchs' windfall profits to the government.

Alternatively, they should be taxed on the market value of their property at a rate that is certainly higher than the 1 percent or lower tax applied to personal worth and is so small that its collection is ceded to municipalities. Applying a tax on marketable personal assets of, say, 4 percent would have Khodorkovsky pay at least $320 million annually to the federal exchequer on his $8 billion fortune. Making the tax retroactive to previous years would go a long way toward compensating the state for selling Yukos way below its market value.

Another pressing issue is to make easier the transfer of excess capital from oil and nonferrous metals into manufacturing and particularly high-tech industries. Apart from creating additional government-run financial institutions to compensate for the underdeveloped banking sector, the government should take special measures to promote the expansion of the capital market as a major channel of capital flows into capital-deficit industries. Special care should be given to reforming the banking industry into a genuine public utility and expanding the insurance business, mortgage and consumer credit, and various forms of mutual and other investment funds. When private capital is unwilling to adequately invest in these activities, the government should, at least on a temporary basis, set up its own institutions to close the gap.

The same is true of government concerns that could lead in developing competitive manufacturing industries where private capital is slow and reluctant to do so. The automobile, aircraft, and computer industries are some examples that easily come to mind. Mixed ownership could act as a good start to spur these largely dormant areas. German and French experience (Volkswagen and Renault are two examples) could be used in these exploits.

Another essential area of alternative economic policy is the consistent improvement of labor share. The comparison with the United States illustrated above shows the inordinately low share of labor in-
come in the Russian economy. But the share of labor income in the United States was not always as high as it is today. For instance, it was only 49 percent of GDP in 1929—practically the same low level as in Russia (see Table 2). However, in the following decades, it increased to 58-59 percent and has been oscillating around that level for the last thirty years. If such an improvement was possible in the typical market economy of the United States, it should be possible in Russia as well and would not contradict market rules whatsoever.

In the United States, this improvement occurred as a result of major structural and institutional changes. Most of these changes occurred in the first two decades after World War II and largely under the administrations of the Democratic Party (Truman, Kennedy, and Johnson) that pursued reforms in the spirit of John Maynard Keynes and the welfare state. These policies led to a substantial increase of the share in GDP of government purchases and the larger role of trade unions in determining wages. Consequently, the structure of domestic macroeconomic demand drastically changed.

In 1929, personal consumption accounted for 75 percent of final domestic demand, gross investment for 14 percent, and government purchases for only 9 percent. This structure is consistent with relatively low taxes that do not present a substantial deduction from either

Table 2

Macroeconomic Proportions in the United States, 1929–1999 (% of GDP)

<table>
<thead>
<tr>
<th></th>
<th>1929</th>
<th>1957</th>
<th>1981</th>
<th>1999</th>
</tr>
</thead>
<tbody>
<tr>
<td>Labor income</td>
<td>49</td>
<td>56</td>
<td>59</td>
<td>58</td>
</tr>
<tr>
<td>Personal consumption</td>
<td>75</td>
<td>62</td>
<td>62</td>
<td>68</td>
</tr>
<tr>
<td>Gross investment</td>
<td>14</td>
<td>15</td>
<td>17</td>
<td>17</td>
</tr>
<tr>
<td>Government purchases</td>
<td>9</td>
<td>22</td>
<td>20</td>
<td>18</td>
</tr>
<tr>
<td>Net exports</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>-3</td>
</tr>
<tr>
<td>Gross profit</td>
<td>44</td>
<td>36</td>
<td>34</td>
<td>35</td>
</tr>
<tr>
<td>Investment as % of gross profit</td>
<td>34</td>
<td>42</td>
<td>50</td>
<td>49</td>
</tr>
</tbody>
</table>

personal consumption demand or from companies' resources for capital investment. In 1929, tax deductions accounted for only 2.7 percent of total personal income and only 13.5 percent of corporate gross profits. This is what big business in Russia considers an ideal macroeconomic structure today. But one can argue that the 1929 structure led to the Great Depression, in which consumption demand turned out to be grossly inadequate and the economy was helpless in the absence of government anticyclical policies and stabilizers. That lesson has been largely forgotten today, but it is worth recalling. Russia is not at all immune to depressions of the old U.S. type.

But the United States was then so apprehensive of a possible repetition of the Great Depression that it drew the necessary conclusions. By 1957, the share of personal consumption in GDP fell to 62 percent, but government purchases rose to 22 percent, fully compensating for the potential loss in aggregate demand, while gross investment remained practically unchanged at 15 percent. The new structure of final demand reflected the increased role of government as a factor of economic stability and was consistent with higher taxes. Tax deductions from personal income rose to 11.5 percent (on the average), taxes on corporate profits to 48.7 percent. The personal tax increase by eight percentage points "ate up" part of consumer demand, but because the share of labor income rose by seven percentage points—from 49 percent to 56 percent of GDP—one compensated for the other. It is also noteworthy that a 3.5-fold increase in the corporate profit tax did not negatively affect the share of gross investment. In fact, business now spends nearly half of its gross profit for capital investment, compared with a third in 1929.

The rise in labor income reached its peak in 1981, by the end of the welfare state reforms. After that, particularly as a result of Reaganomics and following the neoliberal dogma of minimizing the role of government, the share of labor income started falling. This turnaround marked the end of government cooperation with trade unions and a more aggressive policy toward labor.

In 1929-57 aggregate labor income rose at an average annual rate of 6 percent, faster than growth of nominal GDP at 5.5 percent. At that time the unions succeeded in imposing the rule under which growth
in money wages should compensate for both the rise in labor productivity and consumer price inflation. This principle was recognized in collective agreements, and, while helping to create a weak inflationary background, it also promoted growth in aggregate demand and helped make recessions weaker and shorter.

In Russia, the role of trade unions is extremely low. What an alternative incomes policy needs is to guarantee by legislation labor's more active role and the need for the faster growth of aggregate labor income compared to GDP for a substantially lengthy period. Russia could make use of the experience of indicative planning in France, where the government together with trade unions and industrialist associations determined major macroeconomic proportions, including absolute and relative growth of labor income.

Such a policy is likely to meet strong opposition from big business, which wishes to consider any rise in the share of labor income as a reduction in profits. But this is not necessarily true. Given proportions that guarantee fast overall economic growth, profits tend to rise in absolute terms, even though their share in GDP may be reduced.

Another important point is to convince the business community that it has to separate the issue of reducing taxes from that of reducing government expenditure. Lower government expenditure will further reduce aggregate demand and slow economic growth. It will not necessarily free more resources for capital investment.

Policy Recommendations

To summarize, a program minimum of proposed measures can be formulated in the following few points:

1. To establish effective control of the state, as proprietor of the nation's mineral resources, over an adequate large share of the mineral rent and to rechannel it via the government budget and private capital markets into the chronically capital-deficient sectors of the economy. This objective implies the introduction of four special taxes:
• tax on mineral rent;
• tax on market value of shareholdings;
• tax on capital gains shareholdings in privatized, formerly government-owned companies;
• tax on large dividends, particularly those transferred abroad.

2. One of the basic principles of business tax policy should be equalizing profitability in the various sectors of the economy. Sectors with higher profitability should pay higher taxes.

3. Government should retain its presence as owner and manager of business companies in those economic sectors where private capital is slow to invest in modernizing and expanding competitive productive activities. This principle should apply to key manufacturing industries as well as to lagging spheres of financial and other business infrastructure.

4. Government and mixed companies should be especially promoted in sectors with a particularly high potential for competition in foreign markets.

5. In general, the government sector should be used as a major means of promoting competition. By changing its basic business rule from maximizing profit margins to increasing output at reasonable prices, the government sector could act as a pioneer in breaking up monopoly behavior in the Russian economy.

6. Government incomes policy should center on joint determination with trade unions and business associations of major macroeconomic proportions that guarantee fast and stable growth of the economy. Particular attention should be given to a carefully coordinated program of raising the share of labor income to about 60 percent of GDP and drastically reducing the share of poverty and near-poverty income groups of the population.

7. Practical considerations, not ideologically motivated models, should be used as the basis for economic policy decisions and long-term strategies.
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