COMMENT & ANALYSIS: The Soviet ghost in Russia's machine: Economic reform is threatened by over-optimistic fiscal forecasts and state-led industrial policy, argues Padma:

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Vladimir Putin's brand of politics has raised concern. In particular, critics say the Russian president's understandable desire to restore law and order may undermine Russia's emerging democracy.

By contrast, the government's new plan for economic reforms has met only with approval.

The plan, designed by German Gref, trade and economic development minister, sets out targets for the next 10 years, including cutting annual inflation to below 10 per cent by 2004 and increasing annual economic growth to 5 per cent. Tony Blair, the British prime minister, recently gave it his full endorsement.

Yet the core of the plan is critically flawed in two ways. The plan's recommendations on the important task of industrial restructuring are anti-market and a reversion to old ways of managing the economy. Second, its prescriptions for restoring the all too necessary fiscal balance on a sustained basis are unrealistic.

True, the plan addresses a number of problems, such as breaking up monopolies and reforming the country's defence industry. But the central plank of the plan's restructuring agenda is state-defined and state-led industrial policy that discriminates - without serious rationale - among sectors for differential treatment.

Thus, between now and 2002, manufacturing of heavy machinery is targeted to grow at up to 20 per cent a year, and its output will be selectively assigned to upgrade mining, power generation and infrastructure. Between 2008 and 2010, the plan envisages developing the high-technology, science-based sectors and turning them into big exporters. This last phase will witness the "decline of state participation in the funding and support of investment programmes and projects".

The plan clearly envisages changing the industrial structure through a sequential investment strategy. This will turn of necessity into an invasive industrial policy. It would be better to establish largely uniform rules - including incentives for foreign investment - allowing the markets to define the incentives that shape industrial sequencing. In short, Mr Gref and his planners have fallen prey to the mentality inherited from earlier, Soviet times.

The plan's fiscal policy is also radical and based on dangerously optimistic estimates. The consolidated "primary" budget, which excludes interest payments on debt, is currently in surplus. But the future is bleak.

While government spending has fallen from 76 per cent of gross domestic product in 1992 to between 37 and 38 per cent in 1999-2000, serious weaknesses remain, such as the increase in the regional share of government spending from 15 to 40 per cent. At the same time, spending commitments by the regions have grown - ahead of receipts - partly thanks to federal mandates that have not been matched by revenue allocations to the regions from federal taxes. The Gref plan recognises this and projects a consolidated budget deficit of at least 25 per cent of GDP for 2001-2004, with spending at 62 per cent; and spending at 60 per cent with revenues at a mere 35 per cent of GDP for 2005-2010, without new measures.

But these new measures would have to be draconian to shrink the massive deficit from 25 per cent of GDP. Here, the Gref plan becomes a wish list. "Profits from (state) assets and activities" will provide 3 per cent of GDP. Another 4 per cent will come from net new borrowing. The remaining 18 per cent will be offset by slashing spending through reforms such as the means-testing of welfare beneficiaries; by simplifying the tax arrangements and broadening the tax base; by introducing reforms in federal-state tax jurisdictions; and through tough measures such as cutting back on subsidised natural gas supplies to users that have fallen behind with payments.

Can all this be done? It hardly seems possible. For example, in a country that has inherited 156 types of federal benefit programme, distinguishing 236 categories of recipient, which encompass, at a minimum, nearly 45m people, it is a tall order to achieve a significant fall in entitlement expenditures. Unless the economy improves radically, cutting back on a "welfare state", in which almost half the country's voters are beneficiaries, raises obvious problems. These may be surmounted but it is a high-risk, low- probability scenario.

This is where the industrial strategy returns to the scene. It will be almost impossible to balance the budget unless substantial revenues are generated by a growing economy. This requires a big influx of foreign investment with its complement of equity, technology and management. Yet the Gref plan offers a Soviet approach to industrial policy, and hesitates to implement a policy unreservedly aimed at attracting foreign investment.

This hardly inspires confidence in the new Russian economics team. Unless he is made aware of these harsh realities, Mr Putin will fail.

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