

## PRINCIPLE 1. FIND AND DEVELOP YOUR COMPARATIVE ADVANTAGES



The economic theory course for managers is basic. It covers the economic analysis instruments, market economy fundamentals, forms of business incorporation, company costs and profits in the perfect competition environment, perfect natural monopoly, monopoly competition and price discrimination, as well as the company behavior in the oligopoly environment. A special section is devoted to the corporate strategy and tactics in the production factors market. The course makes special emphasis on risk analysis, investment decisions and research of the macroeconomic business environment. This short MBA course presents the fundamental notions only: the rational business principle, alternative costs, market interaction mechanism, the comparative advantages concept and corporate policy at different life stages of a product. These are the key issues that ensure the economic prosperity conditions.

### 1.1. Lost Opportunities Cost

*Economic decision-making is based on the modern economic theory - economics. Economics is an analytical science of the limited resources (land, labor, capital, entrepreneurial skills and abilities) use for production of various goods and services, distribution and exchange thereof between the members of society for consumption of such resources.*

### Rational Business Principles

Multiplicity of the economic targets in the limited resources environment raises the problem of **economic choice** for the managers, that of the choice of the best alternative among the available options, the one that brings the maximum demand satisfaction at the same cost. Every individual, company or society faces the problem of what to produce, how and whom for, that is how to define the conditions and areas of utilizing of the limited resources. Economics tries not only to fix what exists but also works out the best solutions for the existing problems. In the latter case the issue of rational business (**economizing**) arises: the entire society sort of takes part in the game with the rules defined and well-known to everyone.

According to neoclassical theory, rationality is maximizing the individual's utility within the limits of the resources and knowledge available, available knowledge and the expectations in relation to the other partners' actions. It is

expected that the rational individuals are capable of comparing the benefits and costs of their actions and understand the consequences of their activity. At the same time, the conventional norms, traditions and customs play a modest role in the neoclassicists' theories. Meanwhile, the need to decrease the uncertainty forces the economic agents to rely on traditions. Where the uncertainty exists, the neoclassical prerequisites lose their universal power. Maximization can become pointless and a rational individual is forced to rely on the socially acceptable results only. Besides, what was rational yesterday can be irrational today.

The axiom of rationality does not intend to describe the reality in universal terms. It represents an ideal type of this reality, which helps to formulate the main hypotheses of the individuals' behavior irrespective of their activity. The rational choice theory is universal. It formalizes the individual's behavior logic in different situations. In politics it is referred to as the theory of public choice, in sociology - the social choice theory, in history - it is cliometrics, in legal terms - economics and law.

Though the notion of rationality is speculative, in more general terms rationality could be defined as follows: "an individual (1) never chooses alternative X if (2) alternative Y is available too that from his point view (3) is more preferable than X". Numbers from 1 to 3 show three most important characteristics of rationality: its individual character, limitedness and subjectivity.

The theory of incomplete rationality overcomes the limitations of the neoclassical theory as the transaction costs and information, from which the neoclassical theory abstracted play an important role in everyday decision-making. The incomplete rationality theory formulates rationality not only in a strict form (as principle of maximizing) but also in a less strict form, taking into account its time limits when people do not reach maximum but want to meet a definite level of their needs satisfaction. It is based on the latest achievements made by R.Coaws (transactional costs), G. Simon (incomplete rationality), J. Stigler (included incomplete information in neoclassical analysis), G.Bekker (spread the principle of uncertainty to family relations) and etc.

### **Alternative Costs**

In reality people always come across alternative costs. Production of one product means refusal of another. A rational person should calculate not only his future costs but also the costs of the lost production opportunities to make the optimal economic choice. The costs of one benefit expressed in another benefit cost that had to be sacrificed are referred to as the alternative costs (opportunity costs), lost opportunities costs or implicit costs. Let's consider an example. Suppose that a journey from St. Petersburg to Moscow takes 8 hours by train and 3 hours by air (together with the journey to the airport). A train ticket costs 2000 rubles, a plane ticket - 5000 rubles. There are three people traveling: Abramov, Borisov and Vengerov. Abramov's hourly rate is 400 rubles. Borisov's - 600 rubles and Vengerov's - 1000 rubles. Which transport would they choose? 2000 rubles in this case is sunk costs: whatever means of transport you choose you can not spend less. So. extra costs are  $5000 - 2000 = 3000$  rubles. The inevitable time loss is 3

hours, extra (ultimate) time loss is  $8-3=5$  hours. Subject of the analysis is the 3000 rubles against 5 hours. Abramov will earn 2000 rubles for the 5 hours work, his alternative costs (2000) are less than the extra air tickets cost (3000). Thus it is more rational for him to go by train. Borisov's hourly rate is 600 rubles. If he flies, he saves 5 hours and can earn 3000 rubles. Thus the time saving gives him an opportunity to recover the price of the air ticket. So, from the point of view of rational behaviour, overspendings by the work done.

As for Vengerov, it is obvious that as B. Franklin put it, "time is money", as he can earn 5000 rubles in 5 hours, which is a great deal more than the extra air ticket costs. Consequently, from the point of view of the rational behaviour, Abramov will go by train, Vengerov will travel by air and it's all the same for Borisov. This case is the simplest example of the economic decision-making. They are made when **extra (marginal) benefits must be not less than extra (marginal) costs**.

$$MB > MC,$$

Where MB is marginal benefit, MC is marginal costs

A person must not worry about sawdust and grieve over his or his predecessors' actions. He is responsible for his next step and he must make it rational, i.e. compare the nearest benefits and losses. If he always acts this way, he will attain economic efficiency (or will come very close to it). This is especially obvious given the modern market system.

## 1.2. Market Mechanism

### Market

**Market** is a system of relationships where the connections between the buyers and sellers are so free that the prices for the same product tend to level out quite quickly.

Market is, primarily the place where buyers and sellers come into contact, they exchange commodities at an agreed price. There is voluntary property alienation followed by appropriation of other property. Thus, market means exchange of the ownership rights. Costs of search for information, negotiations, determination of quality and quantity characteristics of the commodity or service to be purchased, ownership rights specification and protection, contracting, etc. are inevitable for the deal to take place. Thus, market could be defined as a combination of transactions. The process of exchange involves measurement and evaluation of the realized value. Market acts as a specific form of the interconnection between producers within the framework of the public labour division, with each of them running a business at his own risk. Social needs are identified through the price systems. They transfer information that encourages use of the most economical production methods and the most effective use of the limited resources. Thus, market promotes redistribution of the revenue to the benefit of the more efficient business units that use advanced technology and high-quality resources. In a

developed industrial society market is not the place where buyers and sellers run into each other at random, it is a social mechanism that ensures regular connection between the economic value producers. Wholesalers and buyers play an important role in the leveling off between demand and supply and setting of the equilibrium prices.

## **Supply and Demand**

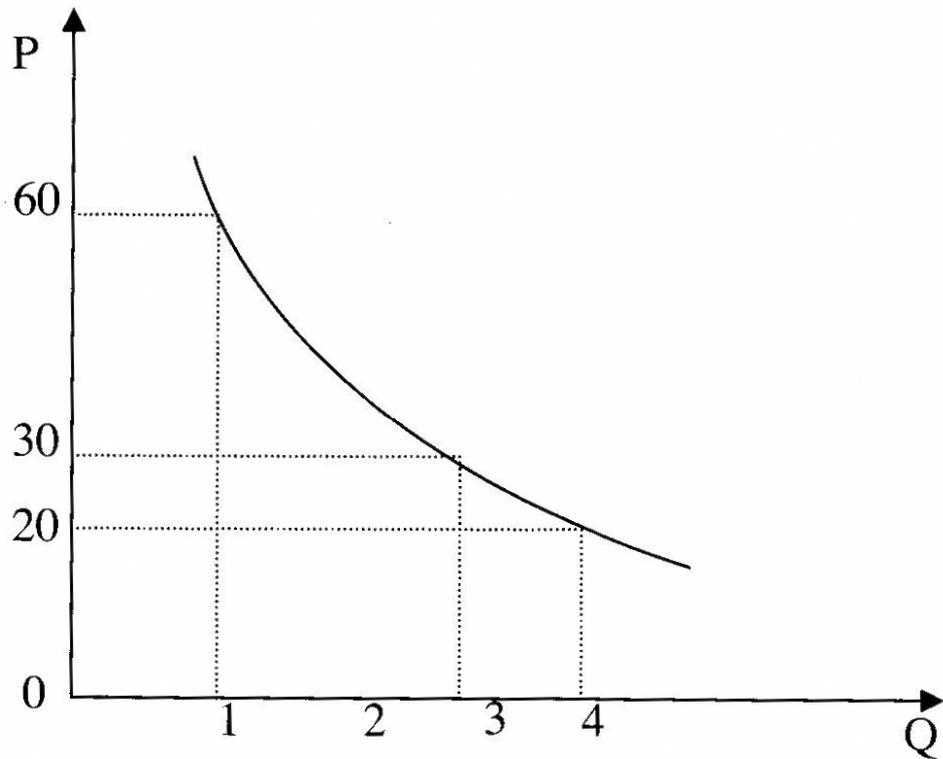
If we consider a situation on the market for some commodity, a definite relation between the price and the volume of the commodity sold becomes obvious. The lower is the price of the commodity, the higher quantity of the product (all other things being equal) are the customers are ready to buy, the higher is the demand for the product. For instance, the customers are ready to buy an item of commodity X at the price of \$60, three items - at the price \$30 each, four items - at price \$20 each, etc. *A reverse relation between price and demand is referred to as the **law of demand**.*

The relation between the quantity of goods sold and the prices level can be shown graphically. *The demand curve is a curve showing quantity of the commodity that the consumers are ready to purchase at different price at present.* Conventionally, in economic theory the independent variable (price) is shown on the vertical axis and the dependent one (demand) - on the horizontal axis (see Figure 1-2). The curve characterizes the relations between the prices and the amount of purchases of product X at a definite time (e.g. January 1, 2007). It has a negative slope, which proves the consumers' wish to buy more commodities at a lower price. In general terms:

$$Q_D = f(P),$$

where  $Q_p$  - demand;

P - price.



*Figure. 1-1. Demand - price relation*

Demand is affected by other factors. Let us consider this influence in more detail

**Demand function** - the function that defines demand relevant to various factors that affect it. The most important of them is the current price of the commodity. We have already established that the lower is the price, the higher is the demand and vice versa. Price change means the move on the demand curve (see Figure 1-1)

Demand is effected not only by the prices but other factors as well: 1) increase (or decrease) of the customers' income, 2) changes in tastes and preferences, 3) price and deficit expectations, 4) fluctuation of expenses on advertising, 5) changes in price of the product- substitutes and complemented goods, 6) growth (or reduction) in the number of consumers etc.

The demand is the function of all these factors:

$$Q_D = f(P, I, Z, W, P_{sub}, P_{com}, N, B), \quad (1.1)$$

where  $Q_D$  - demand;

P - price; I - income; Z - tastes; W - waiting;

$P_{sub}$  - price of the substitute product;

$P_{com}$  - price of the complementing goods;

N - number of customers;

B - other factors.

These factors move the curve either to the left or to the right(see Figure 1-3). For example, an increase of consumer income (in the absence of inflation) results

in the increase in demand, the  $D$  curve moves to the position of  $D_2$ . At the same time, demand can grow at a rate higher or lower than the income growth rate depending on quality of the goods, their place in the consumers' budgets and a number of other features, which will be defined later. This situation is typical of the majority of the goods except low-quality goods. Income growth switches the consumer demand to the goods of better quality while demand for the low-quality products declines, i.e. the curve moves from the position  $D$  to the position  $D_j$

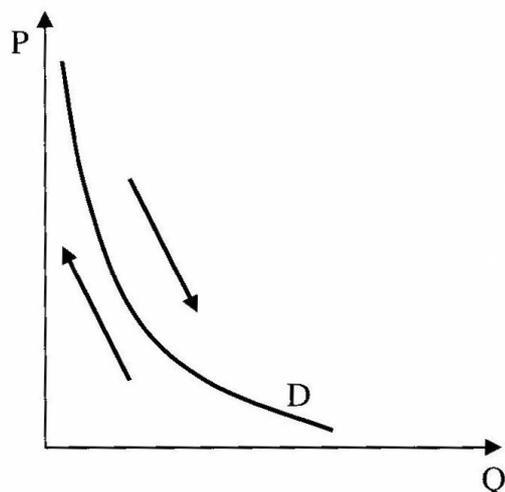


Figure. 1-2. Demand curve

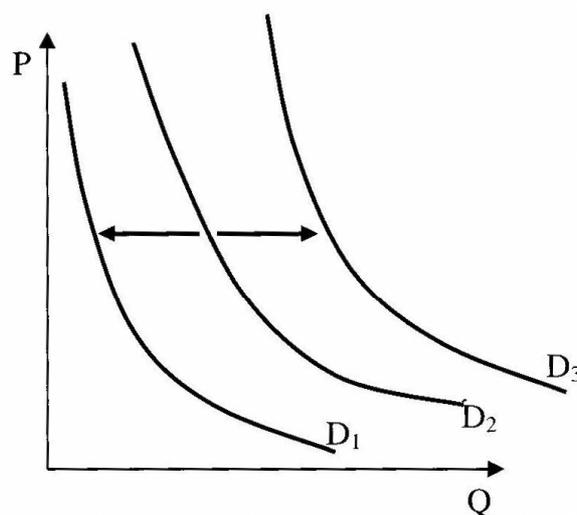


Figure. 1-3. Demand function (shift of the demand curve).

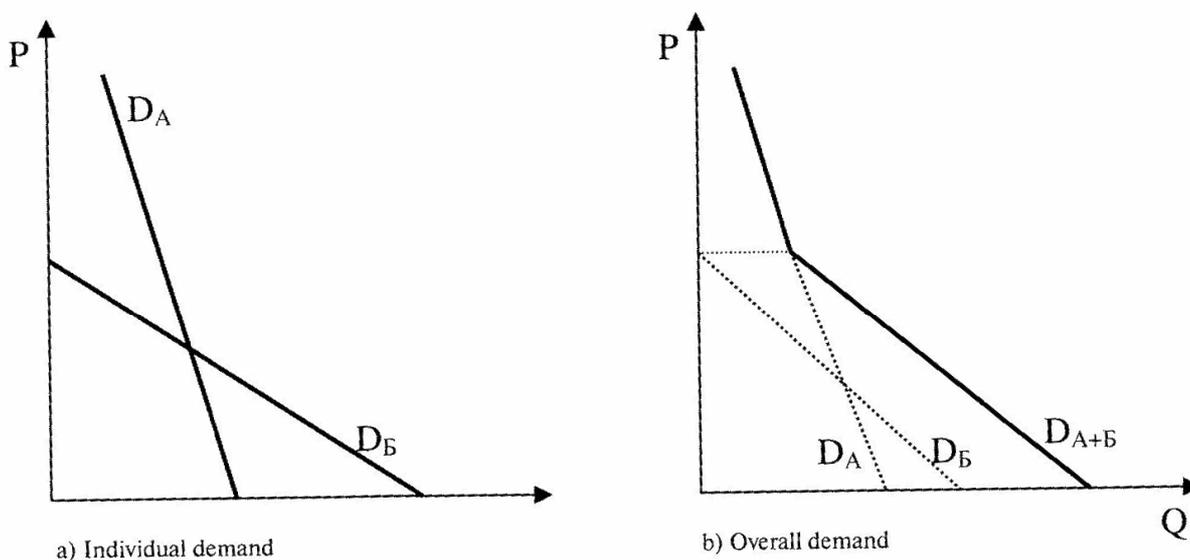
**Growth of the substitute goods prices** increases demand for these goods. For example, increase of the price for red carnations can switch part of demand to the pink (or white) carnations, thus causing their prices to increase too. This leads us to the conclusion that if *two products are interchangeable (are mutual substitutes) there is a direct relation between the price for one of them and the demand for the other*. The price rise for red carnations resulted in growth of demand for the pink carnations.

On the contrary, **increase of price for the complementary goods** reduces the demand for it. For example, growth of the price for skis will lead to reduction of the their sales. Consequently, demand for ski bindings will also decline as the result of the reduction of the *skis sales*. So, if two goods are complementary, there is a reverse relation between the price for one and demand for the other.

In our example increase of the price for skis resulted in the decline of demand for the ski bindings. **The number of customers** is one of the important factors influencing demand. Let us give an example to explain this phenomenon. Suppose, there are two customers - Andreev and Borisov, whose individual demand functions are known (see Figure I-4a). Then, the overall demand is the sum total of Andreev's and Borisov's demands (see Figure I-4b).

In a real market economy, when it comes to the number of customers, the customers' sex and age, average size of the family, the share of retired people, etc. must be taken into account **Customers' preferences** also influence the change in demand; however, the effect is not so easy to define. Besides, the same factor can have a different impact (sometimes a completely opposite) on different groups of population.

Let us summarize. The move along the demand curve reflects **the change in demand**: the higher the price the lower (all other conditions being equal) is demand and vice versa: the lower the price, the higher the demand (see Figure 1 - 2). Shift of the demand curve either to the left or to the right reflects **the change in demand**: it occurs under the influence of the factors that determine the demand function (see Figure 1-3)



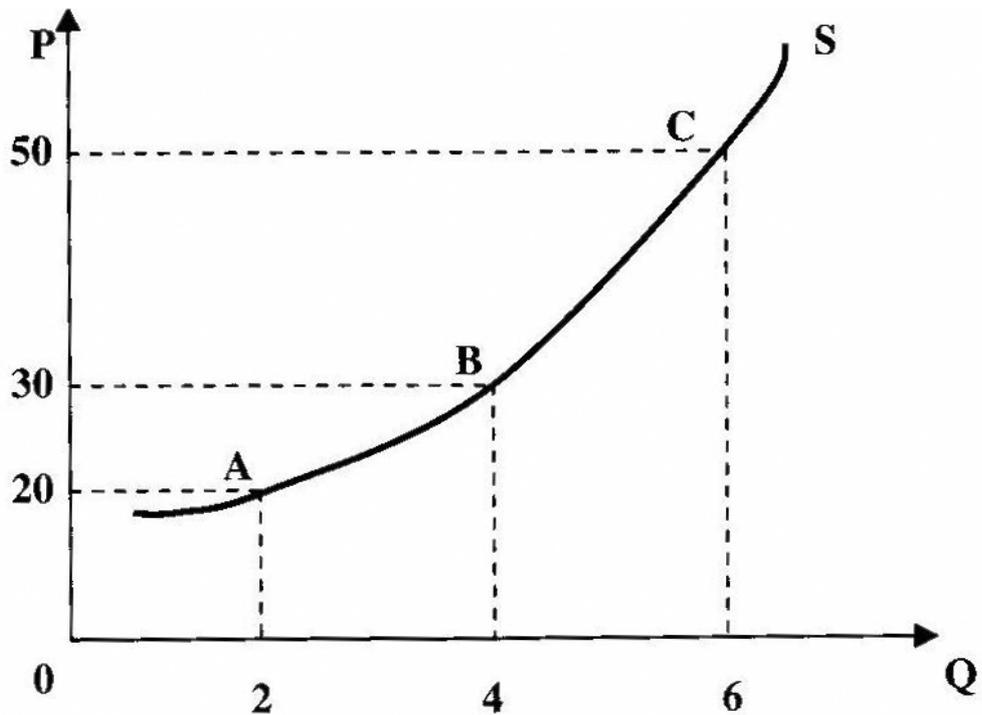
*Figure 1-4. Individual and overall demand*

If we consider the market situation in terms of demand, we will notice that there is a direct relation between supply and the price: the higher the price the more goods (other conditions being equal) the sellers are ready to offer. For example, the producers are ready to sell only two units of goods X at the price of \$20, four units - at \$30 and six units at \$50. Thus, in general terms:

$$Q_D = f(P),$$

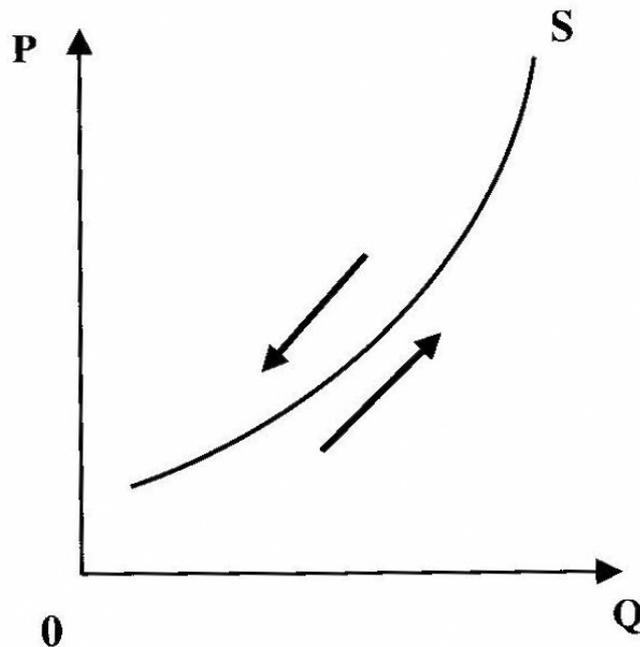
where  $Q_s$  - is supply and P is price.

Direct relation between the price and quantity of the goods supplied is referred to as the **law of supply**. Relation between the produced goods quantity and the level of prices can be shown graphically. **The supply curve** is a curve that shows the volume of goods that the producers are ready to sell at various prices at present, (see Figure 1-5).



**Figure 1-5. Relation of supply and price**

The S (supply) curve characterizes the level of prices and the goods sales at a specific moment (e.g. January 1, 2007). It has a positive slope, which means that the producers wish sell more goods at a higher price. The price is not the only factor influencing the supply.



**Figure 1-6. The supply curve (change of the supply volume)**

Let's consider these in more detail.

**Supply function** defines - supply in relation to different factors affecting it. As we have already round out, current price of a goods unit is the most important of them. A change in the price means a move along the supply curve (see Figure 1-6). In fact, not only prices influence the supply of a type of goods; there are other factors involved: 1) prices of the production factors i resources), 2) technology, 3) price and deficit expectations of the market economy agents, 4) taxes and subsidies levels, 5) the number of sellers, etc. Supply is a function of all these factors:

$$Q_s = f(P, Pr, K, T, N, B), \quad (1.2)$$

where  $Pr$  is prices of resources;

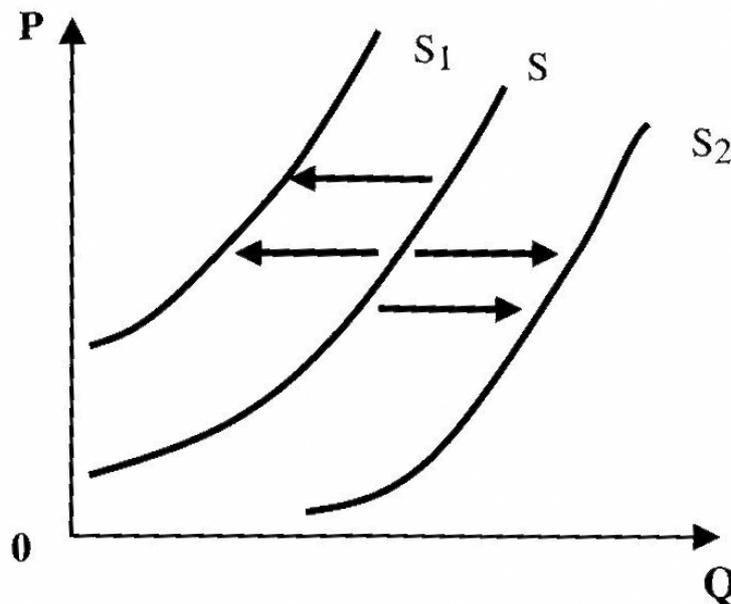
$K$  - is the applied technology;

$T$  - is taxes and subsidies;

$N$  - is the number of sellers;

$B$  - is other factors

For example, higher prices for the production factors result in the reduction of supply, the  $S$  curve shifts to the  $S_1$  position. On the contrary, if the price for production factors decreases supply increases and the  $S$  curve shifts to the  $S_2$  position of (Figure 1-7)

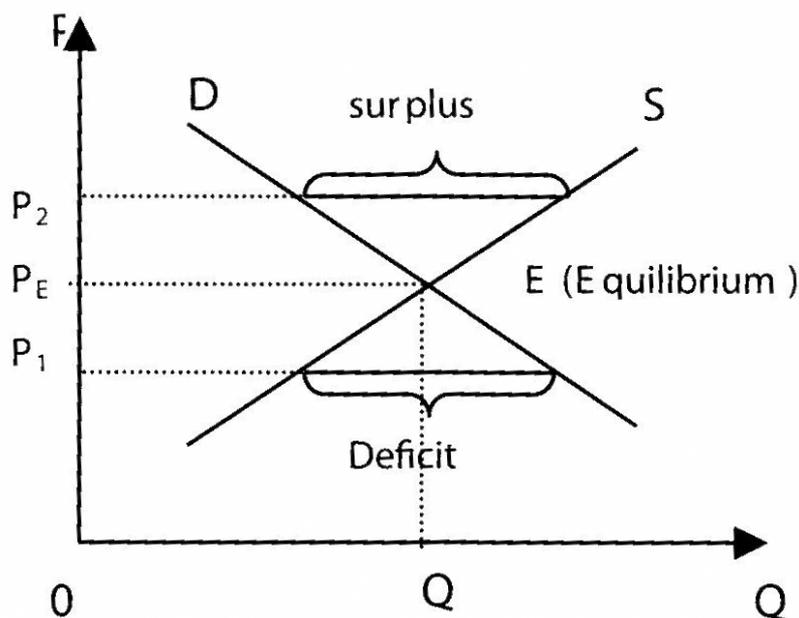


**Figure 1-7. Supply function (shift of the supply curves)**

Let us remind that in microeconomics costs are considered to be the estimates that reflect the value of the production factors at their best alternative use. So, the supply function reflects expenditure of the resources, for which the producer paid

at the price of the best alternative. Had he been unable to do that owners of the resources would use them in production of other goods.

Let's summarize. A move along the supply curve reflects the change in the supply volume: the higher the price, the higher is the supply volume (all other conditions being equal) and, vice versa, the lower is the price, the lower is the supply volume (Figure 1-6). A shift of the supply curve to the left or to the right reflects a change in supply: it occurs under the influence of the factors defining the supply function (Figure 1-7)



*Figure 1-8. Price equilibrium and deviations from it.*

Under the market economy conditions the competitive forces contribute to the synchronization of the demand and supply prices that leads to the equilibrium of the demand and supply volumes.

Throughout the period of market development sellers and buyers are going through the mutual adjustment process. Prices play an important role here, they encourage fast exchange of the necessary information. They make the exchange conditions simpler, clearer and uniform for all participants of the market economy (Figure 1-8). The point of equilibrium is denoted as E.

At the point of equilibrium  $P_E = P_S = P_D$ ,

Where

$P_E$  is the equilibrium price;

$P_S$  is the supply price;

$P_D$  is the demand price.

This means that  $Q_E = Q_S = Q_D$ ,

where  $Q_E$  is the equilibrium volume;

$Q_S$  is the supply volume;

$Q_D$  is the demand volume

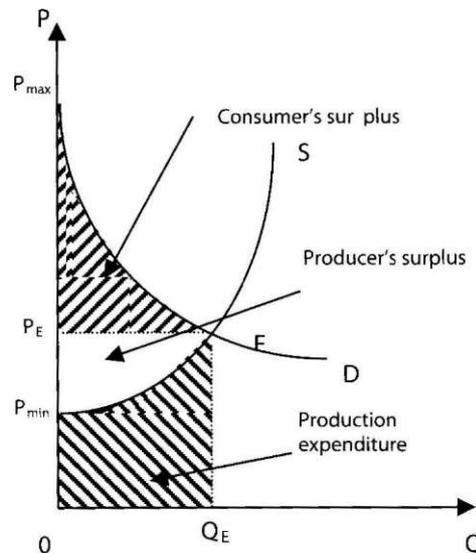


Figure 1-9. Consumer surplus, production surplus and expenditure

**Equilibrium price** is the price balancing demand and supply as a result of the competitive forces effect. Equilibrium price formation is a time consuming process. Under the ideal competition conditions it does not take long for demand and supply prices and volumes to adjust to each other. As a result, the producers together with the consumers benefit from the established equilibrium. As the equilibrium price is usually lower than the producers' maximum price, **the consumer's surplus** can be shown graphically as the  $P_{max}EP_E$  area (Figure 1-9).

The equilibrium price, in its turn, is usually higher than the minimum price that could be offered by the most advanced companies.

If E is the point of equilibrium, then  $P_E$  is the price at which goods are sold and bought and  $Q_E$  is the volume of sold goods (Figure 1-9). Consequently, total revenue is  $TR = P_E \times Q_E$

The total producers' expenditures (costs) are equal to the area of the

The difference between total revenue  $P_E \times Q_E$  (area of the  $0P_EEQ_E$  rectangle) and total expenditure (area  $0P_{min}EQ_E$ ) is the producer's surplus (gain) (area  $P_E P_{min}$ ).

The market spontaneously, automatically encourages formation of the equilibrium prices (A. Smith referred to this process as the "invisible arm" mechanism). Exceedance of the demand price over the supply price promotes redistribution of the resources in favour of the industries of high solvent demand. High prices evidence relative scarceness of the goods, encouraging an increase of their production and, thus, in better satisfaction of the public needs. As the equilibrium price significantly exceeds the costs of the producers with the costs at below average, it promotes redistribution of the resources from the worst producers to the best, increasing the efficiency of national economy as a whole.

### 1.3. The Comparative Advantages Principle

Under the market economy conditions every person must define his comparative advantages - the field where he can produce goods and services at the

least cost or at the same cost as the others but of much higher quality. Adam Smith (1723-1790) was one of the first who created the prerequisites for determination of this principle. His concept is based on the "non-equating equation" idea.

Every person is unique, he possesses natural abilities (or those acquired). Differences between the individuals become socially significant due to exchange and trade.

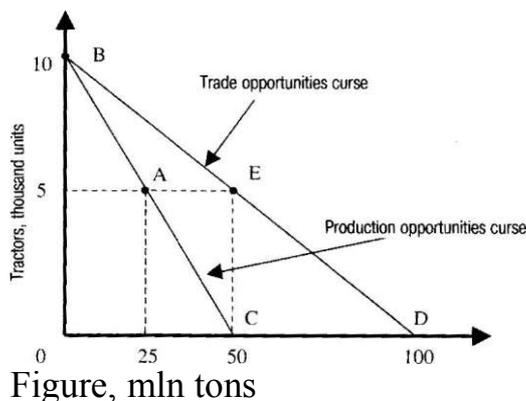
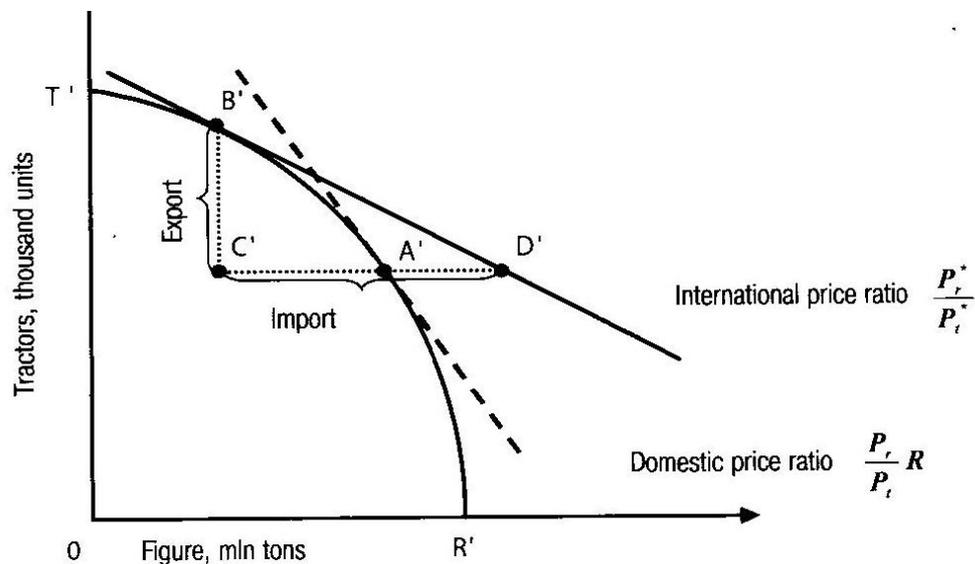
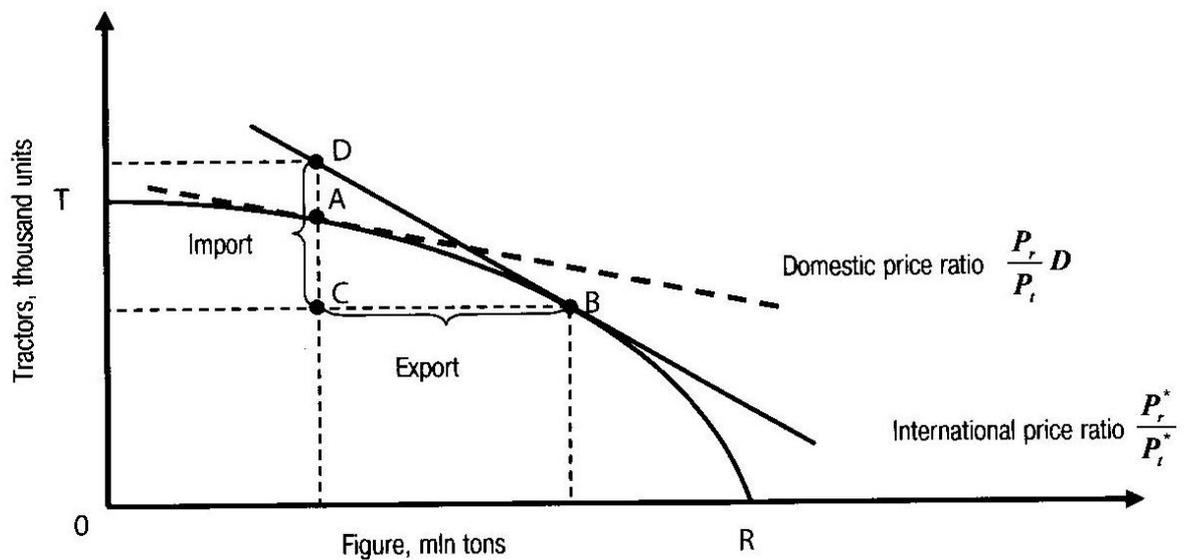


Figure 1-10. Classical theory: curves of production and trade opportunities

Their linearity and limitation become their advantage as specialization increases labour efficiency. Exchange, while minimizing costs, makes "experts in a particular sphere". The individuals become capable members of the society who need each other due to their specialization. As a result, exchange plays a double role: involves individuals in civilization and develops their needs, thus promoting comprehensive personal development.

The absolute advantages concept of Adam Smith was developed further in the works of **David Ricardo (1772-1823)** who formulated the principle of comparative advantages. Initially, his theory was based on the only variable factor (labour price) and full specialization. Let's illustrate it through an example (see Figure 1-10). Suppose that our country produces only two commodities - tractors and rice - and that the relative domestic prices are: a tractor costs 5 tons of rice, and the country allocates its resources equally between tractor production and rice growth. In this case the country will produce at point A (on the curve of production opportunities BC), which equals production of 25 mln. tons of rice and 5 thousand tractors. Let us further assume that the situation in the world is different: one tractor costs 10 tons of rice. It means that the curve of trade opportunities BD lies to the right of the curve of production opportunities, i.e. production of either 10 thousand tractors or 100 mln. tons of rice is possible. Then, it is to the advantage of our country to produce tractors only.



**Figure 1-11. Neoclassical theory: comparative advantages of export**

If preferences in consumption of tractors and rice do not change and the country will still tend to consume them equally, then this country will benefit from production of 10 thousand tractors and exchange of a half of them for 50 mln. tons of rice, i.e. shift from point A to the previously unattainable point E that ensures twice as much rice given the same production of the tractors.

In the 20th century, basic classical theory was considerably improved by the Swiss economists Eli F. Heckscher, 1879-1952 and Bertil Ohlin, 1899-1979. Unlike the classical theory that explained trade by different productivity in different countries (producing the same commodity), the neoclassical theory is based on the fact that all countries have the same excess to the technologies of production of all commodities. However, prices for resources are different in different countries; thus, the countries with cheap workforce will have advantages in the labour-intensive goods production and the countries with the lower price of capital will benefit from production of the capital-intensive commodities.

As the countries differ in terms of the resources available and the production of different commodities requires different balance of the resources, this creates the prerequisites for the mutually beneficial exchange. Let us give an example (Figure 1-11). Suppose there are two countries - a developed and developing. The developing country specializes in the agriculture and its comparative advantage is agricultural production, the developed country's advantage lies in production of the industrial commodities.

As each country has its own comparative advantage, the international correlation of prices does not coincide with the national. The graph shows the internal correlations of the prices (for the developing country  $P_r/P_t D$ , for the developed country  $P_r/P_t R$ ) by a dotted line. International correlation of the prices under the free trade conditions should be somewhere between  $P_r/P_t D$  and  $P_r/P_t R$  (shown by a solid line on the graph). Given the internal correlation of prices  $P_r/P_t D$ , a third world country would produce in point A. However, given the international correlation of prices  $P_r/P_t$  it would be more profitable to produce at point B. In this case its export of rice would be higher by CB. However, the import resulting from this specialization would not only cover all (tractor production) losses related to the AC specialization but would increase by AD, i.e. we could exceed the production capacity boundaries that existed under the zero exchange conditions.

Similarly, a developed country benefits from the international trade: export of tractors B'C' will allow not only to make up for the losses connected with the specialization A'C' but also to improve import of rice by A'D'.

It should be emphasised that trade is balanced for the both countries as the cost of export is equal to the cost of import. Thus, the neoclassical theory claims that the benefits of the participating countries grow together with the foreign trade growth. Though full specialization in production of a particular commodity is impossible (due to alternative costs growth) benefits of the relative specialization are significant. Moreover, they promote leveling-off of the production factors prices as the demand for the surplus factors of production increases as a result of the international specialization.

Some of the market-friendly development strategy components are creation of the human capital, development of competitive internal markets, stable macroeconomics and international integration (see Figure 1-12).

The Keynesian approach to the growth problems turned out to be limited as it only focused on the questions of effective use of the resources and technology. The Neoclassics' criticism of the Keynesians vividly showed that elimination of backwardness does not only apply to the growth problems but covers a wider range of the development problems. The Neoclassics made a significant contribution by striving to prove that development is a simultaneous process of growth and accompanying significant changes that promote transmission of one quality (traditional economy) into another (modern economy). It should be stressed that development accelerates under the conditions of competition stimulating development of the internal market

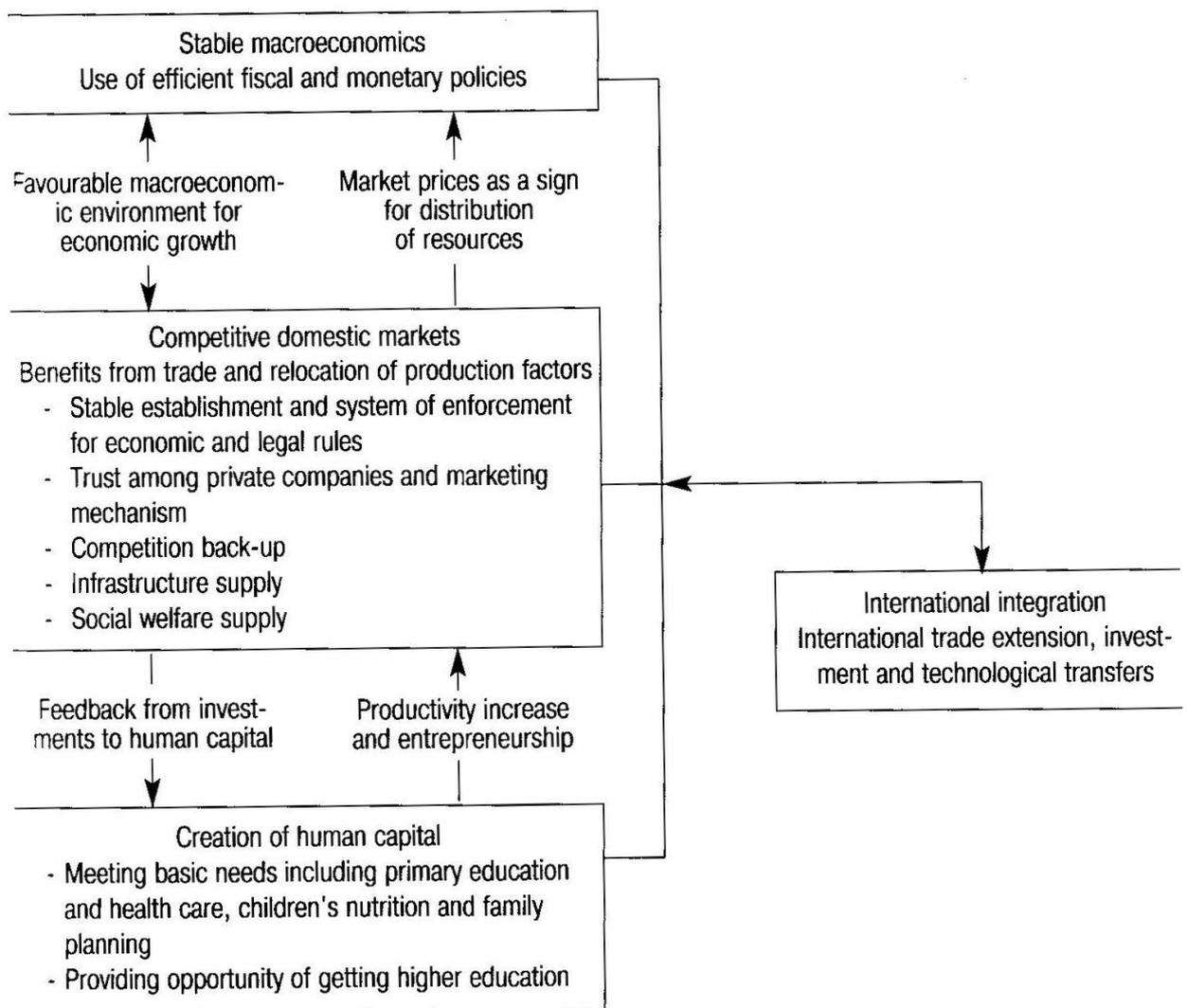


Figure 1-12. Components of a market-friendly development strategy

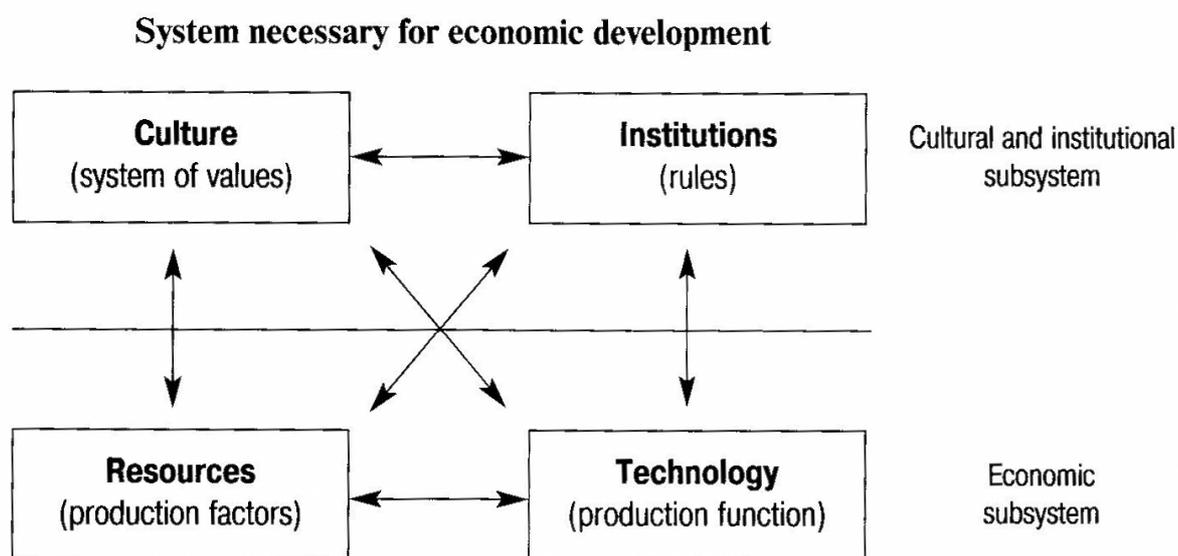
Source: Hess P., Ross C. *Economic Development: Theories, Evidence and Policies*. Philadelphia etc., 1997. P.525

The institutionalists went further. Their research showed that development includes not - the economic subsystem but also a wide range of non-economic variables, including formal and informal institutions, culture and the entire system of values, without which full development is impossible (see Figure 1-13).

However, both the neoclassics and the Keynesians were at a disadvantage as they were unable to recognize natural unsuitability of the developed societies' realities (and a relevant conceptual apparatus) to the catching-up development countries and tended to project historical evolution experience of the European countries on the transitional economies countries.

Their absolute focus of attention there were not only the problems of the per capita income growth but also elimination of the absolute and relative impoverishment, reduction of the inequality, employment growth and growth of the labour resources' quality and human capital on the whole. Human capital creation supposes not only to provision for the basic needs (children's nutrition, primary and secondary education, health care, etc.) but also the possibility for further education and professional development including higher education and different

forms of further career training. Thus, they exceeded the limits of the modern economic theory - economics. Actually, their efforts made it obvious that economic development is impossible without deep changes in the whole system of economic institutions, social and political relations. So, the category of "the economy of development" turned out to be a wider term covering the traditional economic science issues, as well as a wide range of social, institutional and political reforms necessary for continuous growth on the periphery of capitalism and qualitative improvement of the living standard of a great amount of the Asian, African and Latin American population (their behaviour does not fit in the framework of a traditional theory with its principles of individualism, rationalism, complete awareness and market efficiency).



*Figure 1-13. Interconnected development in a social system*

Marketing economy predetermines equality of the opportunities but not equality of the results. It supported by the freedom of choice; however, such freedom is possible only where and when basic living conditions are ensured and basic personal needs are satisfied. Developing countries are characterized by a low standard of living, low efficiency of all production factors, high rate of birth and the subordinate position in the system of international economic relations. Thus, the institutionalists took into account the experience of both the neoclassics and the Keynesians. They provided a basis for their programmes. Human capital creation (favoured by the institutionalists) became the foundation for development of the competitive internal markets (it was the neoclassics' pet subject) that in their turn predetermine stable macroeconomics (which was the focus of the Keynesians attention). All these factors are certainly interconnected and are under both direct and reverse influence. Moreover, they are affected by the world community and, primarily, by international trade and international migration of the production factors.

## 1.4. Life Cycle of a Product.

Under the market economy conditions a company must continuously adapt to the rapidly changing situation. It becomes obvious in the technological progress environment. Forms of competition and corporate strategy change at different stages of a product (service) life cycle. Usually, four main stages are defined (see Figure 1-14)

### Stage 1. "Big adventure"

At the first stage our product or service is unique. So, there are no competitors and there is no need to invent numerous variants. The absence of competition affects price. However, pioneering costs are unproportionally high as the market does not understand or *know the product* or service. Launch of a new commodity or service requires considerable investment. The pioneers are in the most advantageous position to profit.

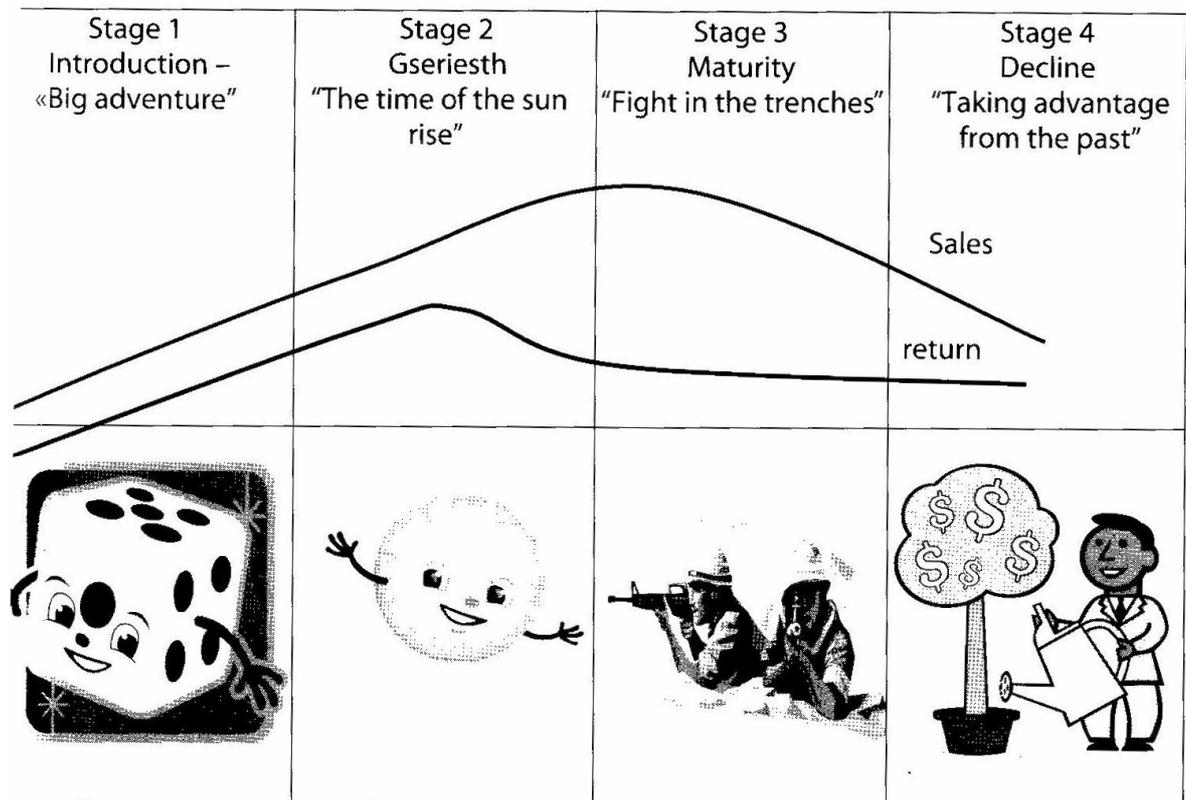


Figure 1-14. Commodity life cycle stages

### Stage 2. "The time of sunshine"

At the second stage demand growth due to market awareness. Other companies set about to produce the same product or service. At the beginning, the competitors do not create any serious problems expanding their market share as they have

not mastered the new technology as well as our company that pioneered that business. Despite the intensifying competition, sales increase. However, under fierce competition the number of various products (services) increases. This requires certain changes in advertising: now it's important to prove the benefits of going straight to our company. If these conditions are complied with in time, there comes the maximum profit period.

### **Stage 3. "Fight in the trenches"**

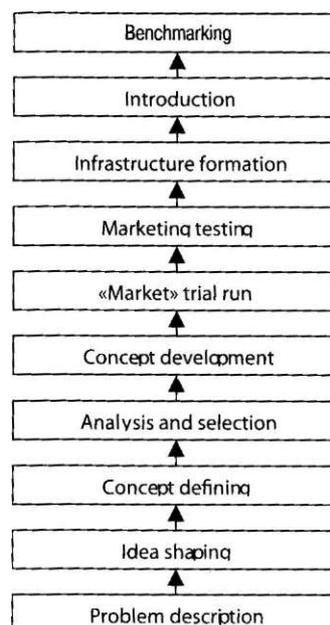
At the third stage strong pressure from the competitors makes it much harder to fight for a market niche and derive profit. Costs rocket as you need to invest in development of the variants. Price competition is accelerating. In these conditions advertising costs become less efficient.

### **Stage 4. "Capitalizing on the past"**

At the companies that are able to adjust to the new situation of a dying business will continue to profit.

If you need to determine the life stage of your products you should draw up a separate table for each product.

The process of a new product (service) development can be represented by the following graph (Figure 1-15). It is filled with a real content throughout a life cycle. Corporate strategy at different stages of a product (service) life cycle is presented in Table 1-1. It shows the changes of the main effort, costs and marketing content, pricing policy and other parameters of the corporate strategy at different product life cycle stages. Let us focus on the pricing strategy.



***Figure 1-15. Process of a new product development***

There are two main pricing strategies: sliding and damping.

***Escalation pricing*** is high prices strategy combined with high advertising costs. This approach is effective when even at the early stage the sales level is less

sensitive to the price. Setting a high price for a new service in these conditions becomes an effective market segmenting method. The escalation policy can be especially effective if the demand elasticity is known. Then, the high price can not only result in higher sales than the low (initial) price but also create opportunities for the market expansion. It happens when the consumers' possibilities tend to be restricted and there is a high consumer surplus

Table 1-1

**Different product characteristics and recommendations for a rational corporate strategy at different stages of the product's life cycle**

		<b>STAGES</b>			
		Introduction	Growth	Maturity	Decline
<b>MARKET CHARACTERISTICS</b>	Sales	Weak	Fast growth	Slow growth	Decreasing
	Return	Negligible	Maximum	Declining	Low or zero
	Consumers	Fans of the new	Mass market		Lagging behind
	The number of competitors	Low	Constantly growing	High	Reducing
	Main efforts	Market expansion	Market penetration	Defending the share of the market	Increase of production profitability
<b>COMPANY STRATEGY</b>	Marketing costs	High	High but somewhat lower in percentage terms	Declining	Low
	Marketing content	Product awareness	Brand preference	Brand loyalty	Selective impact
	Product distribution	Irregular	Intensive		Selective
	Price	High	Somewhat lower	The lowest	Increasing
	Product modification	Essential	Advanced	Various	Providing maximum returns

**Damping** is efficient when sales are very sensitive to the prices even at the early stages - when there is a positive effect of scale and there is a strong potential competition, while the  $\pi$  consumer surplus doesn't allow applying a great variety of prices

## PRINCIPLE 7. COMPANY IS MANAGED BY THE MARKET



Market is emerging in Russia before our eyes within the environment recently driven by the planned economy. Due consideration of such environment is an essential condition for prosperity of the Russian companies. Currently, Russian companies are entering the world market at an increasingly higher rate and operate in the increasing globalization environment. Accounting for the global trends also becomes an essential condition of success. Yet, this is also not sufficient on its own: national and international economy development trends must also be taken into consideration, i.e. viewing of the business of today from the position of tomorrow to establish the sustained growth preconditions. These three aspects of corporate development (the institutional environment of business in Russia, globalization and development forecasts) are dealt with in Chapter Seven.

### **7.1. Institutional Environment of Business in Russia**

#### **These Strange Russians**

Anyone willing to do business in Russia cannot but account for the Russian culture and mentality specifics. This is especially important as the national Russian character is a maze of contradictions.

As a rule, a typical Russian is a melancholic dreaming of the better and getting ready for the worst. Sound pessimism often helps the Russians in avoiding a real catastrophe. Hence, perpetual nostalgia: it used to be better under the Communists than it is now, it was better under the New Economic Policy than in the 30-50s. And it was absolutely glorious before the October Revolution. Thus, many are forever lamenting their loser's luck and passionately dream of a freebie - everything that a Russian gets for free. It is no confidence that various lotteries are so popular in Russia.

Embodiment of the actual contradictions is Russia's coat of arms - a double eagle which the heads facing east and west. Russia is doomed to cooperate with the both. Yet, both are, for some reason, continuously resisting learning from Russia.

As recently the birth rate has been declining significantly immigration of the former compatriots is welcome. Yet, the local authorities are never ready for it. The Russians are incorrigible romanticists and the more difficult is the life, the more conducive for the romanticism, unsinkable, invincible and irrational, is the

actual environment. Planned economy is a distant past, yet people still do believe that the happy future will be created by the national leadership and, at that, within the shortest possible time (doubling of the GDP, national projects, etc.). Hence, yet another characteristic - long-sufferance and expectation of a better and easier life («life has become better - life has become jollier»).

Russia is a Superpower and the Russians love everything huge («we are the tops»). Meanwhile, quantity takes precedence over quality.

The Russians own a lot less personal assets than their western neighbors but, unlike their western neighbors, are much more willing to trench upon the others' property. On the other hand, the Russians enjoy a more developed fellowship feeling («The more, the merrier»). Difficulties during the Tsarist and the personality cult years taught them that survival is only possible if there is a shoulder to lean on («I would not fear tackling a bear if I am with a friend and the bear is not »).

Perception of work is also characterized by the internal contradictions. On the one hand, «no pains, no gains», on the other hand - "work will always wait for you".

Traditional Russian mentality is characterized by negative perception of private enterprise ("honest work does not make you rich"). Unlike the Americans who worship the wealthy, the Russians have been long critical of the sources of wealth. If an American's first thought while meeting a millionaire is: «What a clever and capable man!» then a Russian's first thought would be: «How did this swindler manage to steal so much!».

## **Economic constituents of the post-Soviet Russia: institutional analysis**

### **Households: non-market adjustment to market conditions.**

The problem of compliance of the reform projects with the Russian reality has not been identified straight away. Everyone thought that the market development laws are the same everywhere and nobody studied the level of readiness of various institutes for the radical economic, social and political reforms. The Russian's cultural stereotypes did not promote market reform but, rather, hampered it, and, which is more important, have not been studied by the specialists. Institutional prerequisites of the economy modernization became the focus of the economy reformers much later.

Meanwhile, national mentality is extremely important for transformation of the economy. Russian economic mentality took ages to develop. It characterizes the national perception specifics that developed historically and are manifest as a unity of the conscious and instinctive values, norms and attitudes reflected in popular behavior. Given the shared values, people either accept or reject the new social norms. It is well-known that Russian economic mentality could be described as communal that regards a person as part of the whole. Reciprocation and redistribution processes have always played an important role in Russia. Orthodoxy made redistribution customs of the peasant communes a norm. It also developed a tendency to humility and obedience and prevented identification of an individual as an independent agent by making moral values absolute as opposed to

the material values. Hence, the low rating of the actively achieved values in modern Russia.

Success in Russian culture is, primarily, good luck and consequence thereof (and naive hope for getting rich quick), but not a result of a long-term own effort; rather a result of personal contacts but not that of objective processes. In terms of the national culture, money-making and ownership are often viewed as negative rather than positive values. Freedom is interpreted not as independence and self-sufficiency but as the opportunity to do as you wish (as in anarchy and self-will). It is no surprise that the ***reaction of a major part of the population to the transition period programs is not adjustment to the change but escape from it.***

Russian economy transformation involved a conflict between the new formal regulations with the old informal rules and that of the new non-formal regulations with the old - formal<sup>1</sup>. The result is the situation where the non-formal relations absolutely prevail over the formal relations. Destruction of the old formal regulators opened opportunities for replacement by the non-formal relations. The new non-formal relations were not of purely market kind as they were impacted by the social and cultural imprint of the previous development.

Personal connections are becoming stronger to the detriment of the material, personified exchange - to the detriment of the non-personified<sup>5</sup>.

Analysis of the population's social adaptation to the market identifies two groups of problems. ***The first is related to the expansion of the formal freedoms and rights, the problem of institutionalization thereof,*** as well as actual narrowing of the social and economic opportunities. Establishment of the new life strategies and change of popular awareness reflect both of the trends. Social changes of the 1990s had different impact on the level of freedom of the various groups of the population. The thing is that various social groups of the Soviet Russia had their own perception of freedom, their own understanding of the independent choice and realization of their interests through active economic, social and political activity. The 1990s showed that the Russians perceive their actual individual freedom primarily as social and economic, but not political and legal freedom. Meanwhile, each economic system has its own freedom limits: constant and temporary, natural and artificial, real and perceived. Given the transformation decline, the economic freedoms restriction had a more pronounced effect than the social and political freedoms liberalization. Meanwhile, many have a restricted understanding of freedom: acquisition of new rights and advantages without loss of the existing opportunities and guarantees. Majority of the population cannot perceive any connection between the notions of Freedom - Independence - Responsibility. They want freedom but without responsibility and independence and all consequences ensue.

Under the circumstances, deviation from the legal norms became sort of a norm of behavior while compliance with such norms is an exception. The rift between the declared, desired and actual freedom has rapidly become wider. The above circumstances formed the background for criminalization of the society, establishment and development of the ***non-legal*** freedom. The society is now characterized by dominance of the passive forms of adaptations over the active,

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<sup>1</sup>

rejection of the emerging legal rights and freedoms, reproduction of the employee - employer relations on a more dependent and disfranchised basis than during the pre-reform period. Survival in the disfranchised social environment became possible through the systematic violation of the social norms only. To survive, many are forced to hide their real income. Thus, deviations from the social norms, ***violation of the new formal rights are becoming a new non-formal right.***

The second group of problems is related to the analysis of the specifics of the Russian society's market adaptation given marginalization of the society. ***One of the principal features is that this transition coincided with a deep transformation trough.***

Given the conditions, far from all people found effective adaptation methods. According to the sociological polls, currently, the majority of respondents view the possibility to improve their families' financial situation, to ensure good education of the children, to gain employment in accordance with the professional education, to improve housing conditions as the most significant. **Progressive respondents**, however, are becoming more and more self-reliant and value such rights as establishment of their private business, freedom of travel and residence and to assert their own rights more. **Regressive adaptees and NON-adaptees value the state-provided guarantees of employment and income**, timely salary payment, free education and free medical services **much higher**.

This exacerbates social inequality and intensifies polarization of the society. Although the Goskomstat data significantly understate the inequality level in our country (due to the imperfection of the data collection system that does not give a full account of such factors as the shadow economy scope, non-monetary income, etc.), these, nevertheless, confirm a stable society polarization trend.

Table 7-1 presents the data on the distribution of the total monetary income of Russia's population in 1970-2003. This evidences that the first half of the 90s was characterized by the inequality increase trend. Share of the poorest group of the population (Quintile I) declined two-fold over four years while that of the richest group (Quintile V) increased by more than 1.5 times. Thus, the gap between these became wider. If in 1991 income of Quintile V exceeded income of Quintile I by approximately three times (30.7% against 11.9%), then in 2003 - by nearly 8 times (46.1% against 5.6%). A still wider gap is observed if decile (10 percent) groups are used for the analysis. Thus, the Gini coefficient increased from 0.260 in 1991 to 0.402 in 2003, i.e. by more than 1.5 times.

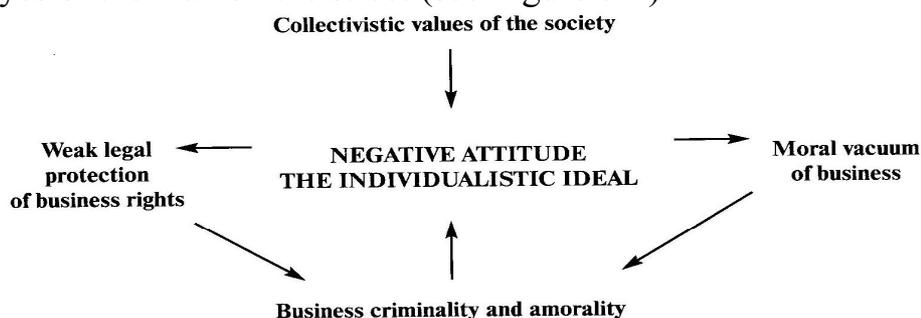
Monetary income of the population	1970	1980	1990	1995	2000	2003*
First quintile (with the lowest income)	7,8	10,1	9,8	5,5	6,0	5,6
Second	14,8	14,8	14,9	10,2	10,4	10,3
Third	18,0	18,6	18,8	15,0	14,8	15,3
Fourth	22,6	23,1	23,8	22,4	21,2	22,7
Fifth (with the highest income)	36,8	33,4	32,7	46,9	47,6	46,1
Gini coefficient			0,260	0,381	0,399	0,402

## **Company: Natural Persons, Paternalism, Barter and Extortion Racket Economy.**

As in the course of privatization the majority of the state property was transferred to the insiders rather than the outsiders, Russia did not acquire an efficient private owner, which largely determined inertia of the traditional economic system, its low growth rates and torturous forms of transition to the market economy.

Attitude of the majority of the population to major newly-emerging private owners is negative as the latter are perceived not as industrious producers who earned their huge fortunes honestly but as greedy predators that alienated the assets from the weakened state or stole the assets from their compatriots. The negative image of the "new Russians" is maintained continuously, which is confirmed by numerous sociological polls presented in the monograph". In the opinion of many Russians, deception of the buyers and the sellers is a rule, while honest business is an exception. This perception is far from groundless. The fact is that removal of the administrative limitations made obvious the shadow economy that existed in the Soviet Russia. Meanwhile, it does not equal the classical market economy form protected the Early Capitalism entrepreneurship in Western Europe. Money-grabbing of the Late Feudalism is money-making by any (including the most dishonest) means, while the Early Capitalism entrepreneurship is value adding in accordance with the market laws. In the absence of the institutional limits, removal of the state-imposed limitations on business was perceived as the permission to make money by any means, i.e. in the first rather than the second sense.

It is no surprise that the Russian business has acquired criminal and immoral overtones. There is a vicious circle of a kind: as a "new Russian" is a personification of a thief in the country's eyes, he has no moral limitations. Censured by the public opinion, he acts in accordance with his image existing in the eyes of the man on the street (see Figure 7-1)



*Figure 7-1. The vicious circle of the Russian business alienation from the society*

### **Statehood Decline - Private Ownership Evolution<sup>38</sup>**

The following three stages of the ownership right changes in the post-Soviet Russian can reasonably be defined:

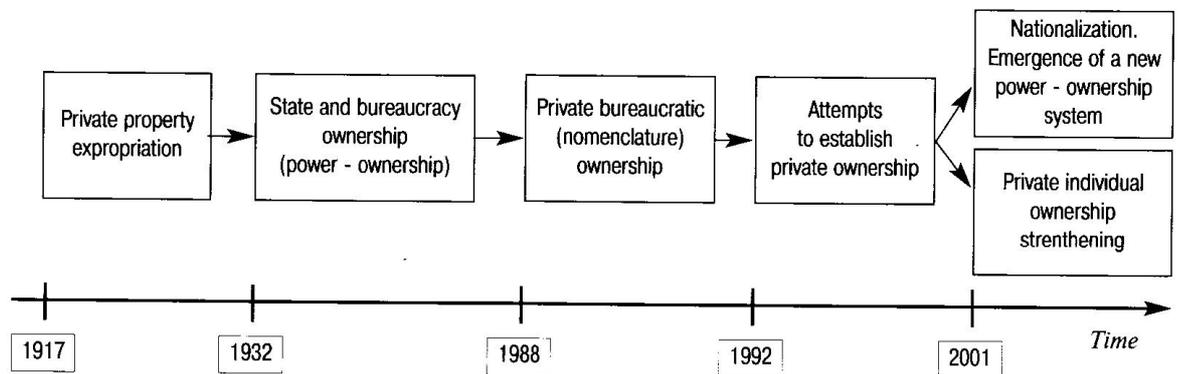
#### **Phase 1: Nomenclature Privatization (1988 - 1992)**

The feature is that the bureaucracy (and, first of all, directors of the former state-owned enterprises) uses the weakening state's property for personal gains by obtaining preferential state loans, licenses for free use of the natural resources,

establishing their cooperatives linked to the state enterprises and channeling profits to the cooperatives, thus laundering the illegal profits. These groups accumulated the first major capital (and/or thus increased their influence on the powers that be), set up companies on the most advantageous markets with the help of the market (or pseudo-market) mechanisms that are here still viewed as an organizational novelty within the framework of the previous Soviet system. Thus, sort of private - bureaucratic ownership evolves (Figure 7-2).

**Phase 2: An Attempt to Establish Private Property (1992-2000).**

To overcome the uncontrolled strengthening of the bureaucracy President Yeltsin's Administration decided to formalize the privatization process. From then on, de facto owners had to formalize their rights. This was also in the interests of the newly emerging owners as they have forever been in danger of expropriation of the acquired property under the circumstances of dilution of the old and lack or order of the new system.



*Figure 7-2. De-facto ownership system changes within the Soviet system framework.*

Main objective of this phase was, in the organizers' opinion, to establish the institutional conditions for the formation and development of the western model of the private ownership system. Here, privatization is deemed as a mean required propping the liberalization and stabilization measures up. Western institutes' import was covered by the Russian (eastern) content. This was initiated through the mass voucher privatization. The voucher stage was followed by the monetary and loan-for-shares auctions and investment tenders. And, although this phase is till continuing (in the form of one-off monetary privatizations) it peaked in the early 90s (see Figure 7-3).

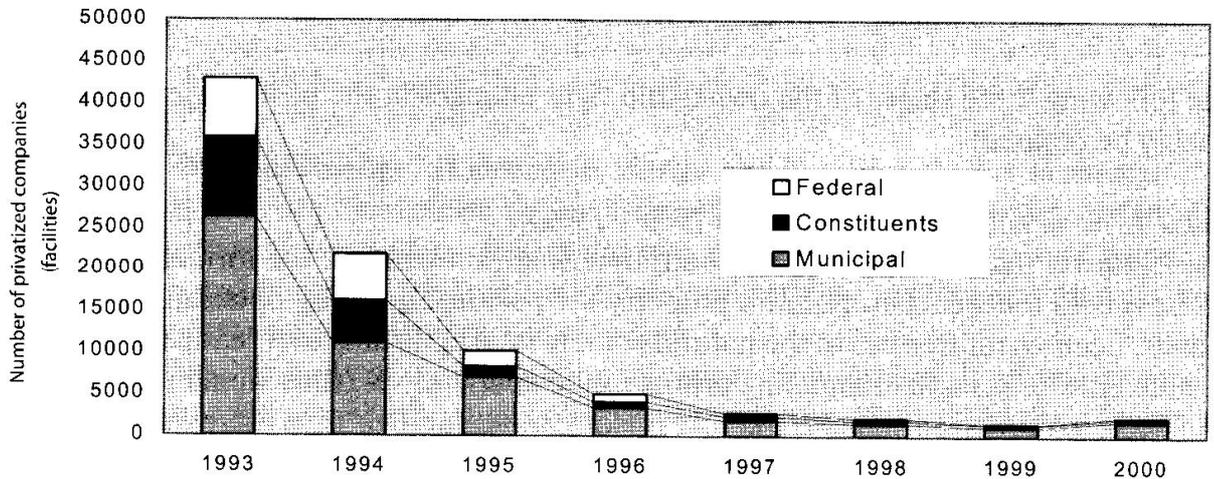


Figure 7-3. Industry privatization dynamics in Russia

Among the chaos of Phase Two, it became obvious by the late 1990s that the power-ownership system still remained dominant both on the federal and regional levels. This is evidenced by the composition of the Russian economics and politics elite (Table 7-2). Soviet nomenclature gave rise to more than a half of the party leaders and three quarters of the government and the president's inner circle members. Regional elite contains even more Soviet nomenclature representatives. More than four fifth of its representatives used to be part of the Soviet party, Komsomol or economy apparatus.

Yet, this does not mean that elite composition never changed. Comparison of the top rulers under Brezhnev, Gorbachev and Yeltsin reveals considerable decrease of the technocrats component (from 88.5% under Brezhnev to 36.4% under Yeltsin) and doubling of the component with basic education in economics or law (from 11.5% to 22.7%). These changes became even more prominent by the late 1990s

Table 7-2

**Composition of Russian top political and economy,  
Mid-1990s (in % of the total elite numbers)**

	Top leadership	Party leaders	Regional elite	Government	Business elite	Total
Total from the nomenclature	75,0	57,1	82,3	74,3	61,0	69,9
including:						
Party	21,2	65,0	17,8	0	13,1	23,4
Komsomol	0	5,0	1,8	0	37,7	8,9
Soviets	63,6	25,0	78,6	26,9	3,3	39,5
Economic	9,1	5,0	0	42,3	37,7	18,8
Other	6,1	10,0	0	30,8	8,2	11,0

Source: Kryshтанovskaya O. 1995: Page 65. (the data were taken from the sociological studies conducted by the Elite Studies Sector by the RAS Institute of Sociology under the guidance of O. Kryshтанovskaya in 1989-1994).

### Phase 3. Institutionalization of the New Power-Ownership (2001-...)

#### Is it Back to Private Property or Forward to Private Property?

As bulk of the state property was privatized by the insiders (ultimately, by the previous managers of the enterprises) rather than the outsiders, Russia did not acquire an efficient private owner (which largely determined the inertia of the traditional economy system, its low restructuring rates and the painful transfer to the new corporate governance forms). This also predetermines the internal reasons for the deep transformation recession during the period of transition from the planned to market economy.

The situation in Russia is much more complex: it is rather difficult to separate the entirely legal and the entirely illegal sectors of economy. Practically each enterprise is a combination of the legal and illegal business to a varying degree. Russian economy is, rather, "double-lane" than two-sector. This, however, does not release us from the obligation to analyze these processes as they are as the illegal business expansion narrows the legal sector and vice versa.

Thus, the split in the legal and illegal business "adversely affects the economy in general by reducing efficiency, investments and through general inefficiency by the taxation system, higher public utilities costs, lower technical progress rate and numerous difficulties in formulation of the macroeconomic policy"<sup>2</sup> and nowhere near frees the society from the need to enhance the institutional structure.

The next step is establishment of the conditions that W. Niskanen referred to as "soft infrastructure". The "soft infrastructure" term introduced by W. Niskanen defines enhancement of the personal economic rights (improvement of confidence, ownership rights, contractual honesty and responsibility, higher dissent tolerance, minorities' rights guarantees, etc.) and establishment of the informal "rules of the game" that ensure functioning of the market economy

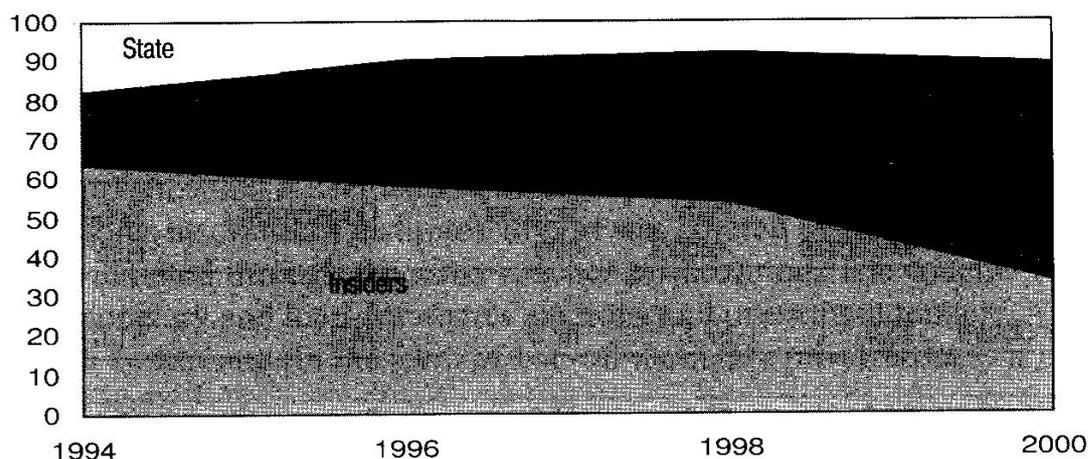


Figure 7-4. Ownership structure of the major and medium-size privatized companies in Russia, %

It is important to draw a consistent distinction between the late-Feudalism moneymaking and the early-Capitalism entrepreneurship, i.e. moneymaking through trickery and cheating and moneymaking under the market laws in accordance with the laws of competition. There has to be an environment

established that makes the late-Feudalism moneymaking disadvantageous and the early-Capitalism entrepreneurship advantageous for the most of the market participants. Only these rules of the game ensure effectiveness of the "good laws".

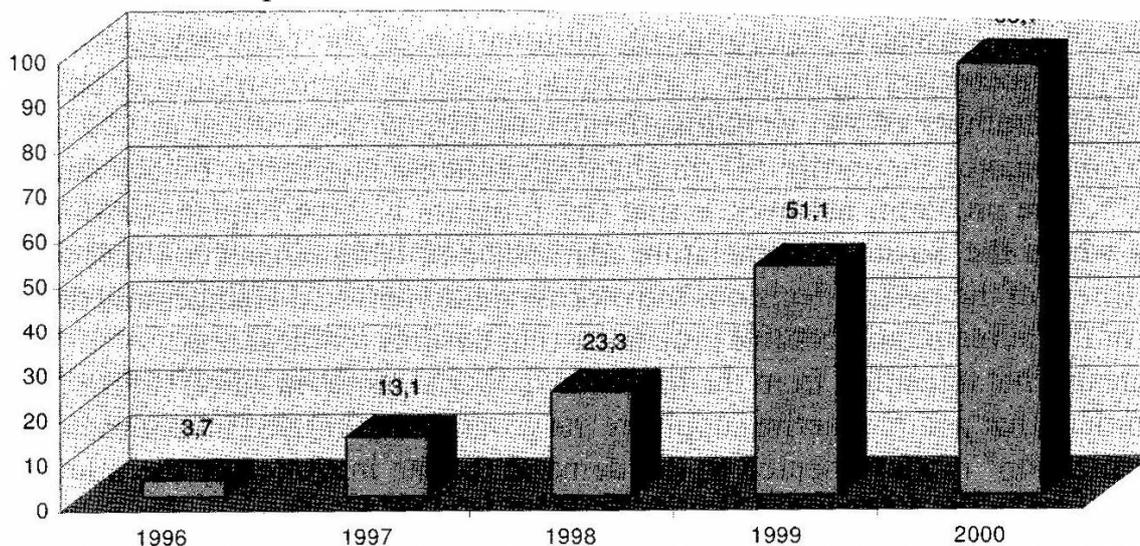
The specific emergent form has to be provided with the specific content to ensure transition to real private ownership.

Private ownership has a wide range of positive effects, including capturing of the assets' economic potential, integration of segmental information, development of the owners' responsibility, assets liquidity increase, public relations development and certification of the transactions<sup>42</sup>. Also, economic freedom is the foundation and an element of the civil society freedoms. It is primarily a necessity that ensures political freedom and, political freedom, in its turn, is a guarantee of economic freedom.

The neo-institutionalists usually understand the ownership system as the complexity of formal rules and informal limitations that regulate access to rare resources of the economic agents that are the title holders<sup>3</sup>. Furthermore, it would be appropriate for the system to

include the economic agents that set these rules, as well as the guarantors that ensure compliance with the said rules.

Alongside the pseudo-private, real private ownership has been evolving. For instance, barter reduction trend evidences decline of the residual state property share and influence. According to the studies, Coase theorem became effective in the 90s. Property transfer from the less efficient to the more efficient owners became active. If in 1994 the insiders' share in the ownership structure of the large and medium-size companies was 60-65%, than in 2000



*Figure 7-5. Equity financing of the IBG investment programs*

this share declined to 30-35%, while the outsiders' share increased from 12-25% to 50-55% (see Figure 7-5).

Currently, integrated business groups (IBG)<sup>44</sup> - an analogue of the American trusts of the early XX century, are becoming more and more prominent in advancement to private ownership. Given considerable uncertainty and lack of trust among the enterprises, peculiar financial and economy complexes are

evolving that include production enterprises, commercial banks, insurance companies and other affiliates that considerably reduce transaction costs of a business. In 2000, 8 major of such enterprises accounted for 2% of the total employment within the Russian economy and ensured nearly 1/4 GDP, while their product was 1/4 of the Russian export<sup>45</sup>. Most of the IBGs evolved from the energy and primary industry companies and (due to the resource rent) currently hold significant financial resources that enable increase of their economic potential. From 1996 to 2000 their capital investment in own investment projects doubled practically annually (Figure 7-5) and they are becoming some of the principal investors in the Russian economy.

It should be noted that the IBGs operate in a large number of the Russian regions. Thus, if in 1993 LUKoil operated in 5 regions then in 2000 r. - in 21 regions; Interros - in 1 and 23 regions respectively, Alfa Group - in 2 and 37 regions. Currently, the largest IBGs already are political and economic competitors of the regional elite. These are objectively interested in standardization of the legal environment and establishment of the united economic environment within the RF territory. Even now, some of them are restructuring the residual state property. Through purchasing the enterprises they optimize the organization structure and finances thereof to increase market value of the assets and dispose of the non-core (in their opinion) divisions (for instance, purchase, restructuring and sale by Alfa Group of Bolshevitchka confectionary plant, Borsky Glass, etc.).

An emerging economy strongly increases the alternative costs of the business based on the informal relations. Given economic growth, uncertainty of the external environment, non-reliability of the partners, lack of trust, contracts violation are becoming costlier and costlier. Yet, a "spontaneous shift from "below" to higher formalization and "transparency" of the economic interaction, - as R.I. Kapelyushnikov notes - may ensure a long-term effect, but only if it is supported from "above" - in terms of the legislation, organization and the politics"<sup>46</sup>.

Possibility of such support became immediately obvious with the advent of the new administration. As known, the Putin's Project includes a system of measures: "(1) Political and economic weakening of the elite groups interested in the old order preservation (2) unification of the legislative environment, elimination of the contradiction between the norms and the procedures applicable ... at various legislative administration system levels; (3) decrease of the number of and simplification of the formal restrictions, as well as the costs related to compliance therewith; (4) toughening of the sanctions for the law and contracts violations"<sup>47</sup>. The problem, however, is that this program is to be implemented by the state apparatus where the Soviet nomenclature methods and technologies are still alive. Thus, there is a threat of the radical decisions transforming into personal changes and further complication of the bureaucratic control procedure that ensures political rent.

This means that transition from the model of "political modernization" of the institutional environment that assumes active supply by the government-related institutes, to the "market modernization" model oriented to the demand for the institutes by the market participants is required in the long term<sup>48</sup>.

Here, specific private property development measures and the related economic policy realized in the sphere of privatization and possible de-privatization must be based on the two common principles: firstly, comprehensive approach to the property legislation reform issues, secondly, establishment of the economic incentives system for all actual title holders.

It should be understood that hopes to establish prosperous market economy over the nearest "500 days" is a useless and harmful illusion. Market modernization of Russian economy is along process and we have to find the courage to live and teach others to live under such complex circumstances. In this regard, economic education in general and economics as a science are gaining a dramatically more prominent role.

MBA courses are of high value for the modern Russia. This is especially true for the institutional concepts that are still hardly known to the specialists, let alone general public in our country. In this regard, the ultimate objective of the economists is study and the widest promotion thereof. Yet, the national specifics study is not an end in itself. The very specifics can be understood within the context of global development only, given the expanding and deepening globalization.

### 7.3. «The Day to Come, What is it Bearing?»

#### Recommendations for Russia: typical priority-setting errors

First of all, we should define typical economic policy priority-setting errors to be avoided (Table 7-5).

#### Economic policy must NOT:

##### 1. Be formulated with an emphasis on "recovery" and "survival";

Liquidation of the catastrophic impact of the 1990s transformation shock has been largely completed. Current Russian GDP is approximately 100% of the 1990 pre-reform level. As the economy has been demonstrating an annual growth rate of 5-7% (which is higher than the average international rate of 4%), in 2007 we are guaranteed to exceed the pre-crisis level. Inflation has also long been within the normal annual growth rate range of 8-10%. Currently, Russia is a country in compliance with the average international standards. Thus, hysterical slogans of the need to fight the crisis, imminent catastrophe, etc. are better left to the political extremist outcasts.

Table 7-5

Industries contribution to economic growth (in GDP pts)

	1999 - 2001 Domestically oriented growth			2002 - 2004 Raw materials export-based growth		
	Annual average growth rate	Ppts	%	Average average growth rate	Ppts	%
GDP growth rate,	7,1	7,1	100	6,4	6,4	100
including on account of: Oil and gas industry	3,9	0,4	5	8,0	0,7	11
Primary industries (metallurgy, chemistry, forestry)	11,1	1,0	14	5,8	0,5	8
Processing industries (engineering, light , food industries)	12,2	1,1	15	7,3	0,7	10
Construction	11,0	0,7	10	9,0	0,6	10
Agriculture	13,7	0,9	12	3,8	0,3	4
Trade	4,5	1,2	17	9,7	2,3	36
Transport and communications	7,1	0,7	10	8,0	0,7	11
Non-market services	0,9	0,1	1	2,8	0,2	3
Other goods and services	5,4	1,1	16	1,9	0,3	5

Source: Report by A.R. Belousov "Long-term Russian economy trends", 2005, page 11.

**2. Be based on pitting the market and democracy against social justice;**

Democracy and the market as such cannot be the economic policy objectives; these are only the means to achieve the objectives. Neither democracy nor market as such are not the ideal methods that automatically create the best social order

**3. Be based on contraposition of the state and the market;**

"Market gaps" (power monopoly, imperfect information, external influence, production for the public good) under modern market economy are bridged by expansion of the state functions. Yet, interference by the state often results in the government being unable to ensure efficient distribution and use of public resources resulting in "state gaps" (deficiency of the information required for decision-making, political process defects, weak control over bureaucracy, the state's inability to foresee and control the short- and long-term consequences of its decisions.

Given the new historical conditions, on the one hand, the boundaries and methods of the state influence on the economy have to be established and, on the other hand, there must be active protection of the economy basis from the forced and destructive interference by the state.

**4. Be focused on any specific social group - the poor, business community, the Russians, etc.;**

Society is developing as an integrated whole where each person depends upon all other people. Establishment of "pets" results in alienation of other society members, in "pulling of the blanket" (rent-seeking) and in higher social tension and conflicts. The formulated program must be of national character and serve to consolidate the nation.

**5. Be formulated mainly in terms of the national accounting system (NAS) ("to double economic growth rate", "to catch up and overtake the US in terms of the per capita indices ...");**

The NAS indices as such are a weak reflection of the qualitative changes: GDP growth may be the result of the intensifying social differentiation, single-industry specialization, etc. Meanwhile, Russian society does not need expanded reproduction of the existing structure but does need structural changes.

**6. Focus unrealistic goals inspired by the false nostalgia for the USSR;**

Currently, Russia is a country of average economic weakness. Within the nearest decade we can compete only with the countries of "our league", such as Spain, Mexico, South Korea and Turkey. This choice of reference points must not be perceived as self-depreciation: there are numerous countries with glorious history than can only dream of Russia's level of development (China, India and Iran). Meanwhile, it should not be forgotten that Russia is a nuclear power and a G8 member (and even the G8 chairman in 2006). Yet, in terms of its economic indices our country is not quite up to the G8 standards and we are yet to justify this allowance and do everything possible to maintain its world power status.

## Tactical Priorities

Let us formulate tactical priorities for the nearest years (Table 7-6). A political movement claiming the role of the Russian modernization leader must formulate specific measures that would identify the overall change vector, would ensure a quick positive effect and would be supported by the widest electorate circles.

Таблица 7-6

Main Characteristics of the Russian Economy Sectors

	Added value	Export	Jobs	Fixed assets	Tax payments
Russian economy - total	100	100	100	100	100
Raw materials export sector	16,8	70,6	5,6	9,1	40,3
Domestically oriented sector	15,2	9,9	27,5	9,2	11,3
Trade	21,1	-	17,2	2,0	19,1
Infrastructure sector	10,0	4,3	8,6	36,9	8,0
Social services sector	9,1	2,6	23,2	32,9	1,6
Other sector of economy	27,9	12,6	17,8	9,9	19,6

Source: Report by A.R. Belousov "Long-term Russian economy trends", 2005, Page 17.

The following "fast-acting" measure could be proposed

### 1. Economic efficiency

Recently, fuel and energy complex industries have been a principal economic growth contributor. If in 1999-2001 domestically-oriented growth prevailed, then in 2002-2004 raw materials export-oriented growth was dominant (see Table 7-3). Yet, it does not mean that there are no problems in this sector. If we are to rely on the fuel and energy complex development, it must be modernized, i.e. we must master modern methods of oil and gas production. Explored world gas resources are 148.9 trillion cubic meters. Given current gas consumption level, these are sufficient for more than 70 years. Russian explored gas resources are 48 trillion cubic meters (32% of the world resources).

## Main Social and Economic Indices (%)

Index	Forecast option	Actual	Estimate	Forecast			2012 vs 2003	2015 vs 2004
				(average annual growth rate)				
		2004	2005	2006-2008	2009-2010	2011-2015		
GDP	1			5,6	5,1	4,9	163	176
	2	7,2	6,4	5,8	6,0	6,7	172	196
	3			6,0	6,2	6,8	174	198-200
Industrial output	1			3,9	3,9	3,6	144	151
	2	6,1	4,1	4,6	5,2	5,6	156	173
	3			4,6	5,3	5,6	156	173
Direct investment	1			8,5	8,1	8,4	215	246
	2	10,9	10,3	9,8	9,8	11,1	244	297
	3			11,1	10,8	11,2	260	315
Real disposable income	1			8,0	6,6	6,2	195	211
	2	9,9	9,1	8,9	7,4	7,2	206	230
	3			9,1	7,4	7,2	207	231
Retail turnover	1			8,5	7,0	6,7	210	227
	2	12,5	11,8	9,7	7,6	7,2	221	242
	3			10,0	7,8	7,3	226	248
Goods export*	1			3	1,0	1,6	146	126
	2	21,9	4,2	3	2,2	4,4	158	148
	3			3,5	2,0	3,8	158	144
Goods import*	1			13,3	7,6	6,0	272	275
	2	18,5	22,2	17,7	10,1	8,7	341	366
	3			17,9	11,3	9,0	371	400

Source: Long-term Russian economy growth forecast, report by the RF Ministry of Economic Development and Trade, Page 11.

Note: Option One - passive, Option Two - active innovations, Option Three - active innovations and high oil prices; \* export and import growth rates in physical terms.

Russian forecast natural gas resources are 166.8 trillion cubic meters. These are mainly concentrated in Western and Eastern Siberia, as well as in the far East. More than 42% of the resources are associated with the Kara and Barents Seas. New technologies are required for realization of this potential. A similar problem is also faced by the oil sector. We are yet to learn to produce oil offshore. Also, energy use is not always rational. We must develop energy saving, as well as new energy and fuel transport technologies. High oil prices could create the prerequisites for the efficient use of the stabilization fund for modernization of the economy. Data presented in Table 7-4 evidence that more than 70% of the exports are accounted for by the natural resources export sector that uses about 9% of the fixed assets, employs less than 6% of the able-bodied population and accounts for more than 40% of tax revenue. Currently, social services sector employs nearly every fourth Russian and holds nearly a third of fixed assets; yet, its contribution to export and tax revenue is much more modest at 2.6% and 1.6% respectively. Natural resources export revenue could be used for technological development. This is the objective of the plan developed by the Ministry of Economic Development and Trade that provides for the GDP doubling by 2015 due to state activity only (Option 3) and under favorable market conditions (see Table 7-7). If

the state fails to implement active measures for modernization of the economy, economic potential would not double and GDP would increase by 2015 by 76% only (Option 1).

## 2. Personal freedom

An absolute priority is personal freedom and initiative development. Capabilities of a nation that is not accustomed to self-employment, - said John Stuart Mill, - a nation that expects from its government relevant instruction and directives on all issues of common interest, are developed by half only<sup>51</sup>. This requires not only the living standards enhancement (as an impoverished and browbeaten person quite often is incapable to use his personal freedom) but also economic initiative development. A person is a fully-fledged citizen only insofar as that person perceives himself a member of the society and makes his contribution to the implementation of the common national goal.

A leading, nationally-oriented social class must be formed. It is no secret that the so-called "offshore aristocracy" developed back in the 90s, that exported its capital. It is no surprise that a country like Cyprus has recently become one of the leading capital importers into Russia. It is, actually, Russian capital previously exported to such offshore zones. The problem is not only capital flight but is that our business elite is not becoming national bourgeoisie and hedges its future on other countries

Another component of the nationally-oriented leading class is the bureaucracy that is gradually transforming from the Soviet nomenclature into competent public servants, an integral part of the modern Western society.

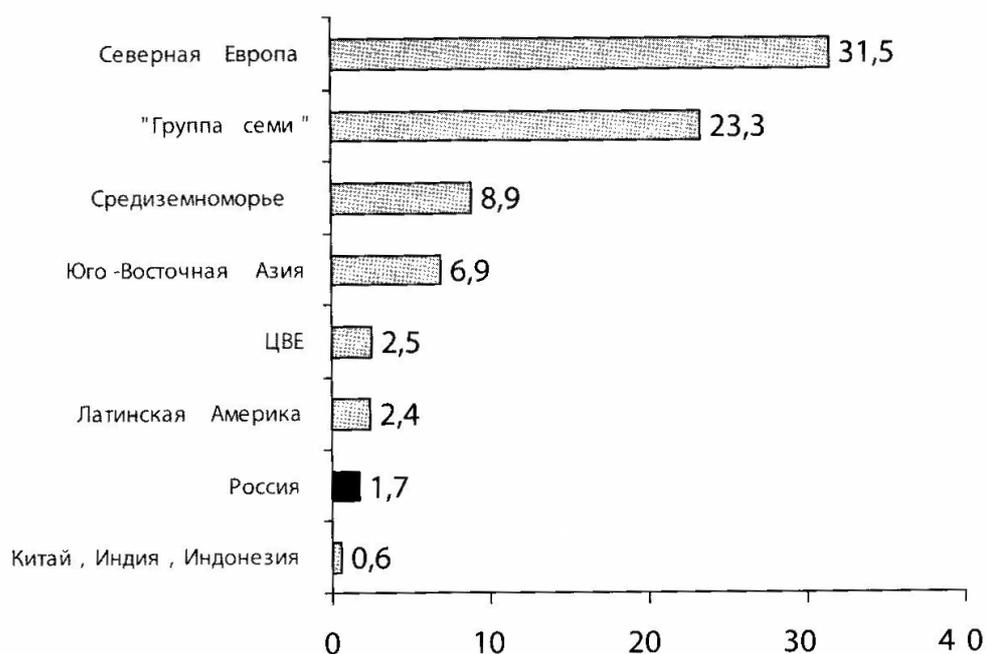


Figure 7-10. Industry wages (USD per hour at the 2004 exchange rate)

Source: Report by A.R. Belousov "Long-term Russian economy trends", 2005, Page 31.

Formation of the national elite must be influenced by the modern education system and culture. Regrettably, these also experience quite a few problems. Currently, Russian universities are undergoing the differentiation process that enhances and reproduces differentiation of the post-Soviet society. Even in the Soviet Union, regional centers representatives had more chances to reach the top of the pyramid.

### **3. Social justice**

In 2004, hourly industrial wage in Russia was USD 1.7 and, although it was three times the wage in China. India and Indonesia, it was 1.4 times lower than in the Central and Eastern Europe and Latin America (see Figure 7-10). At the same time, labor efficiency in Russia was at the level of the Central and Eastern Europe and Latin America (see Figure 7-11).

Yet, compared to G7, hourly industrial wage was lower by the factor of 13.5 and by a still higher factor of 18.2 than that of the Northern Europe (Norway, Denmark, Sweden and Finland) (see Table 7-7). Meanwhile, the gap in terms of added value per employee is not so great: it is 2.3 times less than for the G7 and 2.6 less than for the Northern Europe (see Figure 7-11 and Table 7-8).

Social justice will be promoted by:

- Housing improvement is the basic direction of the Russians' welfare enhancement, including development of the long-term loans system and more active counteraction of the economic crime in residential construction and stimulation of the residential construction competitiveness.
- Establishment of the medium-term program of the public sector salaries - teachers, doctors and law-enforcement agencies staff (the focus must be not on the immediate increase but on steady income growth contingent on the work efficiency).
- Introduction of graver penalties for corruption in public service, implementation of the collective responsibility principle (all immediate colleagues of the bribe-taker are subjected to a strict check and their career development is restricted if corruption is identified).
- Income transparency enhancement. Top officials and leading businessmen are offered to display information on their private means (in the Internet).
- Arts patronage encouragement. The state offers to the business community to finance culture and science organizations guaranteeing media coverage of such PR event and tax benefits

**Russia vs other countries in terms of industrial wages and labor efficiency (Russia = 1, 2004)**

	Hourly Rate	Added value per employee
Northern Europe (Norway, Denmark, Sweden, Finland)	18,2	2,6
G7	13,5	2,3
The Mediterranean Region (Portugal, Greece, Spain, Slovenia, Turkey, Israel),	5,2	1,5
South-East Asia (South Korea, Malaysia, Singapore)	4,0	2,0
Central and Eastern Europe Europe (Hungary, Poland, Romania, Slovakia, Czechia)	1,5	1,0
Latin America (Chile, Columbia, Mexico, Venezuela)	1,4	1,0
Russia	1,0	1,0
New Asian «power centers» (China, India, Indonesia)	0,3	0,5

Source: IMD World Competitiveness Yearbook, 2005, Report by A.R. Belousov "Long-term Russian economy trends", 2005, Page 29.

### Strategic Tasks

Now we must formulate the strategic priorities (for the next decade). These priorities must identify the desired changes of the very "rules of the game" that are perceived both as the objective and the means for achieving thereof. Let us analyze these from the personal freedom, social justice and economic efficiency perspective.

More detailed description of each of the directions is given below.

#### 1. PERSONAL FREEDOM

Development of personal freedom requires, first of all, enhancement of trust between the subjects. Modern economists and sociologists cite popular trust and trust by the population of the social and economic organizations (the state, banks, etc.) as the fundamental institutes. An important role is also played by the development of the private ownership guarantees and consistent economic policy promoting freedom.

Any strengthening of the Russian state must not be perceived as an attempt against personal freedom. If the state establishes equal for all rules of the game, protects the underprivileged part of the society, demands honest payment of the taxes, strives for timely payment of pensions and salaries it can hardly be viewed as an attempt at democracy.

#### 2. SOCIAL JUSTICE

Institutional priorities must be summed up by some succinct and multivalent slogan that can be attractive for the Russians pursuing various ideologies. The following options are possible:

- "Market economy must service social sphere".
- "Poverty is individual; we must act together to ensure dignified life".
- "Middle class is the backbone of Russia".
- "To break the administrative barriers down, to establish public control".

- "To stimulate "regional growth locomotives".
- "To provide targeted support for the vulnerable regions and to ensure the conditions for life quality improvement as one of the criteria of Russia's integrity".

### 3. ECONOMIC EFFICIENCY

The following set of institutional priorities can be offered in terms of the economic efficiency enhancement:

- Establishment and maintenance of competition, antimonopoly efficiency.
- Switch of business priorities from the rent-seeking to productive activity and enhancement of the honest business image. In 1990-2000s, business revenue (especially that of top business) depended on the participation in "political games" and on basic corruption more than on production enhancement. Thus, Russian businessmen acquired an extremely negative reputation of "legal criminals", general Russian population approves any "disinvestment" measures. Corruption must be minimized and lobbying must be within the legal framework for business to gain popular respect.
- National independence from the external economic pressure. Independence from petrodollars and foreign creditors (such as the IMF) must be achieved. Here, export of oil and gas, same as foreign loans must not be rejected. The idea is that no external events and organizations cannot exert any significant influence on the Russians' choice of the national development direction.
- Rational protectionism during the transition period. National industry protection and, in this regard, justification of the domestic market protection measures, especially during the transition period when national economic development is yet achieve the required rate.
- Growth of Russia's attractiveness for foreign labor. For the next few years Russia is doomed to live under the demographic catastrophe sword of Damocles: - reduction of the able-bodied population. Thus, one of the top priorities must be wider use of foreign labor, primarily from the CIS countries.
- Development of the relations of integration with the CIS countries ("economic restoration of the unified post-Soviet environment"). Integration blocks that ensure economic unification of the adjoining countries with common problems (EU, NAFTA, APEC) are becoming stronger the world over. Disintegration of the post-Soviet environment must be replaced by integration. Russia has no intention to encroach on political independence of Ukraine, Kazakhstan, Byelorussia, etc. but must adhere to the course of economic unification thereof. ***"Russia will change but not betray itself".***

Theoretically, development of Russia can follow one of the following three directions: state-dominated; oligarchy or creation of the conditions for strengthening and development of the medium and small business.

These could be referred to as:

- State capitalism
- Oligarchic capitalism
- Competitive capitalism

Development along the state capitalism route means across-the-board interference in economy by the state, intensification of the centralized redistribution of the resources, limitation of the business and investment decisions freedom (by both the federal and regional authorities), controlled openness of the economy and growth maximization on the basis of a limited number of industries.

If the **oligarchic capitalism** scenario is realized, there would be further corporate and industry centralization, relatively prominent presence of foreign companies on the Russian market, delegation by the state of the business decisions authority to major companies but contingent on political approval within the "industrial policy" framework, combination of the economic openness with the selective protection measures.

Under the competitive capitalism scenario, the state maintains a strong regulation policy in the sphere of formation, maintenance and enhancement of business conditions, promotion of competition, support of small and medium business and detaches itself from business decision-making while redistribution of the resources (except social redistribution) rests with the market competition mechanisms; open markets policy is pursued that includes explicit rules and responsibility of the subjects.

Yet, even realization of these scenarios is possible under various institutional forms.

Impact on the policy thereof varies depending on a range of circumstances. The following options are possible depending on strengthening or weakening of the vertical policy model:

- Authoritarianism - democracy, "controlled democracy";
- Protectionism - free trading;
- Closed - open society;
- Modern liberal - classical liberal;

Depending on the stage of the federal political system development, centralism or federalism and regional power can become more or less prominent. The result is the implementation or predominant implementation of the administrative or the liberal model.

Yet, even in this case, the political organizations' role can vary. The parties can become weaker or stronger same as their influence on significant decision-making. Currently, there is an explicit single-party strengthening trend; yet, judging by the historical experience, these are the unstable democracy countries.

Time will show if the single-party system gains a hold in Russia or if it is replaced by the two-party system. Given the presidential systems, establishment of a steady multi-party system is less probable.

Recently, there have been measures to increase the civil society role, yet time will show if these can express the interests of various social groups. It is absolutely obvious that trade unions played a major role in numerous countries (for instance, in the UK, France and Japan). In a number of countries (for instance, in Germany) a major role is played by the entrepreneurs' unions, as well as political organizations of the small and medium-size business.

It is important for the economic policy to be understandable for the general population and for the politicians to convince the population of its correctness. The

policy must be consistent, open and honest. It always must be tactically correct, i.e. focus not only the long- term, final result but also prove its efficiency within a reasonable term as perceived by the population. Only in this case we shall be able to realize our history-determined potential.