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Is There a New Russia?

A Report for the Baltic Development Forum

CEFIR is an independent economic think-tank based in Moscow and staffed by young Russian economists, many of whom received degrees from top Western universities but decided to return to Russia. CEFIR researchers have presented papers on the Russian economy at major international conferences and participated in a number of policy advice projects. A central overall objective of CEFIR is to make a sustainable contribution to building economics in Russia.

CEFIR is an institution-building project of SITE in collaboration with CEPR. SITE is a leading economics research institute at Stockholm School of Economics focusing on the issues facing the countries in transition in Central and Eastern Europe and former Soviet Union. An increasingly important part of SITE's mission is to assist the countries in transition in developing their own centers of research and knowledge. SITE is committed to building analytical capacity supporting governments and business contributing to development of the region. CEPR is an international network of 450 economists seeking to "promote independent, objective public discussion of open economies and the relations among them."

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Executive Summary

The Russian economy is growing. Thanks to the liquidity created by the ruble devaluation and favorable oil prices, growth is broader, involving more industries and more regions, than ever before. More importantly, Russia has for the first time in a decade a political and economic constellation conducive to the broad institutional reforms necessary to put the economy on a path of sustainable growth. Strong popular support has allowed President Putin to make significant progress in weakening the interest groups that have blocked reform, and he has put his weight behind a very ambitious reform program. But the concentration of powers in the presidency also holds important risks, and the lack of clear reform priorities threatens to derail the government program. This independent Report brings together the latest research and data to understand the challenges facing the Russian government and suggest the key reform priorities.
The growth challenge facing Russia is overwhelming. This Report shows that not only are Russian firms dramatically less productive than their counterparts in the West, but the productivity gap has also been increasing rapidly over the last decade. While Western firms grew more efficient, productivity fell in all major industries in Russia through most of the 1990s. As increased demand in the last couple of years has reversed the decline in production, and firms are now utilizing their capacity better, productivity seems to have improved. Vast additional improvements could be achieved by simply introducing better business organization. But managers have not had sufficient incentives to restructure their firms. The fragmentation of product and labor markets has weakened competitive pressures. And poorly functioning corporate governance and soft budget constraints have severed the link between performance and consequences for managers.

But Russia cannot achieve sustainable growth without new investment. For most of the 1990s, investment declined, and the age of the capital stock has increased to alarming levels. New investment is important not only in its own right, but it also brings about productivity improvements. This is particularly true for foreign direct investment. Regional data show strong positive spillovers from such investment, but the size of these spillovers depends critically on the quality of human capital and the extent of economic reforms. And the high quality of Russia's human capital, an important component in productivity, can no longer be taken for granted. Recent figures show that while the number of university graduates is increasing, the quality of education is deteriorating as a result of a 'brain drain' and the exclusion of more and more young talent from the university system for financial reasons.

On the whole, what promotes productivity improvements also generates more investment. Investments in the educational system are critical to sustain productivity improvements and increase spillovers from new investment in manufacturing and services. Poor protection of property rights, in particular weak enforcement of existing laws, undermines the incentives of investors as well as managers. More generally, the entire political and legal context – the business climate – matters. The concentration of powers at the federal level and within the executive branch has come at the expense of special interests and the Russian regions. While this concentration of powers opens up an unprecedented opportunity to implement critical structural reforms, it also creates a commitment problem. Experience from around the world shows that when rules are unclear, or when the power of the ruler is unchecked, economic growth suffers.

The main objective of the reform program should be to establish the checks and balances necessary for the government to commit to stable institutional rules conducive to sustainable economic growth. Russian - and foreign – entrepreneurs and investors need stronger protection of property rights. In particular, the privatization results, as deplorable as they were, must be accepted once and for all. And allowing businesses to own land and streamlining the regulatory environment is important in reducing the scope for bureaucratic arbitrariness and corruption. But to contribute new risk capital, outside investors also need stronger protection against expropriation by insiders, and minority investors must have better assurances against the abuse of power by controlling investors. In striking a balance between the interests of strategic owners and minority investors, the growth challenge facing the economy must come first. Russian industry desperately needs strategic investment and thorough restructuring to increase productivity.

The Russian legal framework can still be improved, but enforcement is the critical task. Judicial reform should raise the pay of judges and introduce discipline through clearer rules and more accountability through jury trials. Administrative reform should also aim to clarify the rules for the allocation of resources within the federal structure. Elements of healthy competition between and within levels of administration would help promote a better business climate. Predictability of the 'rules of the game' is key. Sustainable growth requires sustainable institutions.

In the long term, the generation of investment requires a functioning financial system that transfers capital from savers to investors and monitors how these funds are used. The Russian financial system, what remains of it after the financial crisis of August 1998, is very underdeveloped by international standards. In particular, the banks play little or no role in the supply of capital for investment. Credits to the private sector have increased significantly since 1998, but little has been done to reform the banking system. Poorly capitalized banks working in a soft regulatory environment are unlikely to screen investment effectively or monitor how funds are used. Unfortunately, the Central Bank with the backing of the presidential administration still lacks the political will to implement the necessary reforms. The prospect of a new financial crisis over the next couple of years, as the revenues from oil exports level off and the ruble appreciates further, should sharpen minds.

Our analysis implies that the key priorities are judicial, administrative and social reforms, and reform of the banking sector. Judicial, administrative and social reforms are now underway, even though their implementation is a daunting challenge. The prospects for genuine bank restructuring are less encouraging. The implementation of the reform program and the long-term credibility of the new institutional rules would be greatly helped by deeper integration of Russia into the world economy. As painful as it may be, accession to the World Trade Organization is critical for putting Russia on a path of sustainable growth. Among other things, the preparations for membership would improve enforcement of critical reforms and put additional pressure on the Central Bank to reform the banking system. A free trade area with the European Union - and the prospect of an even closer association - would provide a sense of direction and an 'outside anchor' to the Russian reform program. Ultimately, greater international accountability will also help the Putin presidency commit not to use the tremendous powers it has amassed.

Presentation of CEFIR and SITE

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Introduction

Ten years after the coup that ended the communist regime in Russia, we ask the question: is there a 'new' Russia? Our answer is a cautious 'yes'. This Report assesses the extent to which Russia has over the last decade succeeded in building the foundations for sustainable growth and what remains to be done. Our view is that the Russian economy still suffers significantly from the Soviet legacy and many critical reforms are lacking. But recent economic growth and changes in the political environment have given Russia an opportunity to implement a number of essential market-oriented reforms. Together with what has already been achieved, these reforms should create a stable foundation for future growth.

In the first part of the Report, we analyze trends in output and productivity in Russia since the break-up of the Soviet Union. We show that the reversal of the output fall after the financial crisis of August 1998 has primarily been driven by the devaluation of the ruble. In order to make output growth sustainable, Russia needs to improve productivity and attract more investment both from within the country and from abroad. This requires substantial reforms aimed at increasing competition and improving the general investment climate.

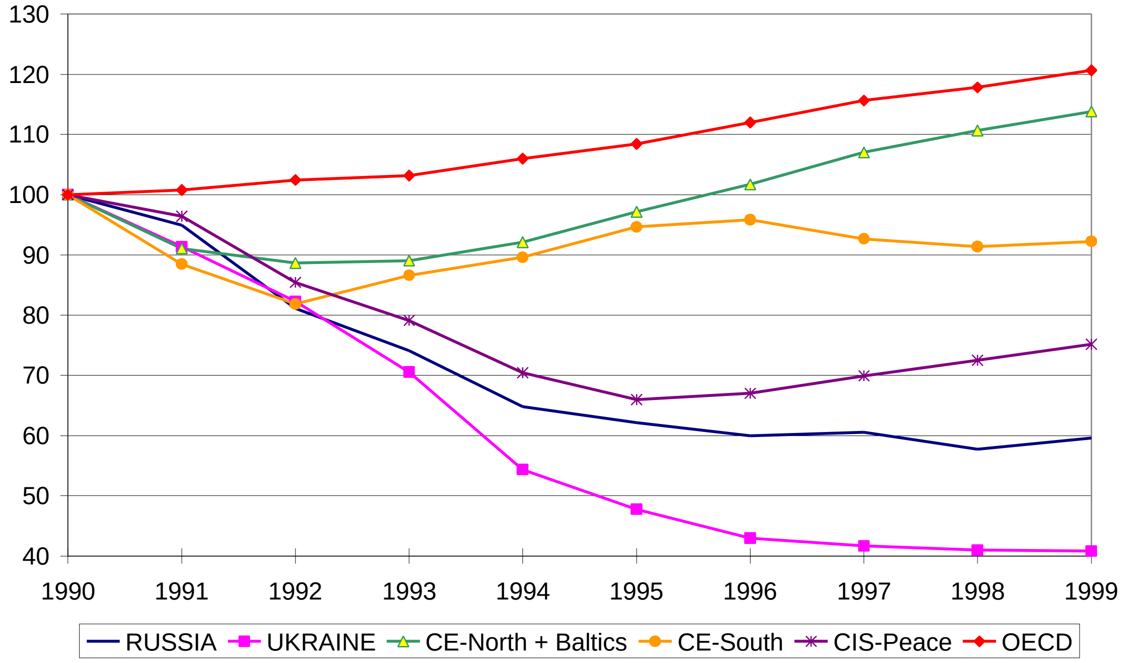
We outline the areas in which urgent reforms are needed. These priorities include increased protection of property rights (and, associated with it, judicial reform), development of the banking system, and reduction in government intervention in the private sector, including regulation and taxation. Among social policy measures, we stress the importance of improvements in education system and facilitation of labor mobility. Whether these reforms will be made depends critically on Russia's political institutions, which have suffered in the past from a lack of accountability and the absence of appropriate checks and balances. Changes in Russian political institutions and their importance for economic reform are discussed in the second part of the Report.

The third part of the Report is devoted to an assessment of recent progress in the economic reforms that are so critical to improvement of the investment climate, while the fourth part explores the impact of potential accession to the World Trade Organization (WTO). We conclude and draw policy implications in the fifth and final part of the Report.

1. Accounting for Growth

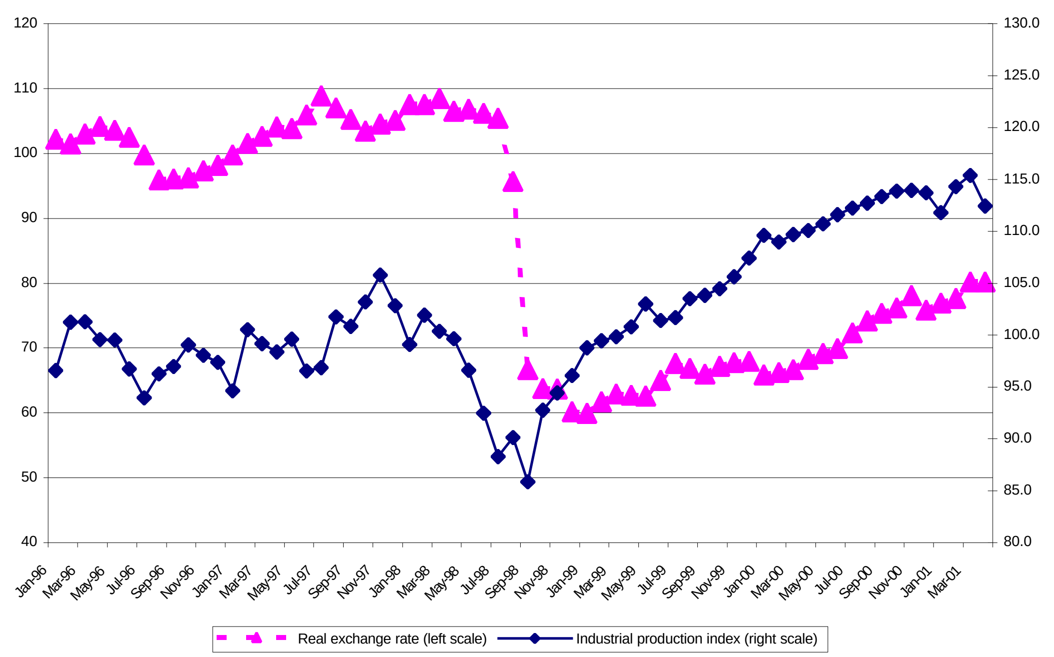
In the period 1991-8, Russian economic performance was disappointing (see Figure 1). As in all European and Central Asian transition economies, the first years of transition in Russia were accompanied by economic decline (Box 3 discusses what has driven the specific growth patterns observed in Russia and other transition economies). But the decline in Russia was deeper and lasted longer than in most other countries in transition. When East European countries had already been growing for several years, Russia was still stagnating. Among CIS countries not affected by wars, only Ukraine performed worse than Russia. In the same period, the OECD countries grew by an average of 2.4% per year. Russia was not catching up.

Figure 1: Real GDP in transition and OECD countries



Source: World Bank

Figure 2: Devaluation brought growth: Russia's real exchange rate and output



The Russian economy started to grow after the financial crisis in August 1998. Instead of leaving the country in ruins, as many economists and politicians expected, the crisis served as a driving force, pushing Russia out of stagnation. The resulting growth was quite impressive: GDP grew by 5.4% in 1999 – fully compensating for 1998's decline – and by 8.4% in 2000. Investment also started to grow substantially during the second half of 1999 and in 2000 reached an unprecedented 17.4%.

Russian economic growth in the period 1998-2000 was largely driven by demand. Over half a year (from July 1998 to January 1999) the ruble decreased in real value by more than 40%, reducing Russian demand for imports, and increasing demand for Russian export and import-substituting products. According to CEFIR estimates, firms that had exported more than 10% of their 1997 output experienced 6% higher growth in production in 1999 than non-exporting firms. Across all industries, the highest rates of output growth were observed in the import substitution industries: 20% in 1999 and 22% in 2000 in light industry, and 25% and 10% respectively in pulp and paper production. Strong growth was also observed in the chemical industry (22% and 14%), and even in machine building (16% and 16%).

It is commonly believed that the main source of growth until recently has been the undervalued ruble (see Figure 2). CEFIR research confirms this: as Box 3 shows, exporting regions grew faster than others before 1996, and later on, they lost their lead because of real exchange rate overvaluation. There are as yet no regional GDP data for the post-crisis period, but the CEFIR estimates of firms' performance cited above suggest that exporting regions regained their lead in 1999-2000.

Since 1999, however, the ruble has been continuously appreciating, primarily because of increases in oil prices, which have resulted in substantial inflows of foreign currency in the form of export revenues. In early 2001, the real value of the ruble was already only 25% lower than its pre-crisis level. Real appreciation of the currency is decreasing the relative prices of imports and increasing the prices of Russian exports. Many observers expected Russian growth to decline or even to become negative. Growth has indeed slowed down, but it has not come to a complete stop. The economy still performed quite strongly in the first half of 2001: total output or GDP grew by 0.9% in the first quarter (and by 4.9% year on year). Gross fixed investment increased by 3.3% in the same period, while industrial production grew by 3.7% in the first half of the year.

Coming back to our initial question - is there a 'new' Russia? – we can ask: is this growth sustainable? Has Russia, finally, started to bear the fruits of reform? Unfortunately, we cannot give a firm positive answer to this question: first, the necessary statistical information is not available, and second, our research suggests that further reform measures are to be introduced to ensure that growth will continue. We should note, though, that there is substantial optimism in the Russian and foreign business communities regarding future growth prospects. In preparing this Report, CEFIR conducted a survey of Russian and foreign business people working in Russia (see Box 5). The survey included a question on their expectations for Russian growth over the next five to ten years. Most of the respondents expect the Russian economy to continue growing at a rate of 3-5% a year.

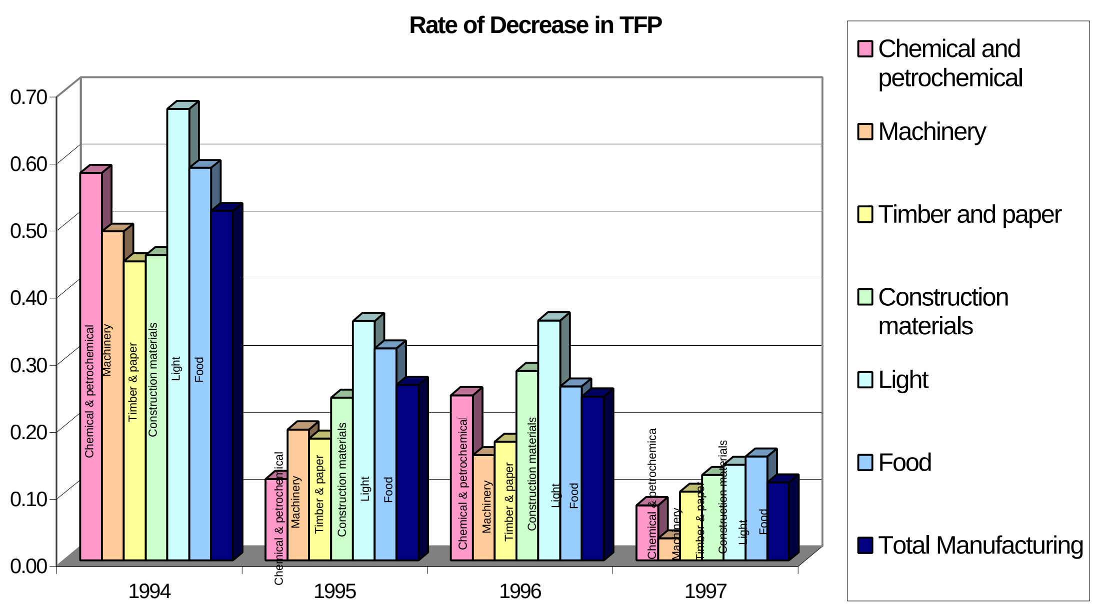
To understand the foundations of this optimism, this section reviews the main factors that can have a positive influence on Russian growth and discusses whether a critical mass of such factors is now accumulated. There are three sources of economic growth: increases in the labor force, increases in capital (investment), and increases in productivity. Given Russia's bleak demographic prospects, economic growth must come from either improved productivity or increased investment. We discuss these two sources below.

1.1 The Productivity Challenge

It is well known that Russian firms are significantly less productive than their Western counterparts. Under central planning, firm managers had few incentives to increase productivity, reduce the costs of production or improve the quality of their products. As a result, most Russian firms were highly inefficient and uncompetitive. In a report on productivity in ten Russian industries, the McKinsey Global Institute shows that productivity levels in Russia are between 7-38% of the productivity levels of similar firms in the United States. The report concludes, however, that a large percentage of this gap can be closed not by substantial replacement of capital stocks, but by improving the organization of business.

In this section we look in more detail at the McKinsey argument, and discuss policy changes that could lead firms to improve their business organization. Technically speaking, we are analyzing factors that have contributed to raising total factor productivity in firms, even during the period of overall decline. By total factor productivity, we refer to that component of growth that is unexplained by changes in the amount of factors of production used. Substantively, this term refers to changes in technology, business organization and human capital.

Figure 3: Decreasing total factor productivity in 1994-7 by industrial sector



CEFIR research has analyzed the changes in total factor productivity during Russia's transition. As Figure 3 shows, total factor productivity in manufacturing declined across all major industries throughout the period 1994-7, and started to increase only recently. Total output declined and Russian firms were forced to produce at a non-optimal level of output given their stock of capital and labor. Due to the lack of adjustment of the work force and wage levels, Russian manufacturing firms lost competitiveness and thus market share to foreign firms, forcing them to decrease their production further. As a result, their total factor productivity decreased.

While overall total factor productivity decreased during this period, there were substantial differences across industries and firms. These differences allow us to analyze the factors that made some firms function better than others. Prior to transition, privatization and competition were considered the most important sources of firm restructuring. It was believed that privatization would create appropriate incentives for managers. Competition, in turn, would lead to faster restructuring.

But the early privatization results were quite disappointing. Although Russia undertook a comprehensive program of mass privatization very early on in its transition, the impact on firms' restructuring was small or even non-existent. When Russian firms were privatized, most were sold to insiders, who did not bring new capital, technologies or human capital to the firm. Instead, they often locked firms into far-reaching responsibilities toward their employees, resulting in massive labor hoarding and little restructuring.

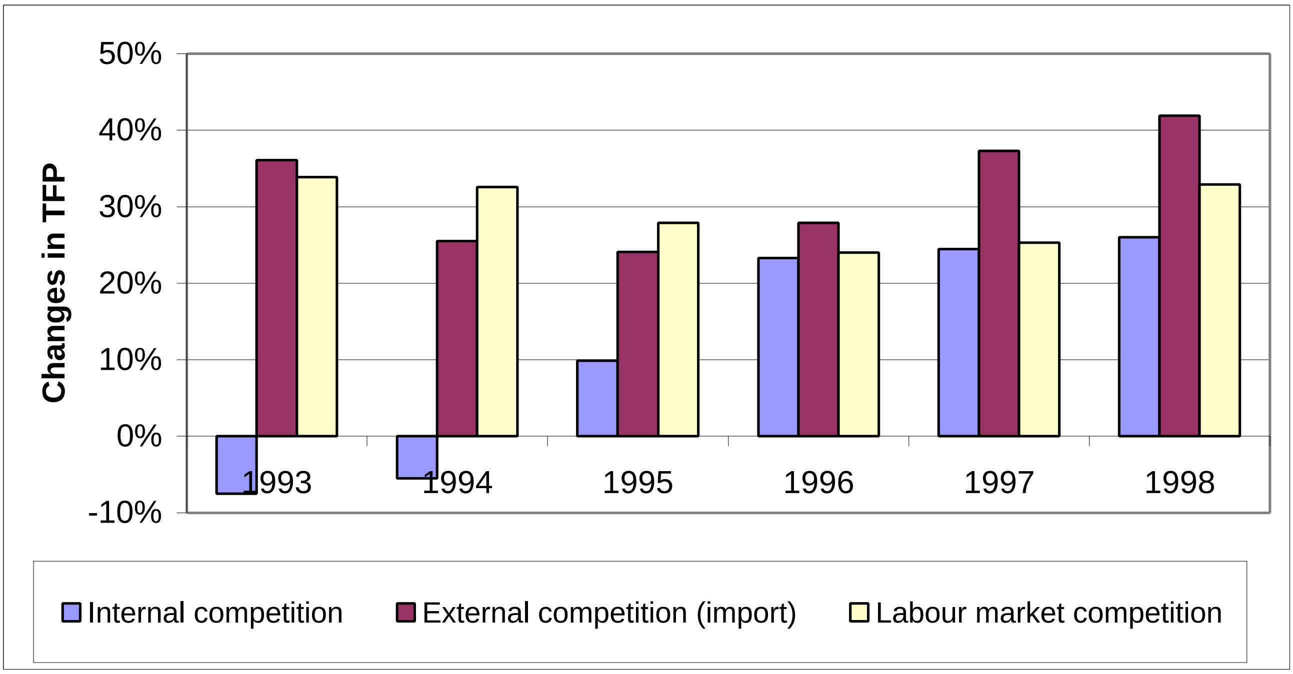
The evidence to date suggests that firms sold to foreigners and outside blockholders (shareholders with at least 5% of total equity) made the most serious efforts to restructure, while the differences between state-owned and insider-privatized firms are fairly small. Thus, many firms did not end up in the hands of the most efficient owners. Financial markets so far have not been very successful in facilitating the transfer of ownership stakes, and many observers have argued that the privatization results should be revisited. Such a measure would create considerable uncertainty for current owners, decreasing their motivation for restructuring and investment, but it would also undermine the security of future owners. If the outcome of privatization was nullified once, why could it not happen again? Moreover, what is it that guarantees that another round of privatization would generate a different result?

Despite the weaknesses in its financial markets, Russian industry has gone through a broad ownership consolidation in recent years. A recent CEFIR survey of industrial enterprises across Russia shows that a substantial transfer of shares from non-managerial employees and the state to managers and outsiders has taken place since 1994 (the end of the mass privatization program). The number of firms with at least one outside blockholder has nearly doubled. Many more firms have blockholders that are customers, suppliers, intermediaries or creditors than in 1994, evidence of increased financial-industrial group activity. Compared to most other countries, however, the distribution of shares remains highly dispersed (for example, 51.8% of firms still do not have any outside blockholders, and despite some consolidation, insider ownership remains quite dispersed in most companies).

Corporate takeovers and the systematic use of bankruptcy to wrestle control away from insider owners have led to the formation of a new breed of corporate groups. While the methods they use are often doubtful, and the outcomes not always the most desirable, the overall mobility of ownership stakes is encouraging. A strengthened financial system would further ensure that willingness, rather than ability, to pay (and thus profit expectations) will determine who is in control of a particular firm.

Competition is critical for applying pressure to controlling owners and managers to increase efficiency. Recent CEFIR research suggests that competition, where it exists, has indeed had an important positive effect on the efficiency of Russian firms. Imports and foreign-owned firms have been particularly strong sources of competition. The research finds, however, that competition is much weaker in industries in which most firms remain state-owned and in regions with poor transportation and communications infrastructure and excessive regulatory barriers. In addition to completing privatization, improving infrastructure, decontrolling prices and eliminating inter-regional trade barriers, much effort is also needed to facilitate the entry of new firms, an issue we will discuss in more detail below.

Figure 4: The effect of competition on total factor productivity



Source: Brown and Earle (2001).

Increased foreign competition should also be a priority. The pure competition effect forces firms to function more efficiently, but foreign competition can also have a demonstration effect: domestic firms get access to foreign products, technologies and managerial practices, providing examples of more effective behavior. In addition, the possibility of using foreign-produced inputs can have a major effect on the quality of the final products. A number of studies examine how important these effects are for Russia (see Box 1).

Box 1: The impact of foreign competition on the performance of Russian firms

Bessonova (2001) compares the effects of foreign competition on different industries. According to her analysis, there is a substantial positive effect of an increase in import competition on the total factor productivity of Russian firms in most industries. But this effect is only realized with at least one year's lag, which is needed for the firms to undertake proper restructuring measures. This effect can be broken down into the pure effect of competition and a demonstration effect on the one hand, and the effect of increased availability of the imports on the other. The effect of foreign competition and demonstration is mostly important in the less complex timber, paper, and food industries. Availability of imported inputs has the most serious effect on more complex production processes, such as those are used in machine building, construction materials, and light industries.

Yudaeva *et al* (2001) look at spillovers from foreign direct investment. Since inflows of foreign direct investment are rather limited to date, it is impossible to conduct analysis separately for different industries, and only evaluation for the economy as a whole is feasible. The results of the study show that, indeed, there are substantial positive spillovers from foreign-owned onto domestic firms. These spillovers are more significant than the ones from imports. At the same time, spillovers in higher educated regions are higher than in less educated ones. This suggests that the quality of human capital is an important factor, allowing Russian firms to extract more benefits from competition with foreign direct investment. We should also note that productivity of foreign-owned firms is higher in the regions that made greater efforts to reform their economies. This means that reforming regions attract more efficient foreign investment. Hence, progress in reform increases the potential for spillovers from foreign-owned firms.

Kozlov and Manaenkov (2001) look at the spillovers from the exporting activities of foreign-owned firms in the period 1994-7. They find that increasing foreign presence has a negative effect on the probability of Russian firms exporting. But this negative effect decreases over time and becomes insignificant by 1997. In addition, higher levels of education reduce the negative effects even further.

Comparing the two types of external competition, competition with foreign direct investment is even more important for restructuring than competition with imports because it facilitates copying of technologies and managerial techniques. CEFIR research shows that the quality of human capital is an important factor, strengthening the benefits to Russian firms of competition from foreign direct investment (see Box 1).

We should note that not only foreign investment in manufacturing, but also foreign direct investment in the service sector is extremely important for Russian economy. Poor development of Russian service sector has negative consequences for other sectors of the economy. For example, the weak financial sector fails to fulfill its function of transferring funds from savers to investors, and, therefore, slows down growth in manufacturing; a badly developed retail trade sector fails to transfer demand signals to the producers and therefore delays required restructuring; and so on. In this situation, foreign direct investment in the service sector can help to improve productivity not only in the service sector itself, but also in manufacturing.

Overcoming the segregation of the labor market is a further factor that will help to increase the productivity of Russian firms. As Figure 4 shows, managers of those firms that have faced less competition in the labor market have fewer incentives to improve productivity. Instead, they extract rent from their workers: there is evidence that wage arrears are higher in those places where labor market competition is lower. In order to overcome this tradition of 'industrial feudalism', Russia needs to make efforts to increase labor mobility, both in geographical and professional terms (see Box 2).

Box 2: Industrial feudalism

A major part of President Putin's agenda is to overcome the political and economic disintegration of the country, the phenomenon described by Russian journalist Yulia Latynina and US economist Richard Ericson (1999) as 'industrial feudalism'. Industrial feudalism emerged in Yeltsin's Russia as a system where regional governors and managers of large enterprises have been able to reign within their 'domains' virtually with a power (and therefore rents) available to medieval barons. Industrial feudalism is essentially based on the low interregional mobility of population. Even though they face low incomes, poor provision of public goods and wage arrears, most Russians have not been able to leave their home regions for more prosperous areas. During the 1990s, regional differentials in real wages, living standards and unemployment rates have been huge, and more importantly, have not been decreasing over time. But the rates of internal migration have been substantially lower than those in comparable OECD countries – see Andrienko and Guriev (2001).

What are the most important barriers to mobility? Empirical analysis rejects the hypothesis that Russians are not flexible and prefer lifetime employment. Indeed, a large proportion of workers change jobs or find second part-time jobs locally. The Soviet style registration system has been abandoned almost everywhere. (In the few places where it remains intact – against the Federal Constitution – it still provides corrupt bureaucracy with yet another source of rents while raising the cost of migration.)

CEFIR research shows that the major barriers to mobility are lack of education and liquidity constraints. Somewhat surprisingly, the empirical analysis shows that controlling for other characteristics, people with higher incomes tend to leave their regions more often. Although people with low income are even more *willing* to leave, they are less *able* to go: they lack cash to cover the migration cost and there is no way to borrow it even if their future wages will be much higher. The liquidity constraints are aggravated by low wages, wage arrears and in-kind payments of wages that persist in concentrated local labor markets, that is, in the domains where there is little or no competition between employers. In fact, by lowering workers' cash income, employers attach workers to land like the medieval barons would do through serfdom. This results in the regional segmentation of Russia's potentially large national labor market. The local employers have no competition from outside and therefore have few incentives to restructure – see Brown and Earle (2000). Hence, although highly inefficient, the inherited industrial structure is sustainable over time, and the economy remains locked in the vicious circle of industrial feudalism.

President Putin's administration is currently attacking the system from several sides, including enforcement of the Federal Constitution, development of mortgage markets, education reform, reform of utilities sector and land reform.

Several policy recommendations follow from the above analysis. Increased involvement in world trade, and particularly increases in foreign direct investment in both manufacturing and services are the two important ingredients that will help Russia to reach world-standard levels of total factor productivity. WTO accession, which is being actively negotiated by Russian politicians, is in important step in this direction. We consider the accession issue in more detail below.

At the same time, continuous effort in increasing and improving the education level of the population is needed for Russia to extract maximum gains from foreign competition. There are worrying signals that the quality of Russian education has deteriorated during the last ten years. The gap between university programs and the qualifications needed for practical work has increased. At the same time, growing numbers of talented young people cannot acquire an education because of financial problems. Dramatic changes in the education system are needed to reduce the growing gap between the education levels in Russia and developed countries. In addition, a system of re-education and improving the qualifications of adults should be implemented in order to improve professional mobility. And a number of measures should be undertaken to improve labor mobility. These would also help to reduce the potential negative consequences of WTO accession.

Returning to the issues raised in the McKinsey report, we agree that Russia has the potential to increasing its growth rates with relatively little investment simply by improving organizational methods. But the easiest way for Russian firms to learn which improvements they need to make is by learning from foreign direct investors.

1.2 The Investment Challenge

While in the short and medium term, transition economies can grow without substantial investment (as Poland has demonstrated), long-term growth requires new investment. This is particularly true in Russia where the average age of capital stock reached 17.9 years in 2000. Of the different possible types of investment, foreign direct investment is particularly important. Foreign investors bring new technologies and new managerial techniques that are lacking in modern Russia. Hence, the more foreign direct investment that Russia can attract, the higher its growth potential. And as discussed above, foreign investment also has spillovers on domestic firms.

Box 3: Growth in transition

A number of empirical research projects have explored the issue of growth in transition during the last decade. The main debate surrounds the relative importance of initial conditions, structural and macroeconomic reforms for economic growth. Using a cross-country approach, de Melo, Denizer and Gelb (1997) show that the degree of liberalization is closely related to output growth. This result is confirmed by Fisher, Sahay and Vegh (1996), who also find that fiscal surpluses and foreign aid are positive determinants of growth while growth is negatively related to initial income and inflation. Heybey and Murrel (1997) find that initial conditions are more important determinants of growth than policy variables. Moreover, there is research that shows that the impact of liberal reform on growth become insignificant when initial conditions are controlled for - see Popov (1998). This issue still remains very controversial. Further research into explaining cross-country differences in growth rates in transition calls for more extensive data sets and theoretical investigations.

Comparison of growth patterns between Russian regions by Gorban *et al* (2001) allowed us to put aside the issue of macroeconomic reforms and investigate more closely the impact of initial conditions and institutional reforms on growth. The list of factors that can potentially affect output patterns in Russian regions includes initial levels of industrialization and export potential, transportation quality, levels of education, attitudes of regional populations to reform at the outset of transition, economic reform progress in the region, and variables that characterize the quality of government such as corruption, democratization in the region, and regional tax collection.

The results show that at the beginning of transition period, those regions with higher export potential experienced smaller output decline. This effect, however, disappears after 1995, which we interpret as evidence of erosion in Russia's competitiveness due to an overvalued currency. In the second half of the 1990s, regions' efforts in implementing economic reforms and liberalizing their economies started to bring results. The best growth performance during this period is observed in the regions with the highest level of economic liberalization. At the same time, such factors as quality of transportation facilities, and, to a certain extent, education, contributed to better regional performance. Surprisingly, democratization had a negative effect on growth, while other proxies for the quality of the government seem to have had no effect. Overall, these results indicate that initial conditions were an important determinant of growth at the beginning of reforms while their effect disappears over time and from some point of transition, growth is closely related to the extent of reform.

The level of investment is strongly influenced by the general environment or the investment climate. And the investment climate is largely determined by government efficiency and, in transition economies, by progress on structural reform. In this section we analyze investment patterns in Russian industry and identify policy changes that will encourage a significant increase in investment.

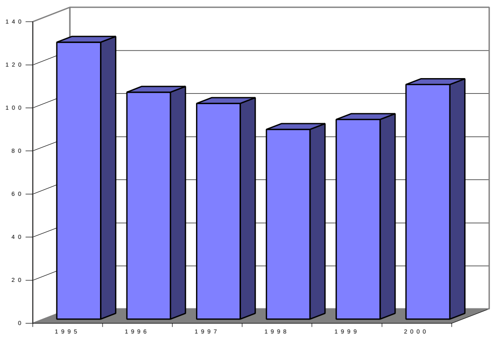
Economic decline in the period 1991-8 was accompanied by a continuous decline in investment. By 1997, investment in most industrial sectors stood at only 10-30% of its

1989 level, and only in the power industry was this level kept at slightly less than 60% of its 1989 level. Investment recovery started in the second half of 1999, and was closely related to massive increases in export revenues caused by devaluation and the increased oil price. Investment went into import substitution industries with the export-oriented ferrous and non-ferrous metal industries being the major exceptions. Investment in the fuel industry only increased modestly, while power production and chemical industries saw no increases in investment.

A major channel for transferring investment funds from exporting to import substitution industries was the formation of a new type of financial-industrial groups (FIGs) based around exporting firms (see Box 4). Owners of such firms became concerned about diversification of their sources of income. As a solution, they purchased majority ownership stakes in firms in other industries, such as agriculture, medicine, construction, car production and so on. The experience of developed countries suggests that financial markets perform the function of income diversification and transfer of funds from savers to investors in a much more efficient way than conglomerates. But in Russia, poor development of the financial sector and poor protection of property rights of minority and outside shareholders make this more efficient solution unattainable.

Figures 5-10. Recent investment patterns in Russia

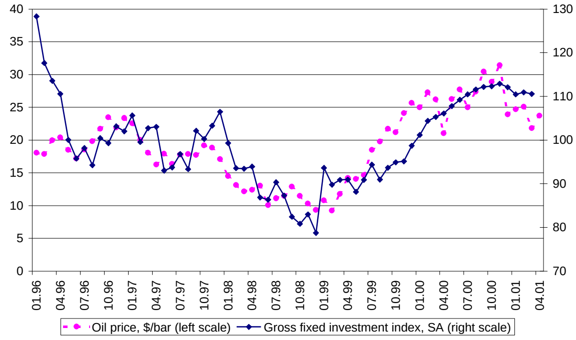
Figure 5: Real expenditure on new



construction and equipment

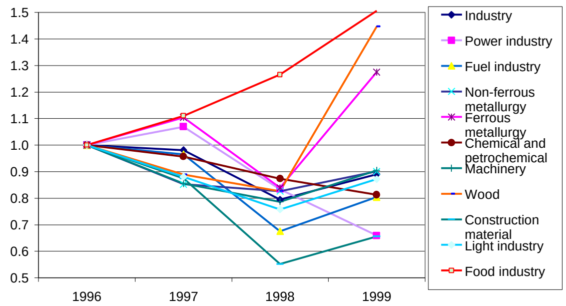
Source: Russian Economic Trends

Figure 6: Investment level and oil price



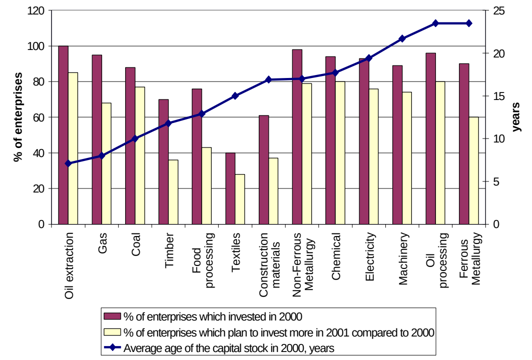
Source: Russian Economic Trends, Bloomberg

Figure 7: Real investment by industrial sector



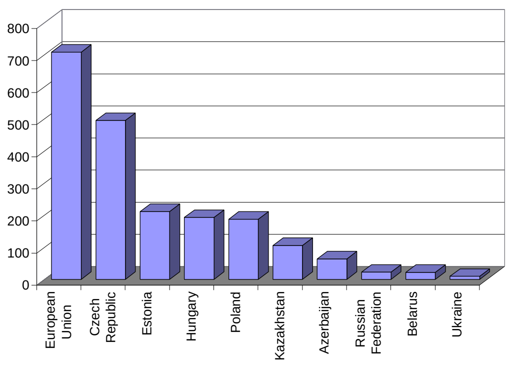
Source: Goskomstat

Figure 8: Equipment age and investment by industrial sector in 2000-2001



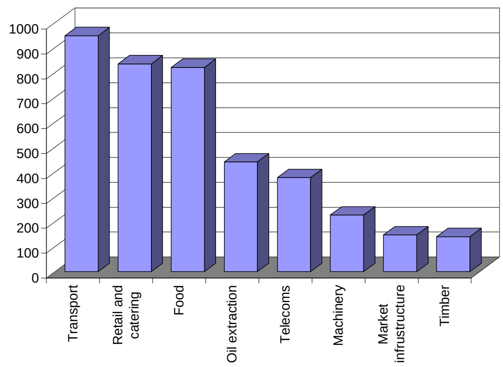
Source: Goskomstat

Figure 9: FDI per capita in EC and selected transition economies, $



Source: World Bank

Figure 10: FDI in Russia by sector in 2000, $ bn



Source: Goskomstat

Box 4: Financial-industrial groups in Russia

The development of a market economy in Russia gave rise to the establishment of financial-industrial groups (FIGs). In 2000, there were about 90 formal groups and many more informal ones. About 15% of industrial output was produced by registered FIGs. Besides, there were a large number of integrated trading-industrial and industrial entities where not only production and trade but also financial ties existed. Most FIGs in Russia are led by banks and they are formed primarily in export-oriented raw materials, chemicals, metallurgy and food industries.

Since integrated structures like FIGs (structures with production and financial ties) are not a unique feature of transition in Russia, it seems reasonable to suggest that their formation and development is part of the general regularity of the market economy rather than the peculiarities of Russian development. Moreover, the traditional reasons for groups' development becomes even stronger in a transition environment because of the absence of many important market institutions when different kinds of market imperfections force firms to choose intra-firm relations rather than market ties.

But our empirical investigations based on data for 1995-7 reveal the different role of banks in Russian FIGs compared with the banks in developed countries (Volchkova (2001)). Namely, banks in Russian groups do not provide credits for enterprises in groups nor do they redistribute the financial flows within the groups in the most profitable way. Our results are consistent with the hypothesis that banks in Russian FIGs could help to solve the problem of contract enforcement in firms participating in groups. This conclusion corresponds to the declaration of the head of the largest FIGs that at that time, their main concern was the effective governance of assets within the groups. In an economy with inefficient banking and financial systems, that means an increase in the volumes of investment implemented by group firms relative to independent firms facing the same investment opportunities. These facts emphasize the importance of integrated structures in an economy where both insufficient investment and bad corporate governance are substantial impediments for structural and political reforms and subsequent growth.

New tendencies in the development of groups have emerged after the financial crisis of August 1998. The sharpening of the liquidity problem because of devaluation and the government's debt default led to the reduction of stock ownership in a number of registered and unregistered groups governed by commercial banks. This changed the strategy of groups' development. Instead of improving the governance structure within the groups, they reduced their asset holdings and tried to survive the crisis.

Both the weakness of former owners and liquidity problems led to a new wave of ownership changes in Russian economy. The active participation of regional authorities in this redistribution was one of the most remarkable features of the changes, especially with the ownership changes in the oil industry. Another important feature of this stage of groups' development is the government's attempt to revive state holdings in strategic industries. Both of these tendencies indicate a strengthening of the state's position in the economy.

The favorable situation in the international oil market during 1999 brought significant cash flows to FIGs operating in raw material industries. This led to expansion of these groups in other sectors of economy such as agriculture, medicine, construction, etc. Hence some fraction of the investment increase in the Russian economy in 1999-2000 can be ascribed to the contribution of groups.

The above discussion brings us to the question of which policies are needed in Russia both to increase investments and to encourage better quality investment. This issue is extremely important because despite the recently observed increase in investment, the level of investment seems to be well below Russian needs. This is particularly relevant with respect to foreign direct investment. While the inflows of such investment have increased in the last two years, Russia is still behind the most successful transition economies in terms of the level of foreign direct investment per capita. As Figures 5-8 show, in 2000, Russia received only $22.60 of foreign direct investment per capita, in contrast with $495.50 in the Czech Republic and more than $100 in Hungary, Estonia and Poland. Overwhelming evidence shows that it is the quality of the government and the speed of the reform process that are driving this difference. Our study of regional investment shows that economic reforms are the major factor explaining cross-regional variation in investment. The Russian reform agenda is too large to be implemented in full in a short period of time so it is important to set priorities. Below we make an attempt to identify the list of factors that can have major impact in terms of allowing Russia to make a significant improvement in its investment climate in the near future.

Box 5: The CEFIR survey of business opinion on Russia's economic prospects

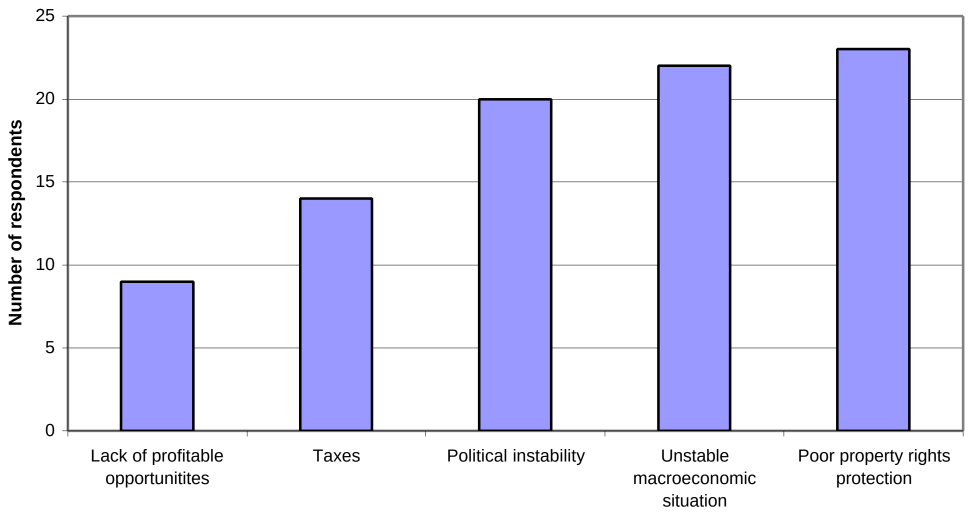
While investment, including foreign direct investment, has started to grow, there is a common feeling among business people and policy-makers that the current increase in investment is still below Russian needs. Poor progress in reform, organized crime, corrupt and inefficient government and an unstable political situation are among the usual suspects as major impediments of investment. But our 2000 survey of foreign direct investors showed that for those investors already working in Russia, the tax system generates many more problems than organized crime or bureaucracy.

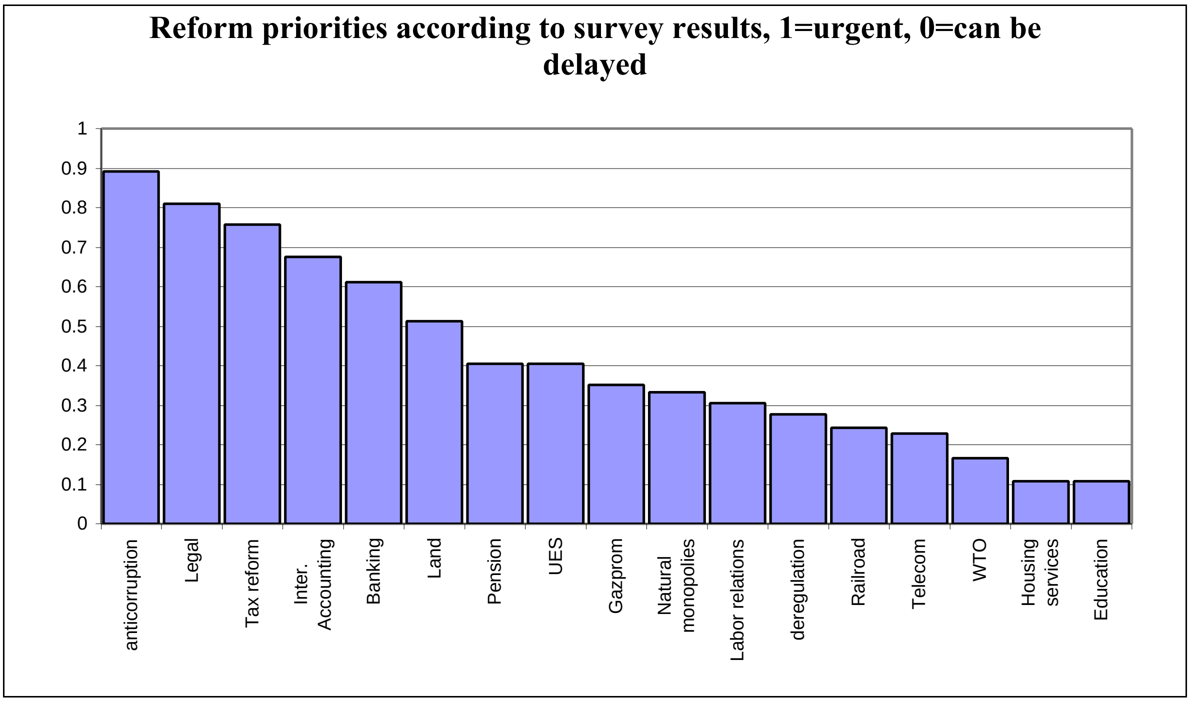
In our 2001 survey, we asked three types of questions as a way to identify major bottlenecks for investment. We asked the foreign and Russian business communities to evaluate the depth of problems in a number of investment-related areas, to set reform priorities, and to identify major reasons for capital flight. Property rights protection was considered the most important reason for capital flight. Among property rights protection related issues, weak protection of minority shareholders and outsiders were thought to be the most important issues. A related issue of lack of judicial independence, particularly in bankruptcy cases, as well as failure to implement court decisions were viewed as extremely serious, and legal reform received the second highest priority in the list of the reform priorities.

The highest priority was given to fighting corruption and reforming the bureaucracy. In contrast to our 2000 survey, this problem was considered more serious, and received higher priority than reform of the tax system. As far as taxes are concerned, most of respondents appreciated the efforts of the governments in improving the tax system, although poor tax administration and the unpredictability of the tax regime are still viewed as problematic by a large number of respondents. The fourth highest priority is given to the transition to international accounting standards, which is very important for foreign investors.

Of other possible problems, land reform was ranked quite high in the list of the priorities, while most of the respondents agreed that government deregulation, regulation of natural monopolies, reform of labor relationships, and housing and community services reform can be put in the second tier of the reform package. Financial sector problems are viewed as important, although banking sector reform is considered as less urgent than legal, tax system and other reforms.

Main reasons for capital flight (according to survey results)





The ability to get back the invested funds is a major precondition for investment. This confirms that adequate protection of property rights, including protection of the rights of minority and outside shareholders, is the one of the most important preconditions for investment. Current Russian laws scores very high in this respect. Pistor *et al* (2000) report indexes of shareholders' and creditors' rights protection in transition economies. Russia has a very high rank for shareholders' right protection: the level of shareholders' right protection, according to Russian legislation, is better than in Hungary or Poland. The level of creditors' right protection in Russia is somewhat lower than in some of the other countries, but not significantly different. At the same time, enforcement of the law is very poor. Survey evidence usually puts Russia as one of the last places among transition countries according to its level of the rule of law, and law enforcement. As a result of poor law enforcement, effective property rights protection in Russia is very poor (see Box 5). This suggests that legal reform should get the highest priority in the reform list. This is important not only from the point of view of domestic, but also foreign investors.

While property rights protection is necessary to attract investors, the financial system is important from the point of view of facilitating investment activities, and channeling them into the most profitable areas. But the Russian financial system is still in its infancy, and fails to perform these functions. As Pistor *et al* (2001) show, law enforcement in transition economies is highly correlated with the development of the financial system. Thus, legal reform will help to boost development of the financial system. Additional efforts are needed, though, particularly in the area of banking reform. After losing all their savings several times during 1990s (after the 1992 price liberalization, in MMM and other financial pyramids, and after the financial crisis of August 1998), the Russian population is very cautious about putting their funds in Russian banks. Strengthening of prudential regulation and banking supervision is needed to overcome this understandable caution of the population in its attitude to the banking system. The entry of foreign banks can also help to improve the situation. Two policy reforms are important in this respect: banking reform and WTO accession. Both are discussed in more detail below.

Finally, the experience of other transition economies demonstrates that small businesses can serve as the most dynamic and important source of growth in such economies. In Russia, small business development and entry of new firms has been hampered by excessive government regulation. In order to improve the conditions for small business development, regulations should be simplified. The government has made important steps in this direction by introducing regulation reform.

We view the policy measures discussed above as major priorities in Russia's reform agenda. This view largely coincides with the view of foreign and Russian investors who participated in our survey (see Box 5). In addition to above measures, investors are concerned with the quality of the government and its ability to implement reforms that facilitate investments, instead of setting barriers to investors' activity. The quality of the government is highly correlated with inflows of foreign direct investment in transition economies. At the same time, concerns about political instability are often seen as major reasons for capital flight and lack of domestic investment in Russian. Therefore, political reforms, which are now happening in Russia, can have an extremely important impact in improving the investment climate and attracting both domestic and foreign direct investment. Politics is the issue to which we now turn.

2. The Political Context of Economic Reform

Russian political institutions have a crucial influence on the government's ability to implement economic reform successfully as well as its level of commitment to that task. The deep structural changes that are necessary to achieve sustainable long-term economic growth are only feasible if they are supported by robust political institutions that can withstand the pressure of various interest groups. But relatively transitory democratic regimes are very different in the degree to which their institutions are conducive to the process of reforms and the sustainable economic growth. The dire experience of many Latin American countries shows how easily some regimes can interpret the concern about the economic growth in terms of populism, protectionism and parochialism.

This leads to the key question: why can some governments commit to reform without sacrificing market efficiency, whereas others cannot escape the temptation of populism and 'particularism'? The answer is highly relevant to the situation in Russia, whose poor economic performance and mediocre record of economic and legal reforms through much of the 1990s can only be understood by looking at the weaknesses of the country's political institutions.

Box 6: Making governments accountable

Governments tend to improve their public performance only in as far as they are directly accountable to the citizens via universal suffrage and multi-party elections. This direct - or *vertical* - accountability of the government to citizens is necessary but not sufficient to ensure government efficiency and commitment to necessary reforms. It must be accompanied by the willingness of the government to restrain itself through the creation of independent public institutions capable of overseeing its behavior and penalizing it when necessary. Such *horizontal* accountability is imposed by the government on itself via mechanisms of separation of power. When vertical and horizontal accountability fail, the government's performance tends to deteriorate: officials steal public funds, bureaucrats demand bribes and citizens evade paying taxes.

There is a third aspect of accountability that can influence governments' performance, namely *international* accountability. This comes from a country's involvement in economic and political alliances, its participation in international agreements and organizations like the WTO, and, more generally, the regard in which it is held by the rest of the world.

This section analyzes how the recent changes in the Russian political system affect the ability of the government to implement reforms that are conducive to economic growth. We focus specifically on the changes in *government accountability* as a key mechanism for minimization of the abuse of power and successful implementation of public reforms (see Box 6). First, we review the political and institutional causes of poor government accountability and its weak commitment to reform during the Yeltsin presidency. We then deal with the political changes during the Putin presidency and analyze some of their economic consequences.

2.1 Government Accountability during the Yeltsin Presidency

In a nutshell, the Yeltsin period was characterized by:

- The enduring policy conflict between the Yeltsin-controlled executive and the Communist-led legislative branches of the government.
- The considerable discretion of the president and his close circle over economic policy issues.
- The populism and particularism of the Duma's economic legislation, pandering to public opinion, especially at election time, and to particular interest groups.

- The mounting corruption of the government bureaucracy.
- Increasing regional disintegration.

This situation allowed little hope of effective reform and sustainable economic growth during the 1990s. It produced a vicious circle of irresponsibility between the state and the public: while the bureaucrats were weakly accountable to the elected president and the Duma, the politicians were hardly responsive to the taxpayers, who, in turn, eschewed any control by the state bureaucracy.

The system of poor state accountability and weak commitment to reform had a number of causes. First, the Russian state, which succeeded the Soviet Union by destroying its old institutions of public and administrative control, failed to replace them with an effective democratic alternative. Although the free democratic elections and multi-party system were officially introduced after the collapse of Communism, they were viewed as only instrumental in the control of power by the new Russian political elite. Each time the outcome of elections (or referendums) threatened the status quo of the elite, the results were either manipulated or grossly influenced in favor of the ruling politicians, using 'administrative resources.' The two most visible examples were the 1993 referendum on adopting the new Constitution, and the re-election of Yeltsin in 1996. As a result, the right to vote was barely perceived by the citizens as a chance to punish the executive or to improve its responsiveness to the public interest.

Second, the new Russian Constitution, the adoption of which followed the violent crash of the Supreme Soviet by Yeltsin and was rumored to be forged at the 1993 December referendum, became a set of 'rules of the game' that had been imposed by one side on the other. This prejudiced its ability to provide a framework within which the contending parties could attempt to resolve their differences by the peaceful process of politics. Furthermore, by making the executive branch very powerful, the new pro-presidential Constitution subjected the destiny of reforms to Yeltsin's personal will and to the discretion of his corrupted bureaucracy. Used as a tool for advancing the president's own political interests and popularity, could it really improve the accountability of his cabinets?

Figure 11 was developed from a comprehensive scale for measuring presidential powers as suggested by Shugart and Carey (1992). It compares the Russian presidency with other presidential regimes along two dimensions: the legislative and non-legislative powers of the president. Its simple measurement technique demonstrates that the total amount of constitutional powers of the Russian president exceed by far the powers given to most presidents in stable democratic regimes.

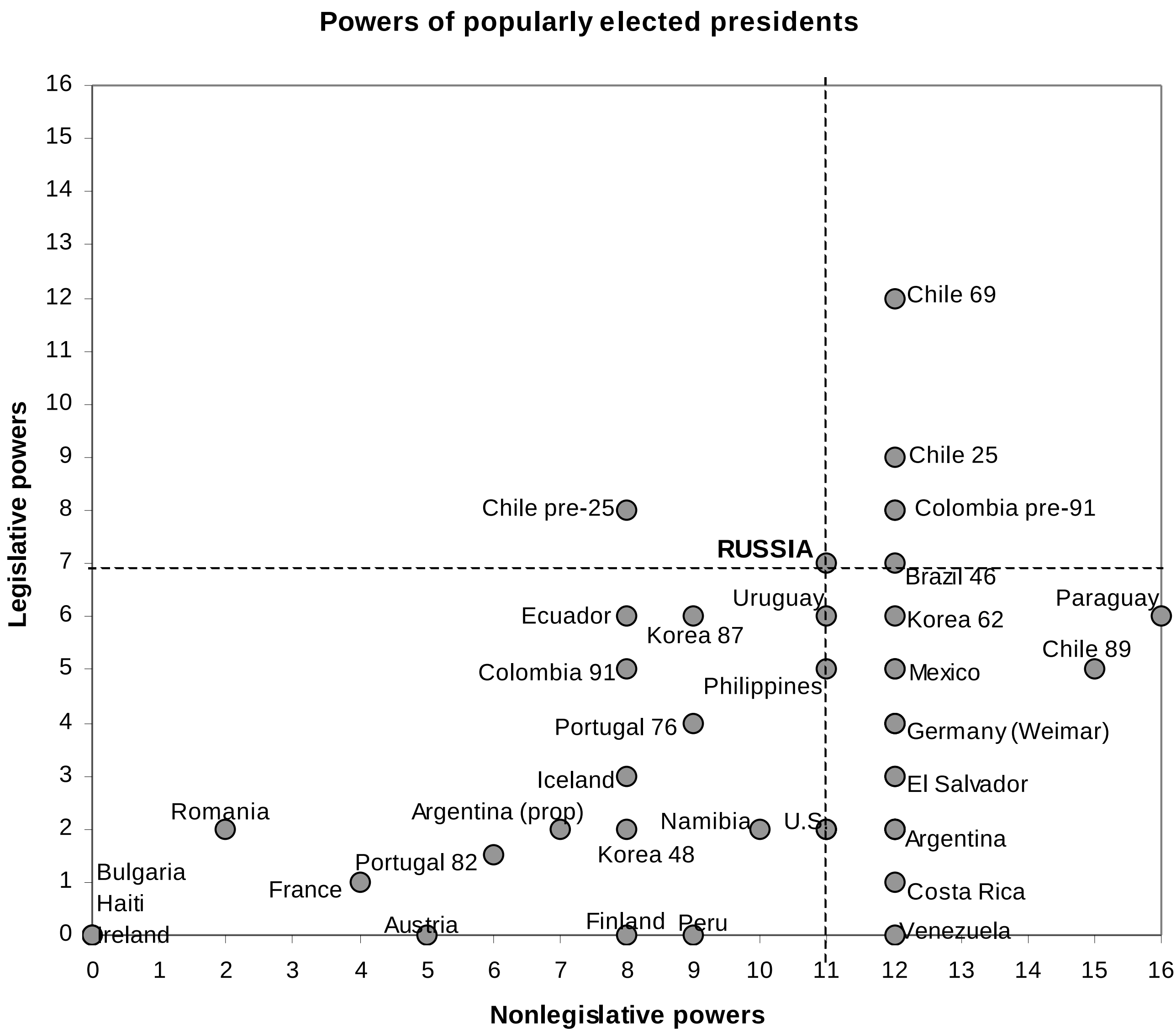


Figure 11. Powers of popularly elected presidents

Although the 1993 Constitution established the executive and the legislature as directly elected institutions with means for autonomous monetary and fiscal decision-making, it failed to provide a workable system of mutual control that could restrict their use of economic policies in pursuit of individual political goals. The lack of appropriate checks and balances made both powers mutually unaccountable and overly discretionary in their policies: while the executive (and its bureaucracy) repeatedly misused its unfettered control over borrowing and spending public money, the legislature regularly exploited its power over the size and composition of the budget. The resulting annual budget deficit was a key factor in eroding investor confidence in the government debt market, which finally collapsed in August 1998.

In addition, the new Constitution provided a broad scope for the two branches of power to survive separately from each other, the implication being that both can hold out for a long time in case of conflict between them. The high rate of separate survival in Russia coupled with the large powers of the president in cabinet formation led to persistent deadlock in policy-making between the president and the Duma. It substantially reduced the government's capacity for coherent action and commitment to reform. By charging the Duma with the task of producing economic legislation and, at the same time, depriving it of instruments to control implementation of that legislation by the cabinet, the Constitution inevitably turned the Duma into very irresponsible and populist body. The president was given almost free hands to reshuffle the cabinet but lacked any strong party support in the legislature to ensure the effectiveness of his government's actions. Government bureaucrats quickly realized that the constitutional deadlock enabled them to be virtually unaccountable to either the Duma or the executive. Since 1993, the government bureaucracy has remained deeply corrupt and inefficient, regardless of who was put in charge of the cabinet by President Yeltsin.

The constitutional origins of government corruption and inefficiency can also be traced to the unrestricted power of the president to expand his administrative apparatus or even create new decision-making structures that were not spelt out in the Constitution. In 1995, the rapidly growing presidential administration included over 40 advisory bodies, policy-making and policy-implementing agencies, and a massive support staff of approximately 7,000. Unlike the formal government, the presidential administration is essentially immune from legislative oversight. This allowed the president to shield government activities from legislative review by locating them within the presidential apparatus.

2.2 Government Accountability during the Putin Presidency

The election of a new Duma and a new president, Vladimir Putin, marked a striking reversal in the direction of government policies. If the Yeltsin period was characterized by the processes of political disintegration and policy deadlock, Putin's term demonstrates the opposite inclinations - toward the concentration of power in the hands of the executive and legislative cooperation between the cabinet and the Duma.

Such divergence arises from several key differences in the positions of the first and the second presidents of Russia. First, while Yeltsin heavily depended on various interest groups during his rule and 1996 re-election, Putin started his political career 'from scratch' - with almost no binding commitments to the existing lobby groups. In this sense, the elections made him accountable more to the general public, whose overwhelming support allowed him to win without a second round, rather than to any particularistic interests, which played a key role in the re-election of Yeltsin.

Second, the rise in oil prices combined with economic growth provided Putin with extra resources for initiating and sustaining his policy initiatives, something that was missing throughout the Yeltsin period.

Third, in contrast to Yeltsin's aggressive anti-Communist stance, which provoked a very staunch legislative opposition in the Communist-controlled Duma, Putin has effectively disarmed the opposition by adopting some of their symbolic values while pushing through his own majority party (Edinstvo) in the Duma. Control of the Duma majority by the president makes both the executive and the legislative branches more cooperative and mutually responsible: while the president can no longer justify cabinet ineffectiveness by reference to the legislature's sabotage of government reforms, the Duma majority has no choice but to support cabinet initiatives consistently.

During the last legislative session, for example, the government successfully pushed through the Duma about 80% of its legislative agenda, consisting of 29 reform laws covering such contentious areas as taxation, land property, pensions, law enforcement and labor relationships. Most of these laws were prepared by the government back in

1996-7 but had no chances of being passed by the former Duma because of the fierce inter-branch conflict.

All in all, the combination of additional resources with the absence of prior commitments and parliamentary opposition have allowed the second Russian president to pursue his own strong political agenda and be personally responsible for its outcomes. But what is President Putin's agenda? How will it affect the accountability of the Russian government and its commitment to the market reforms? Two years of Putin's leadership give a clear direction of his current course: toward liberal economic reforms under strong political control. While progress in economic reform is examined in the third part of this Report, we focus here on the efforts of Putin to concentrate and centralize the political authority.

From the very beginning, the Kremlin has concentrated its efforts on strengthening power along two dimensions: from the regional to the federal and from the legislative to the executive. At the regional level, Putin has shown himself as a proponent of strong federal authority by his resolute approach to the Chechen breakaway republic and the efforts to subjugate autonomy of the regional elites to the will of the federal government. The policy of federal centralization included an aggregation of 89 autonomous regions and republics into seven districts with president-appointed leaders to oversee and restrain the activities of the governors. In addition, the Kremlin has effectively stripped the regional governors of their ability to collective action by forcing them to step down from membership in the upper house of the Assembly, the Federation Council, and instead sending their representatives to the Council. The federal government has also renewed its efforts to enforce the supremacy of the Constitution and federal laws over regional legislatures. Finally, the Kremlin has started a critical review of the old treaties over the separation of powers between the federal and regional governments with the aim of equalizing the regions' benefits from the treaties.

In the area of legislative-executive relations, the Kremlin has also initiated a policy of streamlining power. Within the executive branch, Putin has fully used his broad constitutional powers of cabinet appointment and dismissal to replace many Yeltsin appointees in the 'power' ministries with his own loyal candidates. The changes include the Ministry of Defense, the Ministry of Internal Affairs, the National Security Council, the FSB and others. In the 'economic' block of the cabinet, however, Putin has demonstrated a remarkable concern over cabinet stability and refrained thus far from Yeltsin's practice of discretionary reshuffling of the top personnel responsible for the economic policy. He recently endorsed the commission on government reform to optimize the responsibilities of the ministries and make cabinet appointment policy more efficient.

Two other fundamental initiatives of the Kremlin in restructuring the political system are the reforms of the legislative and judicial branches. Within the former, Kremlin decided to transform the current party system, which promoted a multiplicity of weak and fragmented parties, into a system that will favor few, large and strong parties. The argument is that the latter system will make the legislative process more responsible and predictable, given the fewer number of more disciplined actors. It should come as no surprise, though, that such system will also make legislative bargaining more controllable by the executive. The reform of the judicial branch involved passing a number of laws designed to boost the integrity of judges by increasing their salaries, budgets, etc., and reducing their independence from the newly-created judicial disciplinary bodies.

2.3 Implications

The changes implemented under Putin have a clear course: towards liberal economic reforms under the strong control of the executive branch of government. It is ironic that those changes have become possible in part due to the president-oriented constitutional rules that previously, during Yeltsin's incumbency, prevented the successful completion of reforms.

But the current centralization and concentration of the political power inevitably increases the economic and social stakes from the pursued policies. If the policies are bad, the outcomes will get really bad. If the policies are good, the outcomes will be really good. The problem is that after a certain level of concentration of power, it is impossible to avoid the abuse of power and the temptation to use populist policies.

During the next few years, the main problem for Putin will be a decline in his popularity and the growth of criticism. Until the very recent legislative initiatives, the president has not done anything that would alienate any part of the electorate. His high popularity has also reflected a constellation of exogenous factors that are favorable for the economy, such as the high prices of most Russian export items (notably oil, gas and metals) and a relatively low level of international debt payments. But if the liberal reforms are fully implemented and the exogenous factors wane, a significant part of society will become upset and the president's ratings will decline. In such a situation, his sweeping constitutional powers and control of the Duma majority allow Putin to slow down reform and re-orient his policies toward populist solutions, an option that might become especially attractive when he needs to seek re-election.

3. Recent Achievements and Future Priorities in Structural and Institutional Reform

In the previous section, we analyzed the recent changes in Russia's political institutions and their direct effect on the government's ability to implement economic reforms critical for improving the business environment and stimulating growth. Among these reforms, we consider strengthening of property rights protection as having the highest urgency as it enables new investment and creates incentives for owners of Russian firms. Improvements in this area should come primarily from the reform of Russia's court system, which is currently underway.

Restructuring of the banking sector is also a critical reform as it can create a currently absent mechanism of financial intermediation between investors and entrepreneurs. Unfortunately, little progress has been made in this respect.

Finally, a reform of the state bureaucracy with its fiscal and regulatory powers is crucial to reduce arbitrary interference by the state with private entrepreneurs, hence diminishing the costs and uncertainty of operating a business in Russia. Such reform is currently being implemented in Russia, and its success largely hinges on whether newly adopted legislation is consistently enforced.

In the light of the recent trend for greater agglomeration of political power in the hands of the center, these economic reforms acquire special importance. In addition to influencing Russia's business climate directly, these new economic institutions could provide a balance to the increasing political powers of the central government. They would help ensure irreversibility of economic reforms in the face of increasing concentration of political power in the country.

In this section of the Report, we assess recent progress towards these important economic reforms and suggest further policy directions.

3.1 Property Rights Protection

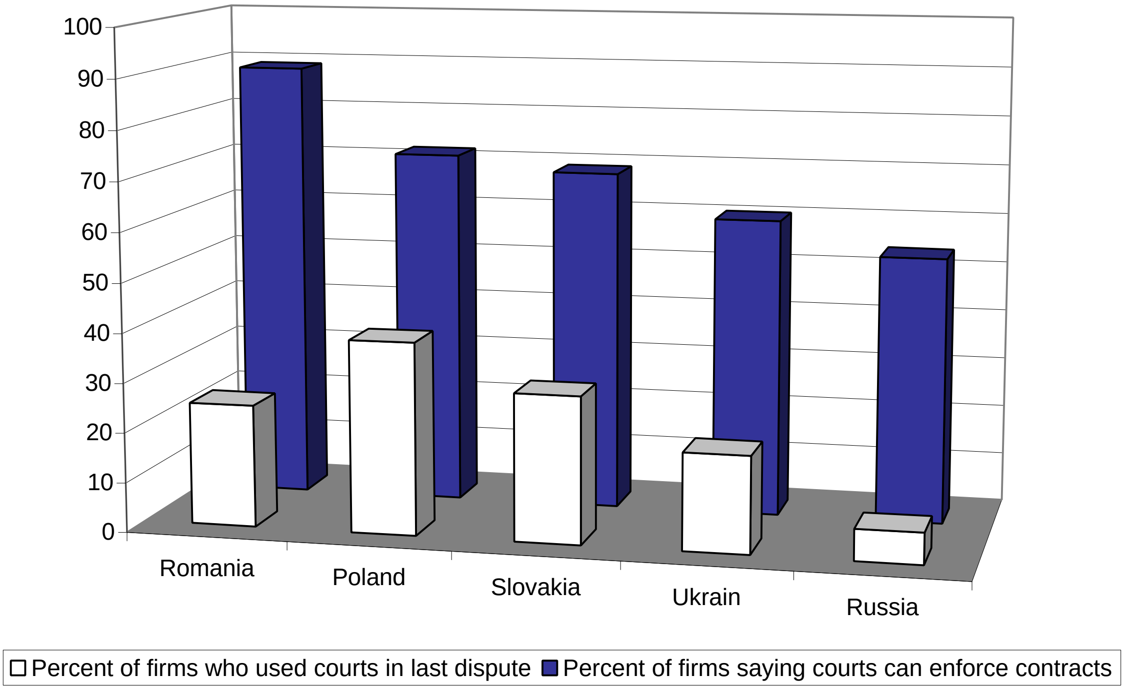
Protection of the rights of creditors and shareholders is critical to ensure investment flows into the country. Poor property rights protection implies that investors face a substantial risk that their returns will be expropriated by others, be it majority shareholders, managers or the state. In the latter case, the institution of property rights plays an important role of providing a balance to the political power of the state, something that remains vital in Russia, where political institutions of checks and balances have not yet properly developed and there is a risk that the recent trend towards increased centralization of power in the hands of the president could lead to loss of accountability of the political center.

Protection of property rights is still very weak in Russia at present. Some of the largest Russian enterprises have gone unpunished for severe violations of minority shareholder rights. Many Russian and foreign banks acknowledged in the past that the lack of lending to enterprises in Russia was due to their inability to ensure that bank credits are recovered. Numerous and ambiguous regulations allow state officials to collect rents from entrepreneurial activities.

At the heart of these problems lies widespread failure of Russian legal system to enforce contracts. The lack of confidence in the Russian legal system is apparent in several surveys of Russian entrepreneurs. In 1994, a World Bank survey showed that only 27%

of surveyed firms resorted to legal action when their customers fail to pay on time, and 26% believed that filing for insolvency of a debtor who has not paid was a waste of time since 'Russian courts are weak and incompetent and the court procedures do not produce the desired outcome'. In a 1997 survey of firms in transition economies, Johnson, McMillan and Woodruff found that 54% of those surveyed in Russia would use the courts to enforce contracts. This is the lowest percentage among the five countries surveyed (see Figure 12).

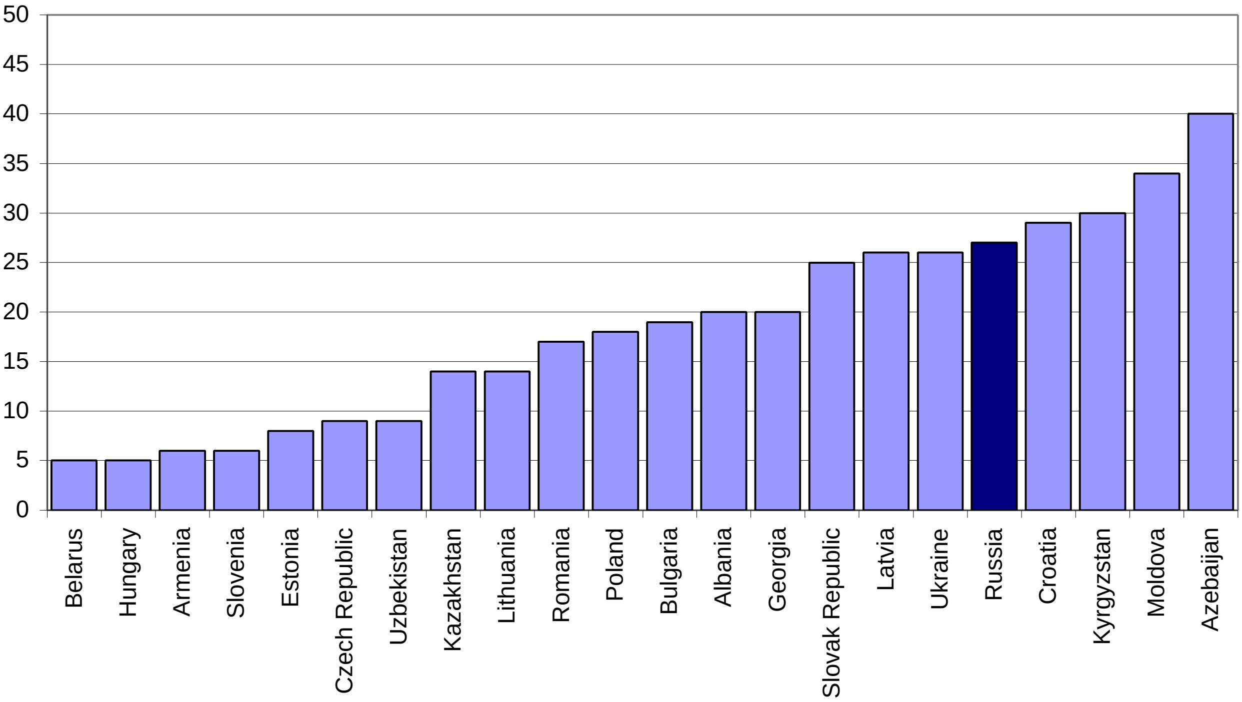
Figure 12: What percentage of firms uses the courts and believes in their power to enforce contracts? Results of a cross-country survey from 1997



Source: Johnson, McMillan and Woodruff (2000)

A World Bank survey conducted in 1999, a year after the financial crisis of August 1998, asked firms to indicate how strongly their businesses had been affected by the corruption of the court system. Over a quarter of the Russian firms surveyed acknowledged a significant impact of court corruption on their activities, which was higher than in most transition economies (see Figure 13).

Figure 13: The effects of corruption in courts remained high in Russia in 1999



Source: Hellman, Jones and Kaufmann (2000)

CEFIR's 2001 survey of entrepreneurs (see Box 5) indicates that the lack of a proper legal system remains one of the most important current obstacles to conducting business in Russia. The three major reasons for the ineffectiveness of Russia's legal system are:

- Lack of informational transparency
- Inappropriate legislation
- Poor enforcement of existing laws.

The Russian government has now recognized that it has a role as a facilitator of informational flows in the country. Given the current level of informational transparency in Russia, steps to introduce international information disclosure and accounting standards remain critically important.

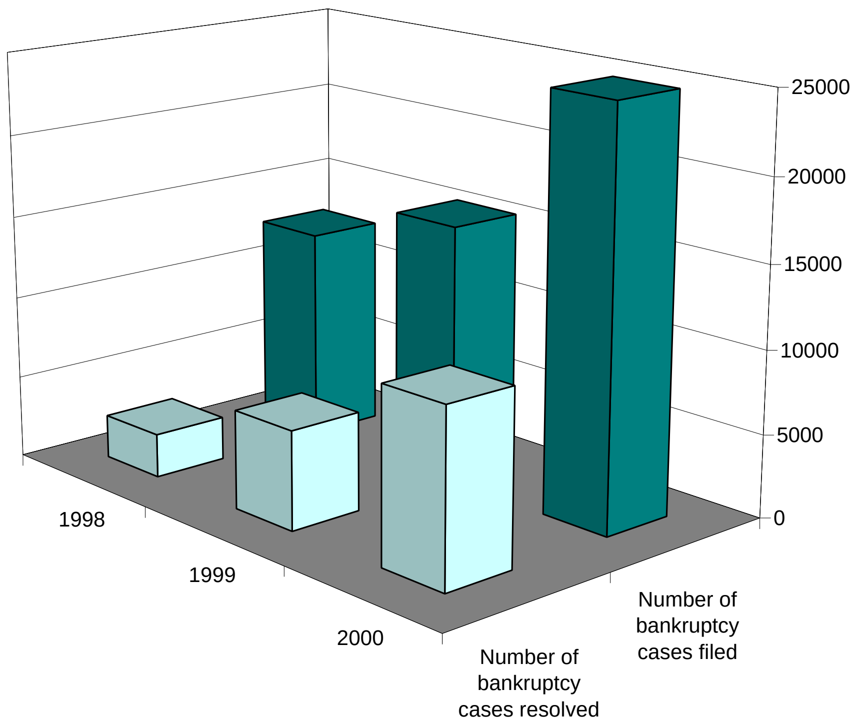
At the same time, the legal framework, much of which was inherited from Soviet days, has proven inadequate under the new regime, but nonetheless has taken a long time to change, often leaving legal vacuums in important areas of legislation. In addition, many of the laws adopted after the break-up of the Soviet Union have been vague and open to broad interpretation. There are instances when laws passed at different times contradict each other and/or the 1993 Constitution.

There have been serious attempts to improve legislation in the area of property rights protection over the past two or three years. The government's economic program for 2001-4 envisions important steps such as ensuring minority shareholders rights through favorable and detailed changes in the law governing shareholder meetings and share emissions and giving collaterized creditors a higher priority during bankruptcy proceedings. While these changes are necessary, the main problem with property rights remains their enforcement.

Poor law enforcement stems first from lack of resources available to courts to deal with arising cases, and second, from a failure to establish the independence of judges across the entire court system. Over the last four years, Russian arbitration courts, which deal with commercial disputes, have processed an average of 75-80% of received cases. The efficiency of the court system in dealing with bankruptcy proceedings is much smaller – only 20-42% of such cases are resolved each year (see Figure 14).

Figure 14. Russian arbitration courts lack capacity to deal with bankruptcy cases

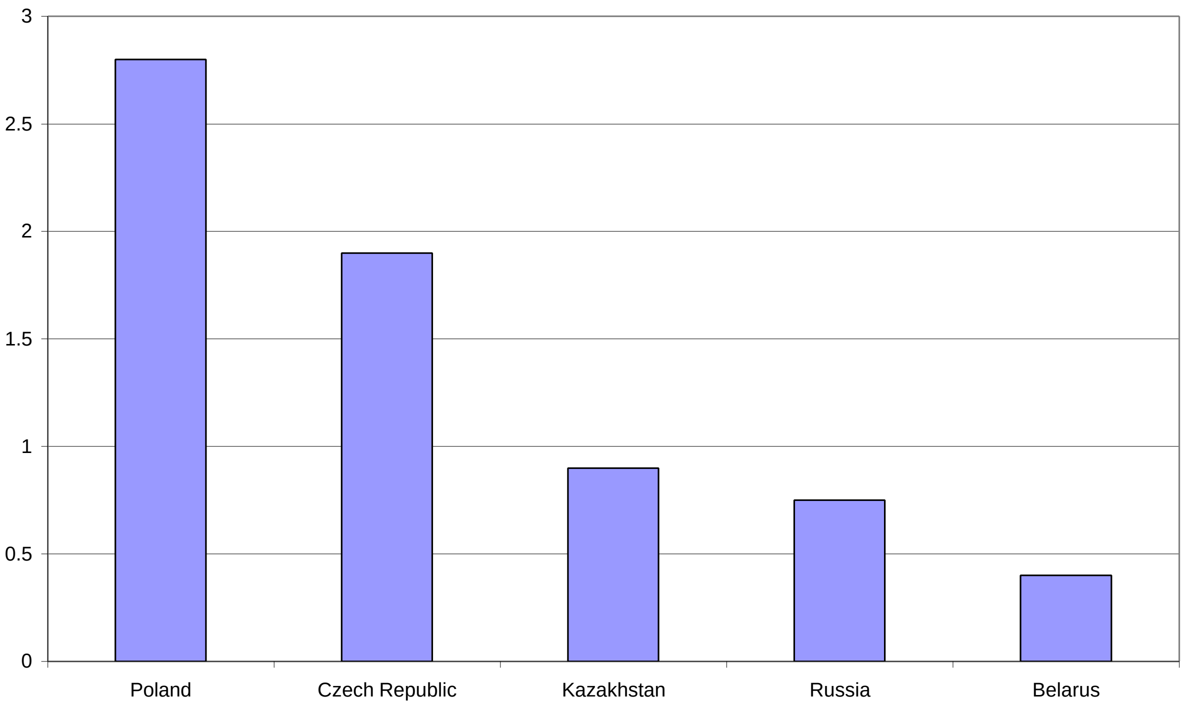
Source: Russia's Higher Arbitration Court



Low salaries, excessive work loads, the frequent failure of the federal government to provide facilities for regional courts, and the judiciary's virtual immunity from prosecution (initially introduced to guarantee independence of judges) have created incentives for judges to accept favors or protection from litigation parties, including local governments.

The problem is exacerbated by the fact that the courts' geographical jurisdictions often coincide with political territorial divisions, strengthening the bond between the local government and the court. The fairness of the judicial process is further undermined by the absence of witness protection programs and the existence of an old Soviet law that allows prosecutors to issue arrest warrants rather than the courts. Substantial anecdotal evidence suggests that the court system is often improperly manipulated (see Box 7). Jury trials, which can help deal with some of these problems in criminal courts, have only been introduced in nine out of Russia's 89 regions.

Figure 15: The share of fiscal spending on the judicial system remains low (1999-2000)



Sources: Ministries of finance and ministries of justice in the countries

Box 7: Political interference in bankruptcy processes in Russia

The interference of local governments in bankruptcy processes is a common occurrence. Lambert-Mogiliansky, Sonin and Zhuravskaya (2000) demonstrate that the bankrupt firms that are allowed to go through rehabilitation rather than liquidation usually have a large number of employees and are located in regions where the governor enjoys substantial power. Such interference greatly reduces the effectiveness of bankruptcy as a mechanism for redistributing resources from less productive to more productive activities and simultaneously creates expectations of impunity among enterprise managers.

The poor state of Russian courts has been apparent for years, yet the reform of the judicial system that had begun just after the break-up of the Soviet Union stalled, and has again come to the fore only in 2000-1 (see Box 8). Government proposals, most of which have received initial parliamentary support, introduce important changes, which, if properly implemented, should lead to increased accountability and professionalism of Russian judges and make the court system more efficient.

Still, this reform continues to be very much a piecemeal affair. Two major criticisms arise. First, the reform focuses on increased control over judges by making it much easier to dismiss and prosecute them rather than changing other types of incentives by, for example, increasing their pay or making them less dependent on local authorities by ensuring federal government financing.

Second, the new proposals strengthen the political center's control over the courts, especially in 'important' cases against the state through the new administrative courts. Combined with the new ease with which judges can be dismissed, this greater control could ultimately reduce the independence of judges and the accountability of the central government. This seems to undermine a critical role of a judicial reform as establishing an institution that keeps in check the power of the government.

Box 8: Judicial reform in Russia 2000-1

The Russian government has produced a number of legislative proposals, suggesting institutional changes to help ensure the accountability of judges as well as to clarify and simplify court procedures.

At the core of the reform are changes in the processes of appointing and dismissing judges, which are intended to make them more transparent and fair. Requirements for appointments are increased and the process made more competitive and open; an upper age limit is introduced. Prosecution of judges for violation of administrative and criminal laws is made significantly easier than before, limiting the virtual impunity from law currently enjoyed by the judicial profession in Russia.

Importantly, the reform plans to introduce jury trials in the 80 Russian regional courts where they do not already exist, which should help to increases significantly the fairness and independence of regional courts dealing with serious criminal offenses.

The package also includes procedure for amending legislation that is inconsistent with Russia's 1993 Constitution, filling a glaring gap in the legislative process. It also aims to create a special type of 'administrative' court to deal with major lawsuits brought by citizens against the government and its officials. To help ensure the independence of such courts from local authorities, the jurisdictions of these courts are territorially different from Russia's political regions and the judges are to be appointed by the president.

Box 9: **Monitoring obstacles in the business environment in Russia**

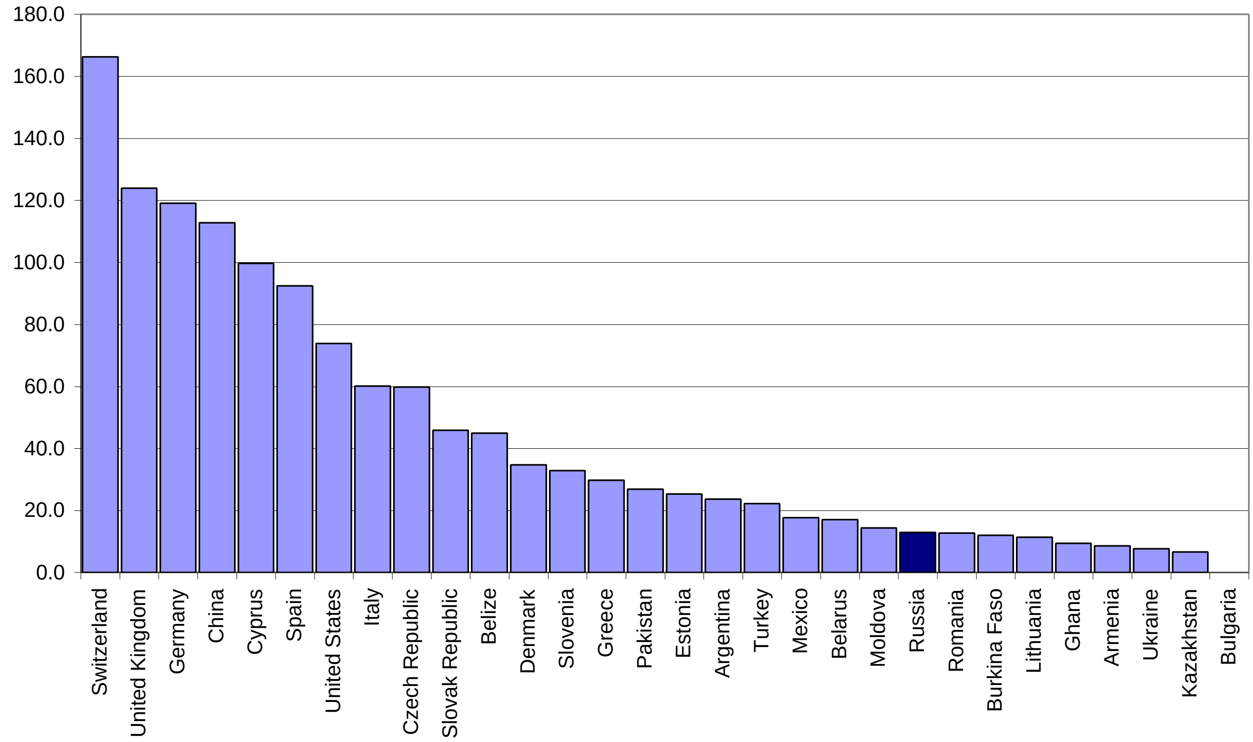
CEFIR is serving as a consultant on a research project sponsored by the World Bank aimed at monitoring the progress of the deregulation of the Russian economy. This reform, which entails simplification of the registration procedures for businesses, as well as reduction of the number of activities requiring licensing, has been proposed by the Ministry of Economic Development and Trade in the past year. As elaborated in the Government's Basic Trends Program, 'the main task of the deregulation of the economy is to lessen bureaucratic pressure on business and increase the level of economic freedom for all participants in economic activities.' Currently, the legislation necessary for the progress of this reform is under discussion in the Duma. As soon as the reform starts, CEFIR will be monitoring its progress by surveying a selection of small and medium-sized businesses in a number of Russian regions over the course of two years.

In the course of the project, it will become clearer what bureaucratic impediments exist on the way of small and medium-sized business. It will be possible to quantify these obstacles in terms of time and money spent on bureaucratic procedures, which frequently contradict federal laws. CEFIR will be able to decompose these impediments into those posed by the different branches of the government, and also observe how this regulation varies across regions. It will be possible to conclude how the degree of economic freedom in a given region relates to business development. Last but not least, monitoring over time will help determine whether the reform announced by the government indeed brings more freedom to business in Russia.

3.2 Banking Sector Reform

A well functioning banking sector is an important facilitator of investment activities, as it channels funds from creditors to borrowers and monitors investment projects on behalf of creditors. The amount of finance that Russian banks channel into the real sector has been very small by international standards, though it has increased in the last two years. We view a substantial reform of the banking sector as critical for promoting investment and output growth (see Figure 16).

Figure 16. Banking intermediation – still lacking in Russia (% of GDP, 1998)



Source: World Development Indicators

Over two years have passed since Russia experienced its latest financial crisis. The crisis rendered the banking system as a whole and most individual banks insolvent. But there is ample evidence that the problem in the banking system predated the financial crisis. Banks were operating under weak supervision and engaging in speculative activities rather than responsible intermediation to the real sector. The overall quality of loan portfolios was very poor. Unfortunately, little has changed in the supervisory environment and the fundamental problems in the banking sector have not been addressed. Very few licenses have been withdrawn and insolvent banks are allowed to continue operating. The initial government reform program was remarkably silent on the issue of banking reform. Even if there has been some movement recently, the president is still backing the Central Bank in its passive stance.

Many observers believe that the Russian banking system is heading towards another system-wide crisis within a couple of years. The combination of ruble appreciation and a leveling off of oil prices can quickly dry out liquidity in the banking sector and provoke a new collapse. Such a crisis could serious derail the implementation of the rest of the reform program.

At the moment, the sector consists of a large number of banks, many of which defaulted on their obligations to depositors and/or other creditors. The market for deposits is now dominated by Sberbank, a bank under Central Bank control and the only bank enjoying an explicit government guarantee on its deposits. A large share of savings is held outside the banking system altogether. Incentives for banks have not changed substantially since massive default of 1998.

In order to create incentives for efficient behavior among banks and to curtail continued expectations of impunity, substantial changes need to be introduced into Russian banking supervision. While critical legal gaps are currently being filled, detailing bankruptcy procedures for banks, making regulations more precise, transparent and harder to manipulate, and introducing a minimum capital adequacy ratio, the lack of proper enforcement of these regulations remains the main obstacle on the road to an efficient banking sector. The primary task then is to curb political and banking lobby pressure on the Central Bank.

An equally important ingredient of banking reform is the overhaul of the judiciary currently underway and described above. To make financial intermediation attractive to banks, it is important to strengthen substantially enforcement of creditors' rights in courts. Empirical studies show that countries with weak law enforcement also have little bank intermediation. Reliable court system is also essential for proper implementation prudential control.

Finally, to increase the efficiency of the banking sector, the state should allow more competition. The planned sale of the Central Bank's share in Sberbank by 2004 and opening of the market to foreign banks should play a crucial role here. In addition, it is very important that the system of state deposit insurance is revised, first to give equal treatment to all banks, and second, to minimize the incentives for risk-taking that it gives to banks.

The key decision-makers are well aware of most of the problems and the available solutions, but there is little political pressure to do something. The recent surge in economic growth has aggravated the problem. The increased liquidity in the financial system breathes new life into previously moribund banks in a weak supervisory environment. To address the lack of political will is a difficult, but nevertheless important, matter. Various forms of outside conditionality are possible, but ultimately change has to come from within through the activation of the political interests and stakeholders most adversely affected by the lack of a well functioning banking system and the potential for a new financial crisis. The media is critical to such a process.

Box 10: The 1998 banking crisis: reasons and responses

The collapse of the Russian banking sector during the financial crisis of August 1998 highlighted serious problems in the supervision of credit institutions in Russia. Prior to the crisis, banks widely pursued imprudent strategies, investing in overly risky projects in the real sector and gambling on the exchange rate. The devaluation of the ruble triggered an across the board default of the entire banking system, including the second and third largest retail banks' refusal to repay the private deposits.

There are three main reasons why the Central Bank, the banking system's top supervisor, ran into substantial difficulties in regulating Russian banks. First, the lack of transparent accounting standards hampered detection of violations of banking regulations. Second, vague and incomplete regulations and laws governing the banking sector – specifically over issues of bankruptcy procedures for banks – made it difficult to enforce discipline in the sector. Third, substantial political pressure on the Central Bank, including arguments that some banks were 'too big to fail' or that there were 'too many banks to fail,' led to selective enforcement of the regulations that did exist.

Lack of clear laws, the weak court system, and the bowing of the Central Bank to political pressure encouraged Russian banks to pursue risky policies in the expectation that they would not be forced to return money to creditors if the risks did not pay off.

Unfortunately, developments following the crisis did little to upset such expectations. Even though the failure of many banks was apparent already in August 1998, the Central Bank was very reluctant to withdraw operating licenses from these banks, a prerequisite for starting bankruptcy proceedings against a bank. The rate of license withdrawal after the crisis was even lower than before August 1998. The licenses of six large banks were eventually withdrawn a year after they defaulted on their obligations and even that was done under pressure from international financial organizations. In addition, a substantial amount of time elapsed between withdrawal of licenses and initiation of bankruptcy proceedings. There were even instances when banks, whose licenses had been withdrawn, received them back in the meantime. This large gap between when a bank's insolvency is recognized and the owner's right to control bank assets are frozen allowed owners of bankrupt banks to channel their remaining assets away from the bank, lest creditors receive the assets as part of the bankruptcy procedures. At present, a number of insolvent banks still have not been liquidated.

In an environment of such lawlessness, Russian banks have few incentives to fulfill a role of efficient intermediaries between savers and investment projects. In addition, even 'conscientious' banks are discouraged from investing in the real sector by the weak legal system and poor protection of creditors' rights as well as a lack of informational transparency.

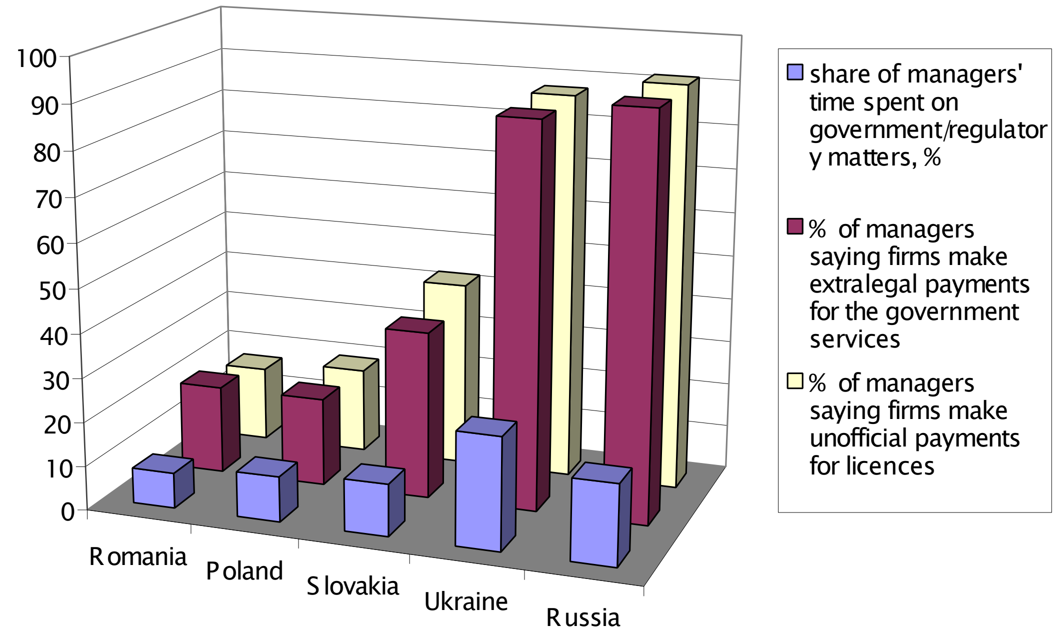
3.3 Regulation and Deregulation

Among the major obstacles to the development of the entrepreneurship (and, consequently to economic growth) in Russia during the past decade, one of the most significant was the vast powers of state bureaucrats, who had at their disposal an abundance of administrative measures allowing them to interfere in business activities. These included excessive and cumbersome regulation of firm registration, licensing, certification procedures (which can all be treated as barriers to entry), inspections (sanitary, fire department, etc.), regulation of investment decisions, and regional trade barriers.

The situation got especially bad in the second part of 1990s, boosting corruption and increasing inefficiency. Different surveys of small businesses undertaken over the period repeatedly showed that Russia was doing worse than other transition economies in this respect (see Figure 17). According to Frye and Zhuravskaya, reporting surveys of small shops in Warsaw and Moscow conducted in 1998, the number of inspections (as well as the number of shops fined by those inspections) was almost six times as high in Moscow as it was in Warsaw (see Table 1).

Figure 17: The regulatory environment in transition economies, survey results

Source: Johnson, McMillan and Woodruff (2000)



Besides general economic inefficiency, which implies a burden on both consumers and producers, the main consequences of excessive regulation include hampering of new business development, especially for small start-ups, which were an essential driving force for economic growth in Eastern Europe. In addition, more firms drift into the shadow economy, which again brings in more inefficiency and lowers tax revenues. Over-regulation leaves a lot of discretion to state bureaucrats, which leads to corruption and makes unfair competition possible.

Table 1: The regulatory environment for small businesses in Russia and Poland (survey data)

	Year	Warsaw	Moscow	Ulyanovsk	Smolensk
Number of inspections per year	1996	9.0	16.3	21.9	16.2
	1998	3.3	18.7	21.9	15.3
Number of agencies conducting inspections	1996	2.6	6.5	6.1	4.4
	1998	1.6	4.9	4.7	4.4
Time to register in months	1996	0.7	2.5	1.8	1.2
	1998	1.2	2.9	3.5	1.1
Number of permits required to open	1996	2.6	6.2	8.7	5.2
	1998	4.2	6.7	5.6	4.5
How legally vulnerable are you on scale 1-10	1996	3.6	5.6	5.7	5.4
	1998	5.5	7.2	8.2	6.4

Sources: Frye and Zhuravskaya (2000) and Frye (2001)

Thus, the reform of the state's administrative apparatus has been long overdue. The government finally acted in 2000 when such reform was introduced. The first block of the proposed package of laws was approved by the Duma in 2001 (see Box 11).

Box 11: Russian administrative reform

The first block of draft reforms, which involves changing regulation of the registration of firms, licensing and inspections, was approved by the Duma in 2001 and it already provides for important changes. The law on registration of firms introduces a one-window principle instead of previous procedure, which involved numerous steps to register and multiple authorities dealing with registration. It also provides for creation of a single firm registry open to the public.

The licensing bill seeks to restrict the number of activities that require licensing, and envisages a mechanism to prevent the expansion of this list. Only those activities that may be dangerous for a third party can be licensed, and only if it is proved that no other method of control can do the job. At present, more than 500 types of activities require licensing. The bill on inspections is an attempt to bind the arbitrary powers of inspectors. Timing of the inspections is clearly specified, and firms are required to keep special registries for inspections.

The rest of the deregulation package is expected to be discussed by the Duma fairly soon, since most of the drafts are ready. Laws dealing with certification are among those that are to be discussed. At present, 80% of the market for consumer goods in Russia is certified (compared to just 4% in Europe); there are more than 20,000 standards, most of which are not observed. The idea of the reform is to make the certification a responsibility of the producers themselves (associations of producers), creating incentives for observing the standards. The package contains drafts that restrict the level of discretion of the inspecting authorities, complementing the law on inspections.

The law on police seems particularly important. Surveys rank the discretion of the police as the main problem for small businesses. Currently, a junior policeman can initiate an inspection of any small business at any time at his discretion motivated by a mere suspicion that rules are being violated. Such a legal norm is harmful for businesses even if they obey the regulation. The situation now is more dramatic, since small firms are still operating in an environment when they cannot exist without violating any rules and regulations - see the legal vulnerability index in Table 1.

While the unpredictability of inspections is a serious obstacle for small businesses mainly, problems with regulation of the investment decisions are one of the major concerns for the whole business community. Now, the absence of a clear procedure for reconciliation of investment projects is hard to overcome, even for larger firms. The major obstacles stem from unclear legislation on construction, unresolved issues with land ownership (a problem largely addressed by adoption of the Land Code), drawbacks in the investment legislation, and especially from regional regulations and discretion of regional authorities. As a part of the deregulation reform, a bill clarifying the procedures required for starting an investment project is to be adopted.

Together with the legal reforms, the removal of administrative barriers should bring a drastic change to the environment in which small and medium-sized firms operate. Important consequences of the administrative reform will be related to changes in the perception of the role of the government in society and different expectations of new entrants.

The results of administrative reform will, however, be much less impressive if the reform is partial, which will be the case if adoption of some measures are delayed or changed significantly under the influence of lobbies. Among the reforms this Report considers, this is one area in which more advances has been made so far. If it is implemented consistently, and a coherent set of regulation laws is adopted, this will give a lot of credit to the government and bring more support for reforms in other spheres. At the same time, a properly conducted administrative reform reducing arbitrary economic powers of the government acquires a special importance when the central government is amassing large amounts of political influence.

In addition, the newly approved tax code, which greatly simplifies tax rules, plus the planned privatization and introduction of competition into the electricity, gas and railway industries should contribute to reducing the power of the bureaucrat and improving the efficiency of Russian markets.

4. International Accountability: The Prospect of Accession to the World Trade Organization

President Putin has said in recent interviews that WTO accession is one of his main priorities for Russia. Certainly, negotiations have been accelerated. But at the same time, there is a substantial disagreement both within and outside Russia about the costs and benefits of accession, the speed and conditions under which Russia should join, and the policy measures that should accompany accession.

In cooperation with Club 2015, CEFIR recently produced a policy paper that summarizes the major points of both Russian and foreign discussion of the issue of WTO accession. This section is based on the ideas presented in that document and revealed during subsequent discussion of the issue on the Internet.

4.1 Costs and benefits of WTO accession

There are three major benefits of WTO accession for Russia:

- Better status for Russian exports.
- Improvements in total factor productivity, and further development of the service sector.
- Increased inflows of foreign direct investment.

Russia is currently involved in about 100 anti-dumping suits, costing around $2.5 billion. Accession to the WTO will allow Russia to improve the status for its exports, thus reducing the costs of anti-dumping suits and increasing business opportunities for those firms that are not currently exporting. In addition, further integration in the world economy and a greater exchange of goods, technologies, and managerial practices with the outside world can lead to potential improvements in the total factor productivity of Russian firms. But these benefits may be outweighed by the exit of inefficient firms, at least in the short term. What is the relative importance of these two effects?
Table 2 provides some data on the state of openness to trade of the Russian economy. It is clear that the Russian economy is fairly open: tariff levels are quite low by international standards, and import penetration ratios are fairly high. Tariff proposals currently under discussion suggest fixing tariffs at a level close to the current one, so we are not expecting a substantial increase in international trade as a result of WTO accession.

Table 2: Protection of industries and share of imports.

	Average tariff, 1999	Share of imports, 1999
Chemical and petro-chemical	7.6	0.32
Machinery	10.1	0.43
- electrical engineering and machine-building	8.5	0.26
- transport machinery	16.1	0.37
- metalworking	7.6	0.48
Timber processing	14.7	0.18
Construction materials	11.2	0.15
Textiles	10.2	0.41
Food industry	11.7	0.33

Russia can expect many more benefits from foreign direct investment. WTO accession should result in substantial liberalization of inflows of foreign investment, particularly in the service sector, and in eliminating some of the uncertainty in economic (mainly trade) policy. These changes should make Russia more attractive for foreign investors, and, therefore, increase the potential for spillovers from foreign to domestic firms.

4.2 Speed and conditions of WTO accession

There is also a serious discussion on the speed and condition of accession. Lobbying groups from different sectors insist on giving them time for development, and delaying accession for a fairly long and uncertain period, that is, until they are ready. Although this position has a valid economic argument behind it, that is, using trade protection as a way to develop ‘infant industries’, we believe that it is not applicable in the Russian case. The problem is not that Russia does not have infant industries, but rather in how efficient their development will be if Russia does not open the economy, and whether the benefits for such industries would outweigh the costs for the whole economy. We believe that the Russian government has little credibility in imposing the threat of future opening of the economy on such industries, and therefore, the scenario that such industries in contrast of fast development would spend most of their resources of lobbying government is very probable. The example of the banking sector, which seized the opportunity to develop despite protection is revealing in this case.

A different approach to the problem advocates speeding up accession so that Russia is be able to participate in the next round of WTO negotiations. We would be somewhat careful with this idea as well, because speeding up may involve weakening Russia’s position in the accession negotiations, which may on net outweigh the benefits of participation in WTO negotiations. To summarize, we would argue for a fairly fast accession of Russia but without an unnecessary rush. Accession in two to three years under carefully negotiated conditions sounds a better strategy, than trying to make a deal by the end of this year.

4.3 Accompanying Policies

We expect that Russia will be a net beneficiary from WTO accession though there may be initial costs of this policy. The costs will be related both to the ability of uncompetitive firms to restructure, but also to the ability of the economy to undergo fast structural changes. Increased mobility, particularly geographical and professional mobility of labor, and development of financial markets as a way of increasing the mobility of capital are essential for speeding up structural changes, and converting Russia into a dynamic economy with high potential for growth.

Measures aimed at improvement of geographical mobility would involve complete abolishment of the ‘registration’ institution, and measures aimed at developing the market for housing. The latter involves development of the market for mortgages, increases in the amount of construction of cheap municipal housing, and simplification of the rules of eviction of inhabitants from expensive private housing into cheap municipal housing.

Increased professional mobility involves measures aimed at reforming Russia’s educational system. What the country needs, as is now common in the West, is to propagate the idea of ‘life-time education’, and to create the corresponding infrastructure. At the same time, it is essential to preserve and increase the possibility of obtaining education for all Russian citizens irrespective of their income status. Development of an educational loans system can help to improve the situation in this direction. As far as the specifics of education is concerned, we advise restructuring programs in such a way as to develop creativity among students, not just rote learning of a certain number of recipes or solutions to some standard problems. We should note, also, that for reaching fast and sustainable growth in Russia, educational reform is the most important. Of course, this may not deliver benefits for the country in the short run, but the biggest mistake the government could make is to postpone educational reform while trying to obtain quick returns from less important measures.

5. Conclusions

0Over the last two years, Russia has achieved economic growth for the first time since the large decline in output it suffered following the onset of transition. This recovery was spurred by a substantial devaluation of the ruble, which stimulated the growth of import substitution industries. But growth can only be sustainable if Russia successfully increases the productivity of its industries and continues to attract domestic and foreign investment. Both of these tasks require a substantial number of structural reforms.

The Russian government clearly recognizes the need to implement serious structural reforms. This is apparent both from its extensive economic program for the next three years, a large part of which is devoted to such reforms, and from its recent efforts to centralize political and judicial powers in the country, which would make reforms initiated by the center easier to implement.

While these seem to be significant steps in the right direction, we see two major areas of concern here. First, the government's economic program for 2001-4 is very broad, covering reforms in almost all areas of society, from health care to the railway network to customs policy. Even though many of these reforms are very necessary and have been thought through in detail, in order to make implementation realistic, it is vital to set priorities among these tasks.

In this Report, we have tried to determine how priorities should be set in order to create foundations for sustainable economic growth in Russia. We identify the need to increase property rights protection, restructure the banking sector and reduce the arbitrary powers of government officials to intervene in private businesses as key to the improvement of Russia's investment climate, and, therefore, its growth potential.

Our survey of foreign businesses operating in Russia shows that there is a large demand for these reforms among foreign investors, indicating that changes in these key areas would be effective in attracting much needed foreign investment. We also emphasize that increases in human capital are an important source of productivity growth. In this context, educational reform and reform directed at removal of barriers to geographical and sectoral mobility of the population are critical for sustained growth in human capital.

Second, we recognize that the recent process of centralization of power in the hands of the president is having serious implications for the course of economic reforms in Russia. Much of the failure in implementing economic reforms during the Yeltsin presidency can be attributed to the lack of political power in the hands of the president to pursue the initiated changes. But while the centralization of political power should make implementation of market-oriented reforms proposed by the center easier and more effective, it also creates dangers arising from the loss of accountability of the central government that accompanies such centralization. Should the agenda of the central government change, recent shifts in political institutions would make it more difficult than before to influence the course of government policy.

In conclusion, we would like to emphasize that our analysis so far has been driven solely by considerations of sustainable growth. At present, Russia suffers substantially from increasing income inequality and a poor system of social protection. While an overhaul of social protection and pension systems is currently underway, we believe that it is critical to achieve sustainable growth in order to reduce poverty and provide foundations for building a reliable social security system.

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