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Structural and Institutional Constraints on Economic Growth

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While analyzing the potential for going ahead with the economic reforms and the prospects for economic growth in Russia, it is crucial to properly assess and consider the structural and institutional factors that effectively constrain the *spectrum of choice* with regard to economic policy decisions. Among such factors, the following ones seem of special importance:

- noncompetitive sectoral and market structures;
- significant price disparities;
- forms and degree of economic openness;
- forms of privatization and actual property structure.

Below we will show exactly how these factors have been and still are influencing the progress and the results of the economic reforms. Based on that analysis we will also provide a rationale for a number of observations on major economic policy shifts that the Russian government is very likely to pursue over the next several years.

1. Noncompetitive sectoral structure.

One of the underlying principles of the administrative planning system, focusing on the 'unified factory' model, has been a deliberate and massive eradication of competition from business life, with the concentration and specialization policy serving as vehicle for creating a noncompetitive sectoral structure to rule out any 'parallelism and duplication'. Pursuant to the inherent logic of that system, the goal of the policy was to reduce the number of entities to be managed at each level of the administrative-command hierarchy.

The methods of reaching this purpose varied from one sector to another. In industries with low concentration and quick turnover of capital – such as the light and food industries and retail trade – improved manageability was achieved basically through instituting various artificial business structures (so-called "amalgamations", "trusts", "chief directorates", etc.). Attachment, in an administrative way, of certain areas to certain enterprises was widely practiced and stood for a geographical distribution of markets. In high-tech, capital-intensive industries (engineering, in the first place), the policy of highly-detailed *product* specialization, when the entire national production of a certain type of instrument, bearing or chemical fiber was concentrated at 1 or 2 plants, began as early as at the stage of equipment procurement[1].

Finally, in the raw materials sector jumbo enterprises were deliberately created to focus on supplying certain predesignated geographic regions.

[1] In market economies, on the contrary, the trend toward technological specialization prevailed, i.e. some types of mass and serial production (metal smelting and forging, etc.) gave birth to independent entities, capable of operating on the basis of orders from various customers.

Therefore, the planning system was shaping up its own specific industrial structure, with each enterprise having a very limited choice of either the suppliers or the customers.

2. Disparity of prices.

Orientation towards a maximum possible independence from the world market, associated with a "hostile imperialist environment", and, for that matter, the 'closed-door' economic policy was another ideological pillar of the planned economy system. This made it possible to develop a specific structure of prices that were very little and in an indirect way related to world prices. In this regard, the role of the state monopoly on foreign trade and the system of several exchange rates, ruling out any direct influence of world prices on the behavior of domestic manufacturers on the internal market, could not be overestimated.

At the same time, the centralized pricing system had its own intrinsic logic. In the administrative and command economy, all enterprises were encouraged to overprice their products to reach the "gross" target figures of the economic plan. Administrative price control, exercised by central economic agencies (State Planning Committee, State Committee for Prices and sectoral ministries), was aimed at neutralizing that trend and proved quite effective with respect to one-product mining and manufacturing industries. The 'end product' manufacturers, however, succeeded in effectively circumventing this obstacle as their products were more diverse, and every slight modification of product could be priced advantageously.

As the isolation from the world market grew, significant price disparities began to appear as prices for raw material resources were relatively underrated, while final products were relatively overpriced. These price disparities were implanted in the efficiency assessment criteria for investment projects and had their impact on the structure of the economy.

3. Intercountry differences within the "Communist Bloc", and the different consequences of the open market policy.

The above mentioned industrial policy had been pursued, with certain variations, in all socialist countries. At the same time, the outcome of that policy and, consequently, the extent of structural distortions varied from one country to another. Those differences depended largely upon the time period spent by each particular country in the "socialist camp", the military and political role played by each country, the initial degree of openness of each country's national economy, and the level of self-sufficiency in raw material resources. By all these parameters, the former USSR had been a way ahead of the rest of the socialist countries, which has largely predetermined the scale and character of structural distortions, inherited by Russia from the Soviet planned economy.

The reformers believed that a swift opening of the economy would become a key incentive for structural changes and reinstatement of competition on the domestic market.[2] This kind of approach was partly justified for industries with low concentration, where the nonexistence of competition rested on the 'organizational monopolies' and the administrative and territorial distribution of markets. For capital-intensive high-tech and raw materials industries, however, that approach has proved erroneous.

For high-tech industries, restoration of a competitive structure of national markets, or an effective entry into the world market required considerable long-term investments to provide a profound restructuring of business entities and technological upgrading of enterprises. Without such investments, these industries, built to cater for outdated criteria of economic efficiency, were destined to become uncompetitive given the accelerated integration of Russia into the world economy.

In the real sector, only raw materials industries (fuel and energy industries, in the first place) and the industries engaged in primary processing of raw materials (ferrous and nonferrous metallurgy, the chemical industry, and the pulp and paper industry) have gained considerable advantages as the economy became more open. Their investment potential has grown substantially. Yet, the accelerated privatization in these industries suggested that the additional revenues to be yielded due to the disparity between the domestic and world prices would, in fact, go into private hands. In a more stable economic and political environment, such revenues would probably be used for restructuring an entire national economy. Instead, they actually constitute a major source of illicit or 'gray' capital flown abroad over the recent years.

4. Forms of privatization and the structure of property.

The initial logic of the market reforms in Russia attached much importance to overall privatization. Liberalization of prices, the open market policy, and the demolition of the 'organizational monopolies' were regarded as the necessary prerequisites for shifting towards a market economy. Privatization, suggesting a transfer of responsibility from the state to private owners and brand-new opportunities for private initiative, had to lay the foundation for the development of self-regulating market mechanisms, by virtue of which the accumulated distortions would be rectified and a competitive market structure would be shaped up. However, the forms of privatization chosen by the government (which definitely reflected the political compromises of the early 1990s) have ironically led to perpetuating the uncompetitive and inefficient industrial structures in many a sector of the economy.

From the economic point of view, one of Russia's major privatization problems was the enormous *diffusion of property*, which entailed, quite logically, a flight of financial resources from the real sector, as the management used their enterprises' working capital to get hold of sizeable stakes.[3] The diffused structure of property was

[2] It should be noted that, in our opinion, the reformers were not consistent enough in liberalizing external trade. For example, when the domestic goods market was being rapidly opened to importers (especially when the ruble was becoming stronger in real terms), the financial market has remained closed to largest foreign banks and financial institutions for a long time. Yet, that policy very well suited the basic interests of the newly emerged trade and financial capital, which the Russian government leaned on substantially during 1991-1998.
[3] This kind of behavior on the part of the management who ran their enterprises and tried their best to retain control over them was quite predictable. At any rate, the lease-based privatization, which had begun under Gorbachev and had been controlled by the "insiders", has appeared far less devastating for the enterprises.

restored rather quickly in the raw materials and manufacturing industries, because taking over those enterprises meant astronomical revenues derived from the disparity between the domestic and world prices.

Outside the capital-intensive sector, real concentration of property has been observed in operational enterprises in the food and light industries, retail trade, etc., which required much smaller starting capital inputs. The potentially high returns on investment were accounted for by quick turnover of capital and domestic market orientation.

On the contrary, high-technology capital-intensive industries have found themselves in the worst situation: due to their uncompetitiveness on the world market they could hardly be considered a source for potential long-term revenues; yet they required huge investments in restructuring. [4]

In most cases, in this sector of the economy the state has not been substituted by *some other* owner, capable of initiating some internal reforms. In practical terms, this meant perpetuation of the inefficient market structure.

Large-scale redistribution of property, when no proper legal basis to underlie the privatization process was available has led to a substantial rise in the *degree of uncertainty* for business entities. Unlike it is in a market economy, the position of enterprises characterized by *good* economic and financial indicators was most unstable. Consequently, the owners and managers of the enterprises began focusing their activities primarily on fulfilling short-term objectives and pursuing short-term interests. This negative trend was further jeopardized by the non-payment crisis brought about by inadequate economic policies of the government.

5. Possible consequences for Russia's economic policy over the next years.

The above may lead us to three important conclusions concerning the basic trends in Russia's economic policy for the next years:

1. Even in the conditions of a stable economy, traditionally focused on short- and medium-term goals and interests, a free market in Russia *is not capable of reinstating competitive market structures in capital-intensive high-tech industries with long production cycles*. Should Russia really need to have these industries, the problem has to be solved by the state, which over several decades in a row has been fostering the noncompetitive industrial structure. This does not in any way mean direct state investments, which are not written in today's budget and are unlikely to be envisioned in the budget in the nearest future. First of all, this policy can and must rest on private investments. But these must be *long-term* investments, which, in fact, has been impossible in Russia over the past decade. Today, long-term private investments in the real sector of the economy would require sound guarantees from the state and, possibly, substantial tax exemptions. Such *private* investments must, in fact, *be coordinated by the state.* Decisions regarding the areas and scale of

[4] Largely, this also refers to city-systemic enterprises that are not in the high-tech sector.

investments must be taken by the investors and in close cooperation with the government.

2. Under the conditions of economic liberalization and accelerated integration into the world market, the distorted price structure formed during the Soviet period has created considerable price-related advantages to the raw materials sector and, on the contrary, substantially worsened the competitiveness of all 'end product' industries, notwithstanding the level of their technological advancement. In such conditions, increased competitiveness of 'end product' industries will inevitably be financed, in one form or another, by the state (or with the backing and active support from the state) *by virtue of redistributing part of the revenues currently generated in the fuel and energy sector and other raw materials industries*. To this end, it also seems important to make use of the Russian capital flown out of the country and accumulated in offshore accounts.[5]
3. This medium-term redistribution of revenues as well as the preservation of a number of 'end product' industries in the long run can only be achieved given *a very slow growth in the real ruble exchange rate*. The current gulf between the exchange rate and the purchasing power parity is actually one of the last available resources, which the government can use to finance structural adjustments in the economy. At the same time, it is important to comprehend that undervaluation of a national currency can provide only *temporary* support to domestic producers.

[5] Special agreements between the government and the biggest tax-debtor companies on a long-term restructuring and a stage-by-stage writing off of their debts in lieu of their investments in particular Russian industries may be a clue to this problem. Meaning enterprises that produce and process raw materials, in the first place. The government might use the threat of bankrupting and, eventually, nationalizing such enterprises for debts as an instrument for persuading them to sign the agreements.