Promoting Competition and Entrepreneurship in Russia

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This note assesses the state of entrepreneurship and competition in Russia and sets out a policy agenda for strengthening these processes, which are vital to a successful transition. Growth through transition arises from the reallocation of existing resources across and within enterprises, the development of new products and production methods, and the accumulation of new productive factors. The process of competition is central to these activities, since this creates strong pressures at the firm level for productivity gains, innovation and investment within an environment where the opportunities for corruption are signficantly reduced. Effective competition requires rivalry among producers, both existing and new entrants, and financial discipline from suppliers, creditors and tax authorities.

1 Market entry, innovation and growth in transition economies

In terms of contributions to the growth of enterprises in transition economies, two factors stand out: the successful start-ups of new private businesses and the development of new or improved products by existing enterprises. The results of a major new survey of over 3500 enterprises in 22 transition economies – implemented by the EBRD and World Bank – show their importance. New private businesses have grown on average at a rate four times that of privatised or state owned enterprises. Similarly, those enterprises that have developed new or improved products have grown at a rate of five times that of those that have not innovated in this way. These patterns are observed for all transition economies, including Russia.

The role of new private businesses in the Russian economy, however, is far below that in other transition economies (OECD (1998)). Based on 1996-97 data, there are about 1 million small enterprises in Russia, accounting for roughly 10 per cent of total employment (and an estimated 15 per cent of GDP). In contrast, SMEs account 47 per cent of total employment in Hungary and 63 per cent in Poland. In addition, the frequency with which firms in Russia innovate is less than in other transition economies. According to the recent EBRD/World Bank survey, the proportion of Russian enterprises that had introduced new or improved products over the past three years was 29 per cent, compared with 36 per cent for enterprises in central Europe and the Baltic states.

In Russia, as in other transition economies, there have been significant obstacles to the competitive process. The functioning of markets has been distorted and constrained by a number of fundamental determining factors:

- inability to sustain internal and external liberalisation in the face of the recent financial crisis (EBRD (1999), Chapter 2);

- political concerns about the social costs associated with fully competitive markets and the restructuring responses that would be required of enterprises if soft supports and arbitrary impediments were eliminated. (McKinnsey (1999));
- the privatisation of state enterprises largely to insiders failed to “de-politicise” firms, but rather led to new complex bargains with the state that have distorted the business environment (Hellman and Schankerman (2000));
- the geographical distance of the Russian economy from the main industrialised market economies (EBRD (1999), Chapter 4); and
- weak competition in domestic product markets due to buyer/seller concentration, a high degree of vertical integration and geographic segmentation (Broadman (2000)).

The first three factors relate to the interaction of economic reform and politics and the persistence of market distortions arising from the policies and behaviour of the state. These distortions undermine the overall quality of the business environment and create an “uneven playing field” that has tended to favour old firms (privatised and state-owned) at the expense of the performance of new private firms. The fourth and fifth factors originate from geography and from excessive vertical integration and regional specialisation in production. These latter two, in turn, were inherited from the era of central planning and were largely maintained through subsequent government policies.

2 Determinants of enterprise performance – Russia in perspective

The impact of competitive pressure, the uneven playing field and the overall business environment can be seen clearly by analysing the performance of Russian enterprises along with that of enterprises in other transition economies. This comparative perspective permits the identification of factors in Russia that impact on the performance of firms, such as the extent of competition from foreign producers, the extent of “soft supports” for enterprises and the quality of the business environment. It is important to recognise that soft supports for enterprise can take many forms, such as direct subsidies, toleration of arrears on taxes and utility bills, and barter. The business environment also has many dimensions that affect enterprise performance, including macroeconomic stability, taxation and business regulation, access to essential services (infrastructure and finance) and the rule of law.

The impact of competitive pressures, soft budget constraints and the business environment on enterprise performance is strong, based on evidence from the recent EBRD and World Bank survey. Key findings from an analysis of the cross-country survey include (Carlin, Fries, Schaffer and Seabright (2000)):

Competitive pressures

- perception of foreign competitive pressure by firms is significantly and positively associated with product innovation and sales growth;
- pressure from domestic produces is less significant than foreign competition in promoting innovation and growth;

- prevalence of soft supports for enterprises in a country, particularly in the forms of toleration of tax arrears and barter, significantly weakens product innovation, investment in new plant and sales growth;

The business environment

- macroeconomic stability and effective business taxation and regulation promote significantly sales growth;
- the rule of law fosters development of new or improved products; and

Origin and ownership of enterprises

- new private businesses and joint ventures grow more rapidly and innovate more frequently than do privatised and state-owned firms, pointing to the importance of market selection among domestic producers through the competitive process.

The survey evidence shows that the competitive pressure from existing firms – particularly from foreign producers – combined with hard budget constraints for enterprises and the entry of new private businesses are key factors in promoting strong enterprise performance in transition economies. However, in Russia, competitive pressures from abroad are relatively weak and soft supports for enterprises abound. Compared with other transition economies, Russian enterprises tend to perceive less pressure from abroad. This reflects both the trade obstacles maintained at the national and regional levels and the geographical distance of Russia from industrialised market economies. Also, a greater proportion of Russian enterprises benefits from soft supports in the form of tax arrears and barter than in many other transition economies.

The quality of the business environment also has a significant influence on enterprise performance, on both the development of new or improved products and sales growth. However, along each of its dimensions, the business environment in Russia is poor relative to that of many other transition economies. Russian firms perceive a relatively challenging environment in terms of macroeconomic stability, business taxation and regulation, access to essential services (finance and infrastructure) and the rule of law.

In addition, it is important to recognise that different types of firms within Russia, as in other transition economies, have different perceptions and experiences of the business environment, with new private business facing particular disadvantages (Dutz and Vagliasindi (2000)). New private businesses in Russia face particularly high hurdles with respect to rule of law (corruption and judicial enforcement of contracts and property rights) and business taxation and regulation. New private businesses in Russia also perceive significant competitive disadvantages from privileged access to essential business services (infrastructure and finance) and from government subsidies, important sources of soft supports for old enterprises in Russia. In fact, the continuation of these soft supports appears to be one of the most damaging aspects of the uneven playing field in Russia relative to other transition economies. Compared with other countries in the region, the new private businesses in Russia perceive these factors to be the greatest obstacles relative to old firms.

3 Industrial structure and organisation in Russia

At the national level, the degree of concentration of industrial output in Russia suggests an absence of a structural competitive problem. For many industries, Russia and the United States have similar market concentration ratios (Joskow, Schmalensee and Tsukanova (1994)). However, this aggregate-level analysis masks three underlying attributes of the industrial structure and organisation in Russia, which have been inherited from the old regime (Broadman (2000)) and which have been sustained or intensified through government policies.

First, many of the dominant enterprises in Russia are highly vertically integrated or have exclusive buyer-seller relationships. However, excess levels of vertical integration can lead to dominance of key supply chains and create significant obstacles to the entry of new firms in product markets. The high degree of vertical integration reflects in part the uncertainties and chronic shortages of the old Soviet supply system, which induced state enterprises to consolidate their supply chains. Vertical integration has also increased since the start of transition, primarily through mergers and acquisitions and through the creation of industry led financial-industrial groups. In Russia, it appears that the uncertainty of market transactions (weak contract enforcement) continues to create strong incentives for vertical consolidation.

Second, large Russian enterprises tend to be organised as single integrated establishments, often located in or near a single city. In contrast, large firms in industrialised economies tend to have many establishments located across domestic regions and foreign countries. On an establishment basis, Russian enterprises are significantly larger than their counterparts in other countries, including the United States. This organisational characteristic of production inherited from the old regime has tended to concentrate the social costs of enterprise restructuring. Reflecting localised political pressures, regional economic policies are often aimed at weakening competitive market pressures.

Third, regional authorities in Russia often seek to influence and control economic activity within their regions by conveying special privileges to favoured firms through taxation and public administration. Such controls, including additional taxes on trade at the regional level, have reinforced the relatively high degree of regional autarky inherited from the previous regime, where consumer goods production was a local responsibility and enterprises served only their respective local markets. Market concentration at the regional level is significantly above that at the national level.

In effect, Russia has been pursuing a “high tax – special privileges” policy where tax exemptions, toleration of tax arrears and other privileges are granted at all levels of government, with particular variation across localities. Business registration is also a regional problem, with a large number of documents to be submitted (many requiring witness by notary offices) and some regions introducing higher state registration payments, and additional registration and license payments to municipal funds (many not even defined by law). Additional barriers created by regional authorities include the arbitrary rejection of registration and licensing applications, outright bans on inter-regional trade, granting of exclusive production rights, and discrimination over loans and subsidies.

4 A strategy to promote entrepreneurship and competition

The above analysis identifies several key priorities for promoting entrepreneurship and competition in Russia. They emerge clearly from the observed paucity of new private businesses in Russia and from the constraints perceived by such firms, from the identification of factors that constrain the performance of Russian enterprises and from the assessment of the industrial structure and organisation in Russia. The main elements of the strategy to promote entrepreneurship and competition seek to ensure equality of opportunity for all enterprises, to increase competitive pressures in ways that can be sustained over time and to improve the quality of the business environment.

Key priorities include:

- Reduce soft supports for enterprises, while promoting the market-based restructuring of enterprises.
- Establish a more level playing field for all enterprises through reform of taxation and other policy-created barriers to entry, public administration and the judiciary at the national and regional levels.
- Reduce impediments to foreign direct investment, including the number and incidence of existing limitations on FDI covering not only manufacturing but also the infrastructure monopolies and service sectors.
- Accelerate the liberalisation of trade, including early accession to the WTO.
- Reduce the international and regional segmentation of markets through commercialisation and increased competition in key infrastructure sectors, in particular telecommunications and transportation.
- Develop a robust competition enforcement regime to deal with horizontal and vertical structural market imperfections among incumbent industrial firms.
- Increase the access of SMEs to infrastructure, finance and business support services.

Specific policy recommendations for each priority are developed in turn.

Reduce soft supports to enterprises that allow non-viable enterprises to remain in the market and to create significant obstacles for the formation and growth of new private businesses. This would require a comprehensive approach that both reduces the arrears and barter problem and promotes restructuring non-viable enterprises.

Soft supports for enterprises in Russia are maintained through a complex network of arrears and non-monetary transactions, in which the federal and regional governments and key infrastructure utilities actively participate (companion paper on Barter and arrears in Russia: principles of a solution strategy). A first step in reducing soft supports would be to eliminate the indirect support of governments for them by requiring that tax obligations are settled in money, by eliminating budgetary arrears and tax offsets, by enforcing penalties for the accumulation of new tax arrears, and by pursuing recoveries of accumulated arrears. Public utilities should also be required to improve their cash collection ratios and scale back their barter arrangements.

At the same time, a comprehensive strategy for restructuring large industrial enterprises should be initiated to address some of the factors underlying the proliferation of soft supports for enterprises. This should include reform of the social safety net, shifting the provision of benefits away from enterprise and towards cash benefits provided by the state to the unemployed. For enterprises that can be restructured to achieve commercial viability, the focus should be on creating purchase opportunities for strategic investors. This can include the privatisation of residual state-owned shares, asset privatisation and ring fencing in joint ventures, and pre-privatisation restructuring. Such an approach also requires the support of the federal and regional governments, particularly where there are close ties between the existing owners/managers and government.

Establish a more level playing field for all businesses, including SMEs, by reforming business taxation and regulation, by combating corruption and arbitrary bureaucratic behaviour, and by strengthening the judiciary.

At the federal level, the main body responsible to support the entry by small entrepreneurs since late 1998 is the Ministry of Anti-Monopoly Policy and Support for Entrepreneurship (MAPSE). There has been some limited progress to eliminate policy-created barriers to entry, including a new federal law to reduce the licensing burden passed in September 1998 and enforcement actions by the Anti-Monopoly Committee against anti-competitive practices by executive bodies at regional and local levels.

Given the extent and depth of the problems, stronger centralised action is needed. In particular, it is essential to streamline government policies and regulations to reduce the competitive disadvantages for small firms. Eliminating excessive and discretionary administrative rules also reduces the opportunities and incentives for arbitrary bureaucratic interference and abuse of power (companion paper on Governance, corruption and the law in Russia). Reform of administrative regulation should include: a sharp reduction and rationalisation of activities that can be subject to licensing via the creation of a positive list, a limit on the overall taxation load and the number of taxes, the removal of all discretion of tax inspectors to negotiate individual deals with taxpayers, and curbs on controlling bodies and the frequency of possible control. These reform-related rules must be precise and subject to monitoring. For example, individual tax rates should not to exceed a specific level, and administrators should be controlled to prevent re-visiting the same enterprise more than once in a given period. All remaining rules applying to business at local and national levels following the simplification exercise should be published. The emphasis should be on an information management system that is low-cost, implementable and widely accessible.

Regional and local requirements should not be allowed to contradict federal rules, and any requirements that exceed the permitted number would need to be revoked. Monitoring should be entrusted to a central Deregulation Office, with direct Presidential support to withdraw central benefits to any region that fails to comply. The ceilings on regulatory requirements should be very widely disseminated, with feedback channels for enterprises to report violations at the grass-roots level. Over time, all rules that have potentially large economic impacts should be subject to a more careful analysis, including rationale, direct and indirect implementation costs, and an assessment of other alternatives.

Remove obstacles to foreign direct investment, by removing impediments in sectors where FDI is prohibited or restricted, but also by strengthening the protection of property rights and the enforcement of contracts, ensuring that foreign entities are treated the same as domestic ones.

The foreign investment record is extremely poor in relation to the population, the size of the market and factor endowments. To spur competition and innovation, it is essential to: grant non-discriminatory national treatment to foreign investors for both right of establishment and post-establishment operations; prohibit the imposition of new trade-related investment measures (TRIMS) and phase-out existing ones (for example, local content measures and trade balance measures including those prohibited by the WTO on FDI); provide freedom to FDI projects regarding all investment-related transfers, including profits, royalties, the right of compensation for confiscation, requisition and other guarantees; provide for binding international arbitration for investor-State disputes; and abide by international law standards for expropriation, that is, expropriation only for a public purpose and with prompt, adequate and effective compensation. These measures are in addition to reducing uncertainty about the robustness of macro stability and more generally improving the protection of property rights and contracts.

To the extent that investment follows trade, government should actively promote foreign trade relationships between local and foreign firms by strengthening agencies that provide market information, quality control and certification services, especially to smaller enterprises with limited export experience or strong potential. To promote knowledge flows concomitant with capital, government should consider a professionally run investment promotion effort including a backward linkage program enticing large best-practice foreign and local corporations to train and utilise smaller local suppliers of inputs and components.

Accelerate the liberalisation of the trade regime, including the roll back of temporary protectionist measures and early accession to the WTO.

After the economic crisis of August 1998, the authorities took a number of steps that have reversed external liberalisation, such as a ban on private imports of ethyl alcohol. These measures coupled with an increase in export surrender requirements and deposit requirements on advance payment for imports have sharply increased restrictions in the trade regime. Furthermore, import and export duties are subject to bureaucratic bargaining. A priority should be the full roll back of these temporary measures.

To spur competition and innovation, more proactive policies to promote trade flows should be also followed, including liberalisation of quota licensing and other non-tariff barriers on imported goods and services. Early accession to the WTO would provide strong benefits in terms of the stability and credibility of a liberal policy regime, regarding trade in both goods and services. Progress in meeting the conditions of the TRIPS agreement would be a particularly important area for immediate emphasis, as it would also help stimulate local innovative activities that rely on intellectual property rights. Access of foreign suppliers to the Russian markets of distribution, banking and other essential business services should also a priority.

Improve the functioning of geographically segmented markets through the commercialisation of key infrastructure sectors, in particular telecommunications and transportation to help overcome bottlenecks in distribution networks. The role of telecommunication and transport as a facilitator for inter-regional and international trade is crucial to reduce transaction costs and to allow exchanges that otherwise would not take place.

Tariff reforms are a priority in both sectors. In the case of telecoms, unbalanced domestic tariff structures need to be addressed, with businesses paying 5 times more than households and facing the highest international tariffs in the world (in terms of GDP per capita). This is partly driven by lack of co-ordination between regional and federal regulatory authorities: regional authorities set long distance calls and interconnection charges, whereas local antimonopoly committees and political authorities determine local calls. With respect to railroads, freight rates are substantially higher in order to subsidise passenger traffic. This is critical since railways account for the vast bulk of Russia's long distance freight transport, carrying well over 7,000 tonne-kilometres per person and outweighing the road freight system by a factor of 3000 per cent.

Additional priorities in the telecom sector are to remove key bottlenecks and develop alternative wireless and Internet technologies. The main impediments are associated with the poor status of satellite and fixed-line networks and the current licensing procedures that do not allow for direct competition between operators offering the same standard. To introduce competition, options available include: unbundling Svyazinvest by separating and liberalising international long distance and local calls; consolidating local telecom operators and allowing them to compete with each other; and licensing additional wireless local loop operators as alternative access providers.

In the transport sector, additional priorities for rail include the phasing out cross-subsidies, unbundling of activities, corporatisation of the core functions of network management and freight and passenger transport together with greater involvement of the private sector in ancillary activities such as heavy maintenance. To promote more efficient use of road freight for shorter hauls and to promote inter-modal competition on longer hauls, sufficient budgetary allocations will be required for road maintenance, provided privately where feasible with part of financing from appropriate user charges.

Develop a robust competition enforcement regime to deal with policy-created obstacles to competition and with horizontal and vertical structural market imperfections among incumbent industrial firms. The aim should be to create contestable markets through a strengthened policy environment and competitive restructuring of industrial enterprise based on careful empirical investigation of specific markets.

While competition policy is still in its early development and is not supported by a stable political consensus, the Anti-Monopoly Committee has increasingly focused on the policies and behaviour of state bodies that limit competition. In 1998, the antimonopoly bodies investigated more than 1700 of such alleged acts resulting in 749 cases. A priority for the Committee should be to assume a much more proactive role in reducing administrative and institutional barriers to entry both within regions and between regions and other countries. A key role of the Committee should be to document, systematise and promote the removal of policy-created obstacles. To implement effectively this role, it would require strong support of the President and federal government and adequate enforcement powers.

An additional priority for the Anti-Monopoly Committee is to more actively prevent abuses of dominant market positions. In 1998, the committee assessed more than 1880 cases and found violations in 1058 cases. In this regard, the Committee maintains a "dominant" firm registry and, in some cases, imposes regulations on profit margins. In their place, the committee should seek to mandate restructuring to overcome excessive market power where existing market structures are not the result of competitive market outcomes. In particular, further horizontal and vertical consolidation should be prevented where structural dominance is already excessive. An evaluation of current merger analysis in terms of pro- and anti-competitive effects would be a useful starting point.

Increase the market orientation of SME support services in areas where markets may not function well absent government intervention to stimulate entry and expansion of entrepreneurs. The aim is to invest in institutional capacity-building and public goods that develop financial and non-financial support services for entrepreneurs.

In 1995, the new State Committee for Support for Entrepreneurship developed a program for the State support of SMEs (up to 500 workers) that for the first time received status as one of 24 special purpose federal programs. The main pillar of the program has been a risk capital fund for partial guarantees and/or interest subsidies for SME borrowers who can back loans with at least 30 per cent of own property. Other SME support services include: subsidies to new job creation by the Federal Employment Service; technology and regional funding schemes; subsidies for leasing services; and training, information and counselling services. Assessment of implementation effectiveness is not possible absent systematic evaluations.

While some of the measures represent a useful start, greater emphasis should be placed on the development of sustainable, demand-driven institutions, products and delivery mechanisms suitable to entrepreneurial start-ups, for example based on matching grant schemes. In this area, in contrast to deregulation, there is scope for significant decentralisation within an overall central framework that maximises the opportunities of experimentation and learning from regional variation.

In terms of financial services, subsidies should be limited to incentives to participating institutions to develop the necessary infrastructure and credit technology to meet the needs of start-ups and SMEs – and not on below-market interest rates that distort resource allocation and will never be sufficient to meet demand. A market-oriented strategy for improving access to finance for start-ups and SMEs should emphasise policies to increase competitive pressure on financial service providers, to upgrade the capacity of banks and related finance providers in meeting the needs of smaller clients, and to address some of the underlying causes of higher risk-related costs. In particular, the risks associated with lending to smaller clients can be reduced by improving not only the laws but the capabilities of institutions such as those that enforce contracts, register assets and collect collateral. Laws developing land registration and a mortgage market, for instance, were passed in 1998 but have not been made fully effective.

A well-functioning law regulating property rights on land would allow SMEs and farmers to use these assets as a basis for bank loan guarantees. In the area of non-financial service provision as well, existing programs should be reviewed in terms of cost recovery, and wherever possible rely for delivery on voluntary private chambers of commerce, larger firms linked to SMEs through buyer or supplier relationships, and other SMEs.

Finally, entrepreneurship training should be actively supported, including assistance with communication strategies of successful private-driven training centres such as the Morozov project. Such efforts have added substantial value, in particular as regional centres have begun to develop networks of their own in regional cities. In addition, broader social entrepreneurship education requires public expenditure on high-profile public awareness campaigns under the auspices of appropriate institutions such as a re-focused Anti-Monopoly Committee.

5 Implementation strategy

The implementation of a strategy to promote entrepreneurship and competition should involve both a government led effort to set priorities, develop strong institutional mechanisms and sufficiently fund activities as well as a grass root effort to develop support by intended beneficiaries. In establishing priorities, it is necessary to be clear on objectives and on the most cost-efficient means of achieving the goals and then to make the necessary budget allocations. The key objective is to facilitate the entry and expansion of efficient and innovative enterprises. Given the centrality of soft budgets for large enterprises and high hurdles for SMEs in constraining competition and entrepreneurship, these first two policy priorities should be tackled first. There is in particular a need to address policy failures by removing the scope and incentives for unequal application of government rules and policy actions.

At the same time, political support for a level playing field must be developed to counter the influence of those powerful business interests that have sought and received special privileges. However, in Russia there are few business groups that can advocate effectively for reforms of the type that would benefit industry as a whole and not just a privileged few. Only 16 per cent of Russian companies belong to such associations, compared to 77 per cent in Hungary and 91 per cent in Turkey. To counter this, 20 Moscow-based entrepreneurs have recently formed an association to advocate collectively for policy reforms. The government should endorse this approach and encourage replication by other businesses throughout the country.

The Foreign Investment Advisory Council to the Russian Prime Minister (FIAC) can also serve as a useful forum for mobilising support for implementation of the strategy. FIAC was originally set up in 1995 as an advisory body of the largest foreign investors to the then Prime Minister Chernomyrdin. EBRD joined in as the only IFI in 1996. FIAC developed into an established institution with plenary meetings held twice a year at the highest executive level (involving the Prime Minister and other key ministers from the Russian side and CEOs from the foreign investors' side). Between the plenary meetings a number of standing committees are working on key issues of the investment climate in close co-operation with representatives of the Russian Government. While FIAC--as many other avenues for policy dialogue with the authorities--has proved to be only modestly efficient, the post-election Government should be more receptive to concerns and recommendations of the international investment community.

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