


# Russia, on the Way to Economic Prosperity



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Is Russia on the way to economic prosperity? So far, the answer is yes—although the abrupt economic transition has entailed several business downturns—the nation has experienced fast long-term growth over the last two decades since it escaped from the transition turbulence of 1998. The annual average growth rate of Russian GDP per capita after 1998 amounts to 3.92%, significantly higher than 1.65%, the world economy's average growth rate over the same period.

However, as is always, there are not only rosy prospects on the Russian economy; more precisely, pessimism regarding Russia's future economic growth seems to be gradually dominating, particularly in the last few years. This ominous mood has been boosted since the recent Russian financial crisis between 2014 and 2017. The tragic crisis, mainly the result of sudden drops in both the value of the Russian currency and international oil prices, reveals the vulnerability of the Russian economy to an external shock, and hence the fragile fundamentals of the economy. Consumption and investment plummeted during the period and a sizable amount of capital flew out, all of which led to dire low-growth during the

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crisis and even minus growth in 2015. The crisis also shifted the long-term growth trend of the Russian economy downward, and full recovery has yet to happen, with the growth trend remaining below what it would have otherwise been.

Hence, it is not very surprising to encounter growing negative views on the prospect of the Russian economy that it either may fall or has already fallen into the so-called middle-income trap (MIT, henceforth). The MIT generally refers to a situation where the growth rate of a middle-income economy stays at a relatively low level, so that its economic development lags behind more advanced economies. The MIT originates from a fundamental property of production in the real economy, namely that the contribution of adding more inputs (labor and capital) to economic growth gets smaller along with further growth.

Therefore, this property, known as the decreasing returns to scale, marginalizes the contribution of adding more inputs to growth, especially for any economy where factors of production are already substantial. On the contrary, this property warrants the importance of "qualitative growth," referring to growth through enhancing the overall productivity of the economy, which is called the total factor productivity (TFP, hereafter), since an increase of output by improving TFP is free from the unavoidable decreasing returns to scale property. Such qualitative growth is, therefore, integral to steady economic growth for a middle-income economy such as the current Russian economy, which has already passed early stages of development, where growth through adding more inputs, or "quantitative growth," can be a befitting strategy for fast economic development.

A careful look at Russian economic data indeed suggests that the glorious high long-term growth after its transition was primarily led by adding more inputs, partly benefiting from abundant foreign investments coveting the rich endowment of natural resources in Russia. It is, therefore, fair to say that those quantitative additions of more inputs largely contributed to the rapid economic growth particularly in the initial stage of development during the early 2000s. However, as the Russian economy grows on, any increase in output from a marginal addition of such inputs is destined to be thinner due to the decreasing returns to scale property. This, in turn, implies that the Russian economy should raise its TFP for persistent growth in long run, or equivalently, for stepping further toward economic prosperity. That is, Russia must pursue qualitative growth, not the quantitative growth to which it has resorted up until now.

Then, how can an economy foster its TFP in order to guarantee continuing growth in long run? To answer this question, we need to clarify what TFP exactly means. In a nutshell, TFP essentially indicates how much factors of production can be efficiently used for goods and services production. Hence, TFP must be closely related to the technology level of an economy as possessing more advanced technology equates into higher efficiency in production, and output per worker will be higher with state-of-the-art production systems in the workplace. This is why many governments try to promote their technology level by investing in R&D themselves and by inducing firms to make R&D investments through a variety of pecuniary incentives such as R&D tax credits.

In addition to the technology level itself, TFP is also closely related to a subtler—and actually more important—aspect of society. Namely, TFP depends crucially on how efficiently resources—not only material factors of production but also intangible ones such as agents' skills and talents—are allocated and organized in society. Suppose that a firm is poorly run but somehow monopolizes all the resources of production. Then, the total output would be smaller than what more capable firms or entrants produce. This is efficiency loss, rendering lower TFP. By the same logic, if for some reason innovative agents are not willing to take a risk launching their creative ideas and instead mediocre agents attempt to innovate, the odds of success in innovation will be slim, and this hampers growth of TFP; recall that TFP is positively associated with the technology level, which increases with successful innovations.

The thing is that, this subtle aspect fundamentally determining TFP must be ultimately related to social factors such as institutions and culture—which we call the "superstructure" of society, borrowing Marx's term—that settle upon what is called the "substructure,"—coined by Marx again—which refers to economic factors at large. Of course, the super- and substructure are interconnected with each other, and superstructure affects substructure chiefly through governing incentives underlying all kinds of economic activities. For example, poor protection of individual income, wealth and property rights will lower incentives to work, invest and innovate, respectively, yielding less production, investment, and innovation. Corruption that prevents more efficient firms and creative agents from engaging in economic activities lowers TFP for the reasons aforementioned in the previous paragraph. Inefficient and weak enforcement of laws rationalizes rent-seeking, thus encouraging redistributive activities that incur a waste of resources affiliated with attacks and fortification for acquiring and defending individual possessions. Also, it is known that collectivism as a specific cultural dimension that punishes for dissenting, standing out, independence and self-reliance is detrimental to the incentive to innovate, so it hinders TFP growth.

Interestingly, and unfortunately, all the examples of adverse institutions and culture to TFP mentioned right above are what Russia currently faces. First, Russia has somewhat poor institutional quality in terms of the protection of property rights and individual ownership compared to more economically developed countries in Europe and North America. Second, Russia has suffered from widespread and severe corruption issues. Similarly, prevalent rent-seeking has decayed efficiency in allocating and organizing resources across sectors, industries, firms and individuals. Also, Russia has fairly collectivist cultures, as other pre-communist societies do, and hence, its efficiency in innovation will be lower than less collectivist societies with other things being equal. The real problem is that it is commonly demanding to *fundamentally* tackle these problems, since it is typically difficult to change superstructure. There are likely to be conflicting interest groups curbing reforms that could possibly enact good institutions and culture, and thus, the superstructure tends to remain the *status quo*, resulting path-dependency.

All in all, we finally come up with a new question, which is more intriguing and meaningful than the question posed at the very beginning of this manuscript. The new question is: "Will Russia still be on the way to economic prosperity?" It depends; the answer will be yes only if Russia raises its TFP by implementing sound institutions and culture through, if necessary, political, cultural and social reforms. This is challenging, but more economically advanced countries have gone through already. So should Russia. **KIEP**