Session 1
What should Government do to Promote Investment?
Three episodes from Russian history
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In the last hundred years, Russia has gone through several episodes where government tried to promote investment. These episodes can hardly provide clear lessons of what to do; however, we can learn from them what is *not* to be done.

The first, and the most famous episode, was the Soviet industrialization in 1928-40. In these years, Stalin's government tried to build modern industries and to reallocate labor from farms to factories. Together with Anton Cheremukhin (Dallad Fed), Mikhail Golosov (Princeton), and Aleh Tsyvinski (Yale), we have developed a quantitative macroeconomic model that allows evaluating these efforts. We find that while Stalin did succeed in creating new industries and in moving tens of millions of people from villages to cities, his policies were actually not successful in economic terms (not even speaking about the huge human costs). First, expropriation of peasants substantially decreased the productivity in the agricultural sector. Second, and more important, Stalin's top-down investment and industrialization policies resulted in misallocation of capital and significantly reduced productivity in the industrial sector as well. We find that government was very inefficient in building and managing industrial enterprises. To sum up, whatever scenarios we consider, we show that Stalin's policies are outperformed by any reasonable counterfactuals.

The second episode comes from the second half of 2000s when Russian government tried to diversify the economy through state-backed investment in the innovation sector. Flushed with petrodollars, Russian government created a number of "development innovation institutions" (DII) –funds and state-owned companies to support innovation from pre-seed to seed stage to early and late stage to production and IPO. Yet, Russia has not become an innovation success story. In 2012, together with Josh Lerner from the Harvard Business School and Bella Research Group, we at the New Economic School carried out an evaluation of the key Russian DII –and compared them to similar efforts in other developed and developing countries. We found that one of the key problems in Russia is that government does not "listen to the market" enough and does not subject the projects it supports to the test of the market. Instead of choosing projects, government and its DII should use matching funds strategy and should not take controlling stakes. We also found that the government should reallocate much more resources from funding the late stage and production to supporting education and early stage. We also found that it is very important to clarify DII's missions and mandates – and commit to the declared rules of the game.

The third and final episode from recent Russian history –the Russian economic slowdown of 2012-14 – is so recent that it yet has to be studied. After the recovery from the 2009 crisis, Russian economic growth suddenly went down to zero. In 1998-2008 Russian economy grew at 7% a year, in 2010-11 it was recovering at 4% per year but starting from the second half of 2012, the growth rate started to fall and became negative in 2013 and early 2014 – even before the Crimean crisis. This slowdown was driven by the poor performance of aggregate investment. While Russian consumption and exports continued to grow, investment was stagnating or even falling. In 2011-14 Russia experienced net capital outflow at 3-4% GDP. Russian stocks are trading at 50% discount to comparable stocks in emerging markets.

Given that Russia has healthy macroeconomic situation (10% GDP sovereign debt and balanced budget), given that there are many investment opportunities, why is capital leaving rather than coming to Russia? Even though Russian government has announced many reforms to promote investment climate and protect investors – and has complete control over domestic politics – investors did not seem to believe these announcements. Apparently, they see that government has *too much* control and cannot commit not to expropriate private investors – through excessive taxes, bribe extortion or over-regulation –in favor of state companies and politically connected oligarchs. This of course creates a

vicious circle– the risk of expropriation shortens the investors' horizon, instead of long-term investments businesses focus on rent-seeking and asset-stripping, which in turn undermines tax base and creates incentives for even greater expropriation in the future.

Together, these three striking episodes imply very simple lessons for any government –and for the French government in particular. If a government wants to support productive investment, it should *refrain* from investing in industrial assets. Its job is to invest in human capital and to commit not to expropriate, not to over-regulate and not to overtax the private sector. These ideas are not new –they date back at least to Adam Smith– but as these three episodes show, they may still be very relevant.