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**Public Preferences and their
Role in Shaping Russian
Economic Development**

Warsaw, October 15, 2004

Main Topics

- Why are Strategic Issues so Important for Russia Now?
- Individual and Group Interests
- Interests of a Group: What They are and How They Emerge?
- Market as a Mechanism of Formulation and Realization of Public Interests
- Why not Market Alone?
- GDP and Public Welfare
- Russia at the Crossroad: What's at Stake?
 - Government's Approach
 - Elements of the “Breakthrough Strategy” for Russia
- Two Main Conclusions

I. Why are Strategic Issues so Important for Russia Now?

- Current economic situation of the country is good enough
- Unprecedented decline of the economy in the 90-s has left a series of dangerous long-term problems:
 - an *extremely high level of wear and tear* of industrial capacities as a whole and production infrastructure in particular;
 - *exaggerated reallocation of resources in favor of raw materials sectors* along with obvious degradation of hi-tech industries;
 - *extremely high level of income differentiation* both among the members of the society and the regions of the country.

II. Individual and Group Interests

Preferences, Interests and Priorities

- Preferences *rank different states of the world* (i.e. commodity bundles for consumer)
- Interest – the *best state of the world* (commodity bundle) affordable under resource constraints (it is therefore located on the indifference curve to which resource constraint is tangent)
- Priority – an *activity, which provides for higher marginal utility than other activities* do (therefore, in optimum position, there can be no priorities)

II. Can Approach to Individual Interests be Applied to Group Interests as Well?

- The essence of a parallel:
 - A group has both a set of preferences with regard to feasible states of the world and limited possibilities (resources) at its disposal;
 - The group's interest corresponds to the affordable state of the world at the highest indifference curve (equal marginal returns of resources would characterize this optimal position)
- The problem:
 - In the case of an individual preferences may be regarded as *exogenous*
 - In the case of a group they are *a result of interaction between preferences of individual members of the group*

III. Interests of a Group: What They are and How They Emerge?

Grounds for Doubts

K.Arrow's famous "possibility theorem":
only "benevolent dictator" can provide for social choice rule, which would permit such a ranking of possible social outcomes that would be asymmetric and negatively transitive, Pareto efficient and independent of irrelevant alternatives

Doubts on Doubts

- First, the fact that decision-making by “benevolent dictator” provides a sound social function rule should not be ignored
- Second, one has to take into account constraints of the model (exclusively individualistic behavior of people; interpersonal comparison of preferences is not accounted for, etc.).
- Third and most important, there are a huge number of various groups and all of them formulate their interests and take decisions

The Role of Institutional Framework

- In order the interest of a given group may take shape on the basis of the individual interests of its members, there should be *a legitimate procedure, institutional framework for aggregating these interests*, recognized by the group's members
- *A tautology*: in order to make a decision it is necessary to make a decision on how to make a decision
- This *verbal tautology reflects a real property of the object* being examined

The Consequences

- Group interests lose their distinctness and tend to “blur”; the *configuration of interests becomes directly dependent on the procedure* adopted for their identification
- Economic science is to investigate *what kind of economic policy has to be devised under a given configuration (pattern) of social preferences*
- It is *not quite correct to contrast political and economic considerations*
- The economic sphere is *not confined* to the sphere of operation of the market mechanism

IV. Market as a Mechanism of Formulation and Realization of Public Interests

- Market mechanism can perform its role only because economic agents are prepared to observe certain rules (to respect property rights, seek to maximize the degree of satisfaction of their needs, etc.)
- Demand function provides marginal valuations of *social* utility; supply function – of social costs
- GDP as a natural criterion of the *market efficiency* on a societal level: its maximum value is to be realized when individual firms do their best to maximize profits

V. Why not Market Alone?

Market failures – situations when the market cannot cope with the task of achieving *socially beneficial outcomes*. Examples:

- Allocation of resources for the production of “public goods”
- Externalities
- Informational problems
- Society is dissatisfied with the results produced by the market

VI. GDP and Public Welfare

- Ideally, society would have to choose such a *final product (as a vector)* in current period and in future, which would maximize its utility function under existing institutional framework
- Aggregate money indicators (GDP included) should be considered only as *rough* and, from a ‘pure science’ point of view, *not entirely correct approximations* of the level of economic activity and social welfare
- That is exactly why in majority of cases *governments try to complement such indicators with a set of other ones*, which reflect this or that side of public preferences. The latter serve as an instrument of additional approximation to the ‘genuine’ level of social welfare

VII. Russia at the Crossroad: What's at Stake?

VII.1. Government's Approach

Strategic Targets

- To *double GDP* during 10 years
- To *combat the poverty*
- To radically improve the situation in *education and health care*
- To create an efficient *innovation system*
- To *modernize* the economy as a whole

Means

- Structural reforms

Now emphasis is being placed on *reform of the budget sector*. Main idea: *transition to financing according to concrete results*

- Further liberalization in all spheres including
 - Foreign exchange and capital flows liberalization
 - Flat 13% personal income tax, etc.
- Conclusion: *market fundamentalism is the theoretical basis of economic policy in Russia*

Problems

- Rapid GDP growth is *not equal to modernization* of the economy and eradication of poverty
- Premature liberalization in some areas (capital flows) *makes economy vulnerable* to market shocks
- Medium- and long term macroeconomic stability is in danger because of *proliferation of speculative activity* in conditions of immature financial infrastructure (role of poor tax system)
- Huge funds are *immobilized*
- Conclusion: *contradiction exists between the declared strategic aims and economic policy*, which has been pursued till now

VII.2 Elements of the “Breakthrough Strategy” for Russia

On the Role of Basic Research and Education

- Both should *match the chosen model of economic development*
- Basic science is an ‘expensive amusement’ and it is worth having it only in case when the respective country puts forward *big targets*
- Education: *serious changes are needed*
 - One option - *introduction of payment for education* in state universities launching simultaneously a system of educational credits
 - Another possibility – *extension of conditional credits* to students of state high school institutions. The resulting debt is to be written off automatically after graduation according to a certain schedule if the respective person works in the country in fields corresponding to his education

On Industrial Policy

- Essence: formulating priorities and *creating, for a limited period of time, preferential economic conditions* for their implementation
- *False arguments* against rational industrial policy:
 - undermines macroeconomic stability
 - isolation from favorable influence of market forces leads to further lag relative to world level
 - resources allocated for implementation of industrial policy will necessarily be stolen
 - the risk to make a mistake when determining the priorities of industrial policy is too big

On Financial Resources

- To *do away* with a target of reducing expenditures of the extended government each year by 1 percentage point of GDP
- To *put right collection of rent* on natural resources and to mobilize income from state assets
- To *use “excessive” foreign exchange reserves* for financing through long-term commercial credits imports of hi-tech machinery and know-how

On Privatization and Small Business

- To set up *state holding companies*, which would manage public assets on a purely commercial basis
- The “breakthrough strategy” cannot ignore opportunities given by the *development of small business*. Industrial policy should not be a policy for industrial giants only. The breakthrough in future can take place only if Russia succeeds in creating favorable conditions for entrepreneurial initiative on the ‘root’ level

VIII. Two Main Conclusions

- The correct choice of economic course cannot be done without taking into account *the system of public preferences*. It is as wrong to speculate on abstractly best economic strategy, which would be independent of this factor, as to try to determine “objectively” best bundle of goods, which consumer can buy for his income without paying attention to his tastes
- Russia needs now pragmatic, non-ideological formulation of its long-term interests and elaboration of economic policy, which would match these interests. So far we are in position when *it is necessary to correct either targets or means of their realization*