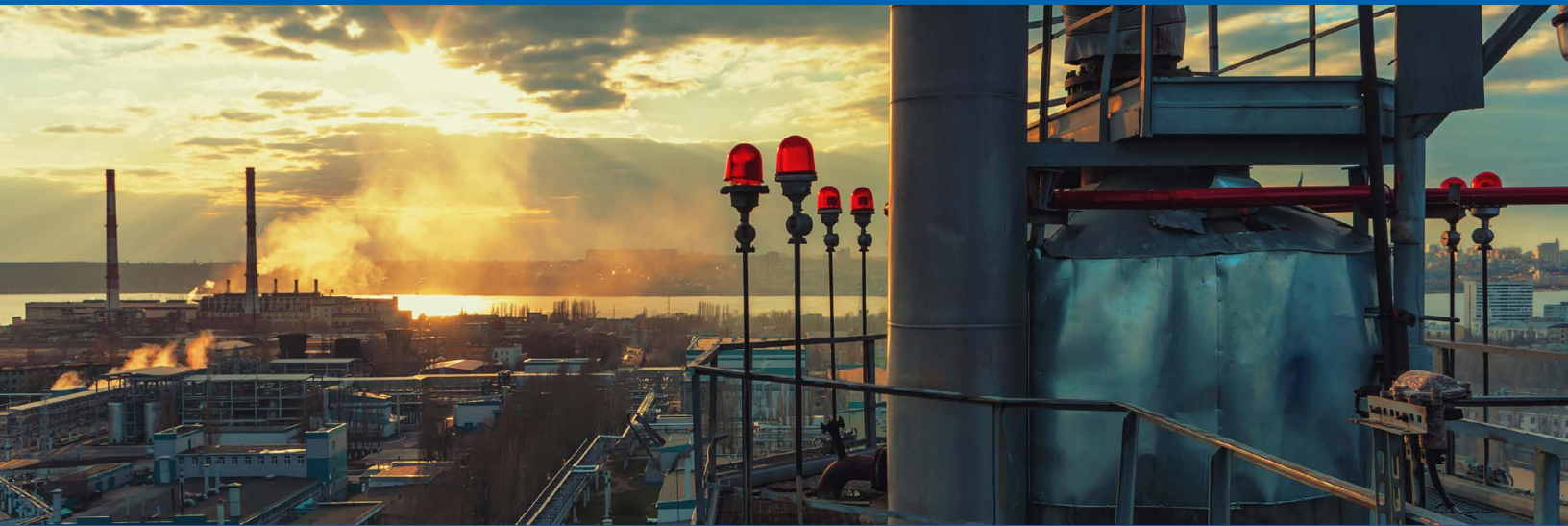


Transition Project



Decentralization of the Economy



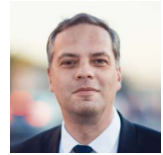
FREE
RUSSIA
FOUNDATION

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The most important element of building a state focused on the welfare of citizens, rather than on consolidation of power and aggression, should be successful market reforms capable of creating a prosperous, highly competitive economy with limited government intervention, a high degree of competition, flourishing private initiative and investment, favorable conditions for small and medium-sized businesses, without corruption and without conditions for the emergence of state-affiliated monopolies and oligarchy.

This task has become much more difficult with Vladimir Putin's invasion of Ukraine in February 2022 and the unprecedented international isolation and sanctions that followed. The old model of business as usual (where Russia became increasingly authoritarian but continued to trade with the West and gain access to Western technology, services, commodity and capital markets) is no longer possible. Putin's pivot to Asia works only to a limited extent: China and India are interested in Russia mainly as a supplier of cheap material resources and a buyer of consumer goods, but not as a potential global competitor in manufacturing. Asian countries are unable and/or unwilling to act as a donor of capital, skills and technology to Russia, as the West has been since the 1990s. Trade with Asia is also less profitable because of rising logistics costs: most of Russia's economic activity is concentrated in the European part of the country, so that there is lower economic gravity and rationale for trade.

Normalization of relations with the West remains the only option for returning Russia to normal economic development. In the event of Putin's departure, Russian society and the Russian elite are likely to demand normalization of relations with the democratic world, which could be used to influence fundamental shifts in Russian politics and the very foundations of the Russian state that require democratization, institutional checks and balances, payment of war reparations to Ukraine, and prosecution of war criminals.

It is quite possible that Putin's immediate successors will have no interest in either democratization or negotiations with Ukraine and the West. Unlike Germany in 1945, Russia, being a nuclear power, is unlikely to be occupied. But any post-Putin government will have to reckon with very strong economic leverage in the hands of the West and will be interested in the support of its citizens. The easiest way to get that support is to shift the blame for all previous

problems onto Putin and offer Russians a program of economic development. In turn, the most obvious first step of any economic development plan is the lifting of sanctions. **In exchange for the lifting of each category of sanctions, the West would be able to demand appropriate steps in troop withdrawal, reparations (including frozen assets), prosecution of war criminals, release of political prisoners, and democratization.**

Economic reforms will be an important component of the decentralization of power in Russia. The centralized rule of the siloviki and the revival of an aggressive imperialist state under Putin would have been impossible without the prior consolidation of economic forces. Under Putin, the centralization of the economy has gone to the extreme. According to the European Bank for Reconstruction and Development, the share of the private sector in the Russian economy has declined significantly since the takeover of Yukos and other private companies. A few of the largest state-controlled banks (Sberbank, VTB, Gazprombank, Rosselkhozbank, etc.) accumulate up to 75% of the total assets of the Russian banking system. According to the RBC-500 [rating](#), 12 of Russia's 15 largest enterprises are owned, either wholly or indirectly, by the state or by Putin's cronies. Since the beginning of the full-scale war, the Russia state is now actively expropriating private enterprises — with subsequent nationalization or transfer to politically connected businesspeople.

How to decentralize the Russian economy? The Russian democratic opposition has accumulated a huge baggage of experience and forward planning for post-Putin economic reforms over 20 years. Key reform ideas were accumulated in the very famous 2018 presidential [program of](#) oppositionist Alexei Navalny; most of the authors of this report contributed to that work. Sergei Guriev and Vladimir Milov, authors of Project Transit as well as Navalny's presidential program, regularly discuss the details of future reforms on their [YouTube channels](#); Vladimir Milov has co-authored several major reports on key economic reforms in recent years, including an important [report](#) on the demonopolization of the Russian economy, prepared with Mikhail Khodorkovsky's Institute of Modern Russia.

A number of steps can help reshape the Russian economy from the current highly centralized, corrupt and cronyist model into a powerful, privately driven, competitive and open economic system that is highly integrated into global markets and capable of generating prosperity and growth.

But first, let's outline how Putin's war against Ukraine has affected economic reform plans.

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- Russia continues to inflict colossal damage on Ukraine and bears an undeniable moral and legal responsibility to repair it. During the two years of the war, direct damage to Ukraine's infrastructure and buildings, according to World Bank calculations, reached \$152 billion; according to the same [World Bank estimates](#), rebuilding the Ukrainian economy will cost \$486 billion. With each day of the war, these sums increase.
- The West's rejection of Russian oil and gas has serious short- and medium-term consequences. Although Russia is able to redirect some of its oil and gas export flows to Asia, the Asian market does not guarantee a similar level of profit from hydrocarbon exports due to much higher costs and more stringent pricing conditions.
- For 30 years, the West has been the main donor of Russia's development in terms of technology, skills, capital, etc. **Western countries believed and continue to believe that democratization and economic development of neighboring countries contributes to their own prosperity and security. Asian countries, on the other hand, are not interested, and often not capable of acting as a comparable major donor:** their interest in Russia is pragmatic, and they are definitely not interested in Russia becoming their competitor in the technological and production spheres.
- The war has serious negative domestic consequences for demographics, labor market, education system, and infrastructure that will take years to correct.

Many rightly point to the experience of Germany after World War I, where overly burdensome reparations contributed to the rise of revisionist sentiments that eventually brought the Nazis to power in the 1930s. It is important to find a solution to the reparations problem that does not create additional incentives for ultraconservative forces that exploit the issue to stir up resentment and imperial revanchism.

There are two possible solutions to the problem of reparations to Ukraine, both of which can help avoid shifting the excessive burden of reparations onto the shoulders of ordinary people (who are already bearing the burden of sanctions, inflation and other consequences of the war; 20 million Russians [live](#) below the poverty line – and that's just the official figures). These solutions are not mutually exclusive.

First, as proposed by Russian opposition leader Alexei Navalny, Russia could automatically redirect an agreed percentage of revenues from energy exports to Ukraine. The country would lose some export revenues, but would

not impose an additional tax on ordinary citizens.

Second, there are hundreds of billions of dollars of frozen assets owned by the Russian state or Russian oligarchs in the West over the past decades. [Using these assets](#) to finance Ukraine's reconstruction would help avoid placing additional burdens on the Russian population, but it would also serve as a symbol of justice for the corrupt oligarchy that has long plundered Russia.

Declining oil and gas revenues are not only a problem for Russia, but also an opportunity. **The excessive concentration of oil and gas rents has led to a disproportionately strong central government, excessive corruption, social inequality, and oligarchy.** Getting rid of oil and gas dependence may finally force the Russian economy to diversify, not in words but in deeds. Russia has every reason to expect to enter the world market of green energy technologies. According to the International Energy Agency, the market for clean energy technologies in a zero-emissions scenario could reach \$900 billion by 2030 and \$1.2 trillion by 2050. This is approximately the same amount as the global oil market is now. Russia has the qualified labor force, technological capacities and raw materials necessary for the transition to green energy: according [to](#) the Ministry of Natural Resources and Environment, the country has 15.6% of the world's reserves of rare earth metals, 7% of nickel reserves, 32% of platinum and palladium reserves, and 3.5% of cobalt reserves.

Prioritizing the development of green energy technologies over oil and gas technologies also implies a way to reduce inequality in society and build an economic model with equal opportunities, as discussed below.

Of course, the transition to a green economy will require serious investment from international financial organizations, Western states and the private sector. **But we can hope that Russia's admission of guilt in the war and reconciliation with Ukraine will eventually open the country to international investment.** The World Economic Forum's Global Competitiveness Reports have consistently ranked Russia among the top ten economies in terms of market size. This is the reason why many Western companies are so [reluctant to](#) leave Russia, even after promising to do so after the aggressive phase of Putin's war against Ukraine began. International financial institutions and development banks, which are rapidly prioritizing green investments in their portfolios, will also play an important role. While Putin's Russia is one of the world's biggest polluters, a post-Putin Russia will provide an unprecedented opportunity for international organizations to contribute to reducing global emissions.

Reconciliation with Ukraine and the West would encourage hundreds of

thousands of skilled and talented Russians who [left](#) the country during the decades of Putinism, but especially after Putin's aggression against Ukraine in 2022, to return and actively participate in the country's development. Competitive, educated and skilled Russians left; many of them are eager to return to a normal, democratic Russia when their basic rights are guaranteed. It is important that these people return or at least stay in touch and contribute to Russia's future development.

What economic reforms are most needed

The new Russian government must clearly demonstrate a determination to quickly implement the basic reforms needed to convince investors, entrepreneurs, and skilled professionals of Russia's future and prospects. We have a comprehensive plan for these reforms. The creeping increase in state dominance of the economy under Putin, the high level of political risk, and the all-powerfulness of the FSB and other security and regulatory agencies are the main factors that have deterred investment in Russia over the years. **Most of the priority reforms will be political and institutional rather than economic.** These will be briefly summarized and discussed in more detail in the respective chapters.

One of the key institutional weaknesses of the Russian system since the 1990s has been the lack of an independent judiciary (we discussed this in detail in [Chapter 3](#)), which makes the rule of law impossible. This is a very painful issue for investors: in such a situation, property rights and dispute resolution are not guaranteed. According to the World Economic Forum's Global Competitiveness Report, Russia ranks 90-100th in the world on such criteria as independence of the judiciary, effectiveness of the legislative framework in challenging regulations and resolving disputes, undue influence, favoritism of government officials, property rights, intellectual property protection, and conflict of interest regulation. Much has been written in recent years about the steps necessary for successful judicial reform (see, for example, a detailed [plan](#) by renowned jurist Mikhail Benyash). We also discuss legal and judicial reform in detail in [Chapter 7 of the Transit Project](#).

The security and law enforcement agencies should be placed under civilian oversight, as provided for by law. The FSB, the successor to the Soviet-era KGB, should be completely abolished because of its counterproductive institutional

role and its transformation into a shadowy mechanism of control over all state bodies and economic players — just as the Gestapo was liquidated immediately after the fall of Hitler’s regime, on May 8, 1945. The FSB will be replaced by compact security and anti-terrorist agencies with a narrow range of tasks. The Ministry of Internal Affairs (MIA) will be similarly reformed. Emphasis will be placed on the development of effective local police, with the introduction of elections of district police chiefs, either directly or through local councils. Most of the central apparatus of the MIA will be abolished; among the units to be eliminated immediately are the political police units (the “center for combating extremism”), whose officers will also be subject to lustration. Sending entrepreneurs to prison for economic crimes before a court verdict will be legislatively prohibited and replaced by other types of preventive measures (bail, house arrest, etc.).

The economic policy of the new times should be aimed at stimulating private initiative and private investment – something that Russia has failed to achieve under Putin. The share of business income in the total income of the Russian population has fallen from more than 15% in 2000 to about 7% today: the majority of Russians’ income comes from salaries or benefits received from the state or related entities. In all the years of Putin’s presidency, the Russian government has failed to achieve its 2000 target of 28% of GDP for fixed capital investment: even in the best years, it was just over 20%. Since 2008, according to the Central Bank of Russia, capital outflow has amounted to more than \$1.1 trillion.

The main focus should be on deregulation of the economy. There will be a deregulation commissioner who, at the request of business associations, will require ministries and agencies to provide justification for regulations within 45 days and will cancel these regulations without written justification.

It is necessary to ensure radical transparency of budgets at all levels (federal, regional, local) by introducing independent audit and oversight by NGOs as a statutory requirement (e.g. mandatory pre-publication of the draft budget for discussion by civil society).

Russia already has a national hotline for corruption and undue pressure on business. In the future, it should be separated from government agencies and empowered to receive and consider complaints about corruption, favoritism and undue influence by government officials. The media would be encouraged to conduct anti-corruption investigations and journalists involved in such investigations would be protected by law.

The new Russian government will take serious steps to integrate the Russian economy into the common European market: these include negotiations on the creation of a free trade area between Russia and EU

countries, the unilateral abolition of entry visas for EU member states as well as other democracies - the United States, Canada, Australia, Japan and other OECD members (recall that Russia already has a bilateral visa-free regime with countries such as Argentina, Brazil, Israel, Jordan, Morocco, Tunisia, Turkey and the whole of Central Asia); more on the new government's efforts to integrate the Russian economy into the European market. It is the abolition of most trade barriers; the Russian customs service, which currently employs about 50,000 people and is a serious burden on export-import trade, will be reformed and its powers narrowed.

Small businesses are now under six different special tax regimes (simplified taxation system, unified tax on imputed income, unified agricultural tax, tax on the self-employed, trade levy, and tax on the patent system), which together provide only less than 2% of consolidated budget revenues. The flip side of this system is the overstaffing of the Federal Tax Service (FTS), which employs about 150,000 people; many of them are specifically engaged in tax control of small businesses. This is not normal; the tax system for small businesses should be radically simplified, with a simple and easy system of annual payments replacing all burdensome current taxes.

The state should withdraw from key sectors of the economy and monopolies should be unbundled; the details of these measures have been detailed in [roadmaps](#) prepared by Russian independent experts in recent years. Privatization of state-owned enterprises should be linked to unbundling and introduction of competition to replace existing state monopolies and oligopolies. Privatization should be conducted in an open and competitive manner, with the involvement of international consultants and investment banks, without limiting the access of foreign investors. Privatization proceeds should go directly to the accounts of Russian citizens or to the country's Pension Fund.

The pension fund should be transformed from the current pay-as-you-go instrument into a Norwegian-style investment fund, with capital to be formed from shares in state-owned companies and proceeds from privatization after these shares are sold on the open market. The Russian national pension fund has the potential to become a key investor in vital long-term development projects. The transition from a pay-as-you-go pension system will also reduce taxes on personal income, which in Russia today are among the highest in the world.

The banking sector should also be decentralized, the state should completely withdraw from the capital of commercial banks, and banks should be fully open to international competition. At present, the concentration

of assets in the banking system and under the control of the state, as already mentioned, is extremely high.

Demonetization of the banking system will significantly facilitate access to finance for SMEs. According to the World Economic Forum's Global Competitiveness Index, Russia ranked 118th in the latest available ranking for SME financing. The dominance of large banks makes access to finance primarily for large oligarchic businesses linked to the state, while it is much more difficult for SMEs.

Russia's public finances should be significantly decentralized. At present, the federal government and federal funds together accumulate about 65% of all consolidated budget revenues, while regional budgets accumulate only 35%. Own revenues of local budgets account for less than 5% of Russia's consolidated budget (they are accounted for as part of consolidated regional budgets). While it is impossible to determine in advance the "optimal" ratio of resource allocation between the federal center and subnational governments, we believe that it is necessary to leave at least 50% of revenues to regional budgets, including at least 20-25% to local authorities. The federal government should keep less than 50% of budget revenues. These proportions should be enshrined in the new Constitution of the Russian Federation. The new Constitution should also strictly delineate powers between the federal center, regions, and municipalities, eliminating vague interpretations and "joint mandates" (which tend to lead to federal dominance in decision-making). All subnational mandates should be supported by appropriate revenue sources.

How to build a society of equal opportunities

One of the key negative features of Putin's economic system, which has a strong impact on the social situation and politics, is deep inequality and excessive concentration of wealth. Income differentiation in Russia has grown significantly since the 1990s: according to Rosstat, today the incomes of the top 20% of society [exceed](#) those of the poorest 20% by more than 15 times.

The concentration of wealth in the hands of a few richest people in Russia is extreme by the standards of comparable economies: even after the devaluation of Russian oligarchic assets as a result of international sanctions, 7 Russians [are](#) currently ranked in the top 100 richest people in the world according to Forbes, and 23 in the top 500. South Korea has a GDP size close to Russia's,

but there are zero people from there on the list of the world's 100 richest people, and 3 in the top 500. Another comparable economy, Italy, has 1 person on the list of the 100 richest people in the world and 8 in the top 500; Spain has 1 and 2 respectively; Poland, whose economy is smaller than Russia's but still in the top 25 in the world in terms of nominal GDP (plus Poland is comparable to Russia in terms of post-communist transition experience) has zero people on the list of the 100 richest people in the world and only one in the top 500.

The difference is that in these countries there is no such level of economic concentration (especially in the hands of a few corporations closely linked to the state) as in Russia; the level of openness and competition is much higher. Another problem is nepotism and non-transparent government decision-making, which leads to favoritism. As mentioned above, according to the Global Competitiveness Ranking, Russia ranks 90th or lower on such criteria as the prevalence of corruption, undue influence, favoritism of government officials, and conflict of interest regulation.

The models for overcoming these problems are described above: demonopolization of the economy and ensuring radical transparency in decision-making and permanent institutionalized public control.

On the other hand, the level of social capital development in Russia leaves much to be desired: according to the World Economic Forum ratings, the country ranks 100 (or below) in the world on such criteria as social capital, existing environmental treaties, freedom of the press, and healthy life expectancy. There are significant problems with the health care system (highlighted by the COVID-19 pandemic) and the education system, the quality of which has deteriorated in recent decades. Health care and education are seriously underfunded and are clearly on the periphery of Putin's government's attention, which is preoccupied with war and corruption.

The share of expenditures in the consolidated budget of the Russian Government is distributed as follows:

- More than 40% is allocated for military and security purposes, financing economic projects and the state apparatus;
- Just over 20% is for health and education spending.

Military and security spending must be drastically reduced. Of course, as in the early 1990s, this could lead to significant (albeit much smaller) layoffs and the release of labor. Employees of defense enterprises who have lost their jobs should receive social support and access to retraining programs (including those supported by international organizations). Former law enforcement

officers could join the professional army.

The state should drastically reduce the financing of economic projects. **All non-infrastructure projects should be handled by private investors. A system built on state-funded grandiose projects only breeds corruption and monopoly by** Putin's oligarchic cronies, who dominate the Forbes list.

The introduction of competition at all levels of the economy and radical reform of public expenditure policy in favor of the development of social capital (health care, education) will help to reduce inequality in society.

The already mentioned transition to green energy will serve the same purpose: renewable energy is very labor-intensive and, unlike oil and gas, does not generate significant super-profits or rents, which become a source of oligarchy, corruption, and rich central power dictating its will to other players. Value added is much more evenly distributed: profit margins are low and labor costs account for the largest share of value added. Fossil fuel industries do not need many jobs, but generate huge rents. Green energy creates significantly more jobs than fossil fuels: the total number of jobs in the current Russian extractive industries is 1.7 million, while green energy can create 5-7 million jobs.

Mechanisms of oligarchic takeover of society should be destroyed, businesses with interests in other industries should be banned from owning Russian media, strict standards for transparent financing of political campaigns should be introduced, all possible conflicts of interest should be carefully declared and subjected to detailed public scrutiny. Dark money in political campaigns should be banned.