

*Bear Traps
on Russia's Road to Modernization*

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Two Themes:

- 1. Danger of misdiagnosis of economic problems.**
- 2. Myths about what produces growth.**

1. Danger of Misdiagnosis

- The inputs (physical capital, labor, human capital) into Russia's production function are all mismeasured.
- They are assigned inflated values because of failure to take into account that they are handicapped by nature and by legacies.
- Mismeasurement (inflation of value) of inputs
→ wrong analysis of causes of low output →
wrong policies to increase growth.

2. Myths about What Produces Growth

Especially on human capital side.

Findings:

- The loss to the Russian economy from handicapped capital” is very large.
- For physical capital inputs alone, handicaps may be causing Russia to underperform by as much as 30% compared to most-advantaged competitors.
- Human capital and labor handicaps add even more.
- Russia performs as well as it does only thanks to oil.

Policy Conclusions:

1. Remove existing handicaps to capital; avoid adding more in future.
2. Concentrate even more on oil and gas — a “Resource Track” policy instead of false “Modernization.”

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Introduction - 1

- Modernization is more than just having new capital.
- If the location, structure, and production and supply chains are not appropriate, then merely replacing the depleted, out-of-date capital with physically new capital is not true modernization.

Introduction - 2

- “Scrapping problem” — choice between (1) replace old machines with new ones or (2) scrap entire technology/approach, start fresh.
- (1) produces short-term results, but dooms to long-term failure. (2) is costly in short term, better in long term.

Introduction - 3

“Making mistakes and correcting mistakes”

- The Soviet economy made very large mistakes and allowed them to persist for too long.
- Free market economy makes many mistakes (because tests more). But corrects quickly.
- Harsh process, disruptive. Risky. Cannot be overly afraid of chaos and instability.

1. Historical Prelude

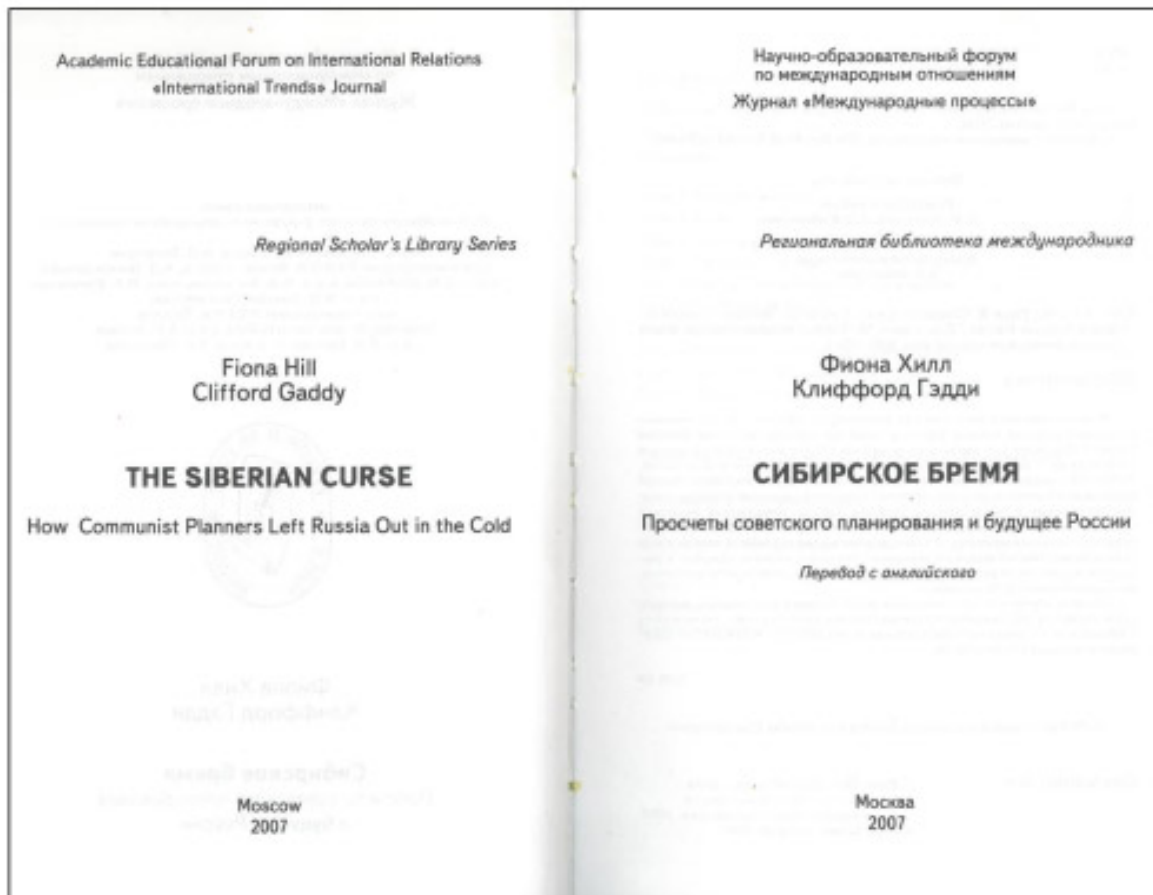
Russia's transition:

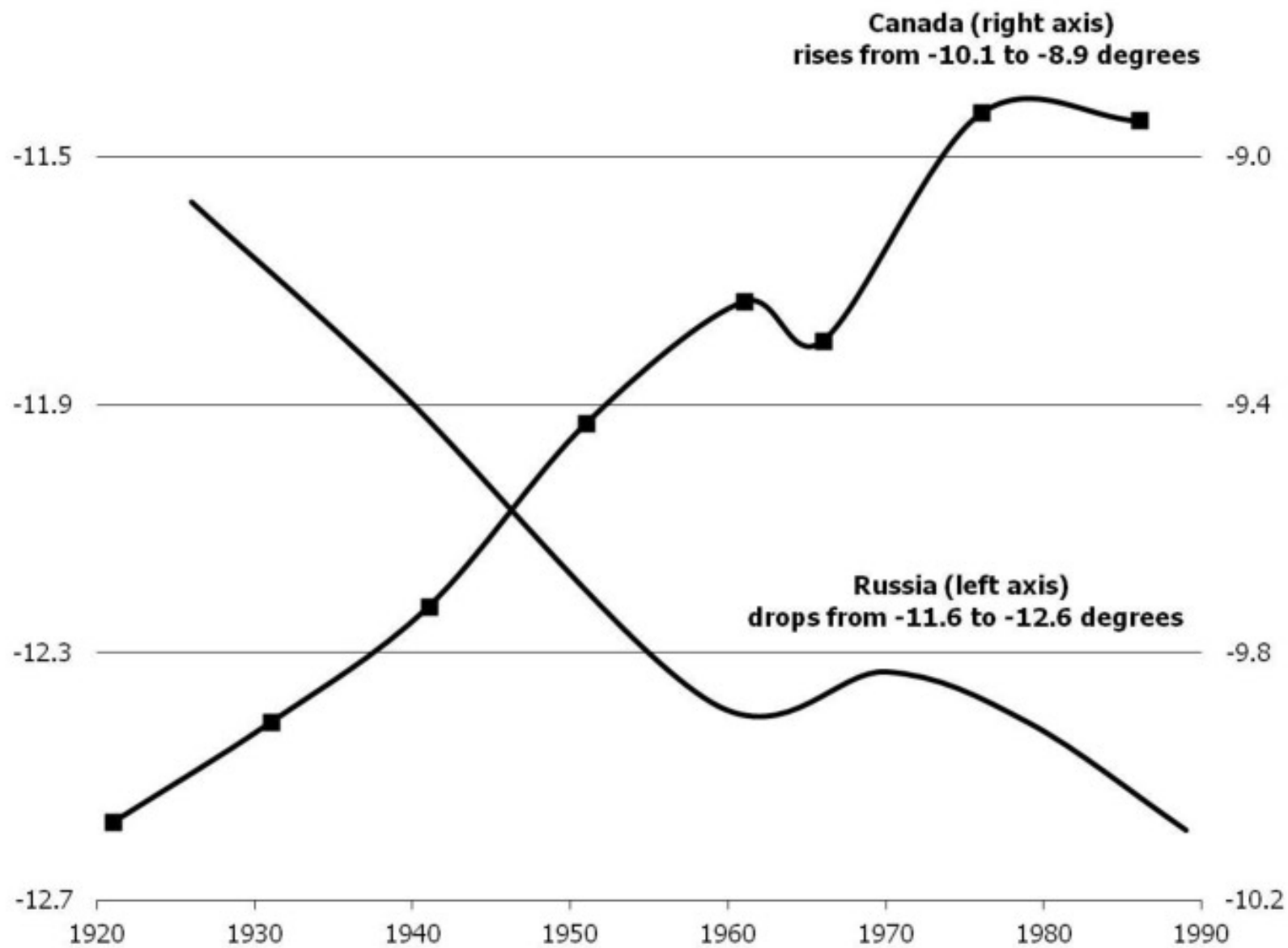
- No write down of value of assets inherited.
So old assets kept, with illusory value.
Everyone complicit in maintaining
pretense.
- Subsidies. Virtual Economy.
- Needed to maintain location, structure,
chains.

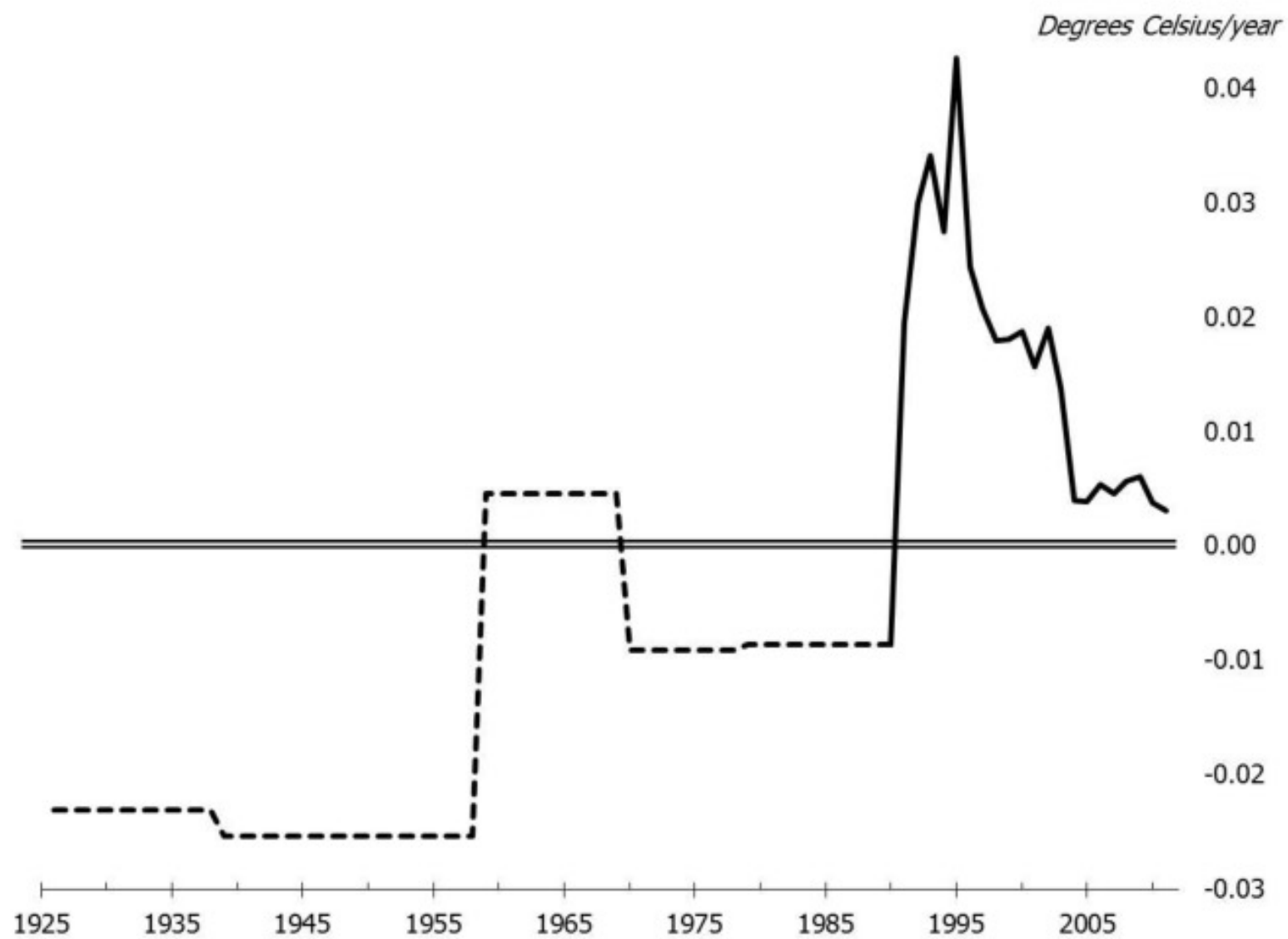
2. Investment (physical capital)

- Illusory value of assets = inflated value. Handicapped by location, historical legacy, production relationships.
- τ -factor (tau-factor) = discount. Gap between actual and measured value.
- Why is this important? Because we misjudge the cause of poor performance. You think you have lots of capital. When performance fails to live up to expectations, blame low productivity due to “institutional” failures, Rule of Law, corruption, etc.
- And fail to remove handicaps.

3. Economics of Location [="Siberian Curse"]







Not only cold; also distance (remoteness).

Should Russia then focus its resources on modernizing its transport network? In the typical country with such an inadequate network, the returns to such investment would be high. But it is important to think about the problem more carefully in the case of Russia. While improvements in transportation infrastructure will have cost-reducing effects, they will do nothing to eliminate the burden of a highly dispersed population and the lack of empty space. Building a transportation network to minimize the costs of the current spatial location is a bear trap. Even a cost minimizing, efficient transportation system cannot eliminate the burden of running an economy that is spatially misallocated. In fact, it would likely deepen the problem in the long term. Such a system would still be needlessly high-cost relative to its competitors abroad. A policy of this sort ignores the opportunity cost of the cities. If the cities should not be there, building more roads to them makes things worse. It is not a sunk cost. If it were, it could just be written off as a mistake. But expanding the transport infrastructure to connect cities over vast distances reinforces the original mistake and creates even more costs in future. Even more wasteful than the "Bridge to Nowhere" is a "Bridge to Somewhere that Should Not Exist." Rather than spending money to build more and better roads to connect non-economic locations, policy should be directed at phasing out those locations, making them less important. Resources could instead be used to better link cities and people that are more rationally located.

4. Federalism — “Lights On”

- Normally, federalism is good. Competition, check on predation by central government. Assumption is that each region can be winner, can grow. But efficiency \neq growth everywhere. Some regions should shrink.
- But Russia's federalism allows all to fight against shrinkage.
- Moreover, winner regions do not want losers to reform! Reform causes externalities for winners. So winners (Moscow) supports policies to keep population in place. Cheapest way? Keep factories going at minimal level, “keep the lights on.”

5. Human Capital

Population size. The population is shrinking, to a greater extent and for a longer time than almost any other country's today.

Age structure. The working age population is collapsing. The number of young and old people each productive worker will have to support (the "dependency ratio") is going to rise sharply.

Fertility. Birth rates are down.

Mortality. Death rates are up. Not only are they much higher than those of the rest of the world, but they have grown worse over recent decades.

Health. The overall health of the population in all age groups is poor.

Education. The stock of skills is in question. The education system appears to be performing poorly despite high levels of education per worker.

5. Human Capital

Ask, how affect growth?

Population size — NO

Health — NO

Education — YES (but measure correctly)

Location — YES!

6. Conclusion

- “War on Moscow” → centralized “Lights On”
- Our proposal: “Resource Track” — embrace natural resources sectors, especially oil and gas.
- Make it national priority, higher even than military defense sector.