THE NEW POLITICAL ECONOMY OF RUSSIA

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Preface

When its transition from a centralized to a market economy began in 1991, Russia had to face the challenges of building a new society largely without any tradition in the social sciences, in particular, in economics. Moreover, Russia's reformers and Western advisors had very little access to reliable data, and there was essentially no conceptual basis for thinking about the transition process.

A decade later all this is changing. A new generation of Russian social scientists are returning to their home country after solid training in the West. Their numbers are still small (altogether, at this writing, only some ten Russians with doctorates in economics from leading Western institutions have returned to Russia), but they are already making a difference in Russian intellectual debates as well as in policymaking. They return armed both with the theoretical insights necessary to analyze the issues facing Russian policymakers, as well as an understanding of the large stock of research that has accumulated from a decade of transition experience. They are applying their skills and knowledge to the construction of new data sets, and are fundamentally deepening the policy debate in the country.

The new generation is also contributing to a reform process that has become increasingly Russian-owned. The broad and far-reaching reform program developed under the leadership of the current minister for economic development and trade, German Gref, involved a broad range of Russian experts and drew on new analysis of Russia's economy. Young reformers, like Mikhail Dmitriev, Arkady Dvorkovich, and Elvira Nabiullina, demonstrate a new attitude toward the utilization of solid data and research-based input in the policy process. Systematic efforts are underway to measure quantitatively the extent reforms are implemented in Russia and to estimate their impact on a broad range of aspects of Russian economic and social life.

The authors of this book are proud to participate in these developments. We have all been part of building the Center for Economic and Financial Research (CEFIR), an independent economic research think tank in Moscow that aims to make a long-term, sustainable contribution to economics and economic policymaking in Russia by building indigenous skills and capacity in this field. At the core of CEFIR is advanced research on the Russian economy. CEFIR's staff are young Russian economists, many of whom have receive degrees from top Western universities but have decided to return to work in their home country. The ultimate aim is to build the analytical

capacity necessary to support a locally owned and sustainable economic and social development.

In writing this book we have drawn on the research accumulated at CEFIR. Many of our colleagues have contributed in various ways. We are particularly grateful to Yury Andrienko, Eugenia Bessonova, Irina Denisova, Maria Gorban, Sergei Guriev, Konstantin Kozlov, Alexey Makrushin, Elena Paltseva, Konstantin Styrin, Natalia Volchkova, Oleg Zamulin, and Ekaterina Zhuravskaya for valuable contributions. Katharina Pistor, Pekka Sutela, and Tony Shorrocks read selected parts. We also thank Guido Friebel (Stockholm Institute of Transition Economics, SITE) who commented on several drafts, as well as Anatole Faykin (SITE), Maria Gorban (CEFIR), Jody Lanfrey (SITE), and Romesh Vaitilingam for their editorial work.

The first version of this book, a report entitled *Is There a New Russia?* was presented as a background paper at the Baltic Development Forum in St. Petersburg in September 2001. We thank the forum for its financial contribution supporting this original work. We would also like to thank members of the European Business Club, the American Chamber of Commerce, and Club 2015 for participation in our survey of business representatives. Finally, we want to recognize the generous contributions of Lisbet Rausing to the core funding of CEFIR and the project-related support offered by, among others, the World Bank, the U.S. Agency for International Development, and the Swedish International Development

Agency. And it was the Russian-European Centre for Economic Policy funded under the TACIS Program of the European Union that brought us all together in the first place.

The New Political Economy of Russia

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1 Introduction

Russia's economic and political development over the last decade has defied expectations many times. Very few, if any, had predicted the collapse of the Soviet Union or the collapse of output that followed. The Russian financial crisis in 1998 surprised some, but not others. And almost everyone failed to predict the dramatic recovery that has taken place since. This book attempts to understand all these developments with a focus on the economic and political regime shift that followed the succession of Boris Yeltsin by Vladimir Putin as the president of Russia. The new political economy of Russia has brought idle capacity in the country's industry back into use, but will it be able to mobilize new investment and create stable foundations for future growth? This is the fundamental question we address in this book.

The Russian economy is growing. And thanks to the liquidity created by the ruble's devaluation in 1998 and to high oil prices, this growth is broader, involving a wider range of industries and regions, than ever before.

More importantly, for the first time in a decade, we are seeing a political and economic constellation in Russia that is conducive to the broad institutional reforms the country needs to foster sustainable economic growth. Strong popular support has allowed President Putin to make significant headway in dealing with interest groups that have blocked reform in the past, and he has put his weight behind a very ambitious reform program. At the same time, the high degree of concentration of powers in the Russian presidency that Putin has pursued entails real risks, and a lack of clear priorities threatens to derail the government program for reform.

The growth challenge facing Russia is overwhelming. Russian firms are dramatically less productive than their Western counterparts, and the productivity gap has been widening rapidly over the last decade. Whereas Western firms became more efficient over the same time period, productivity fell in all major Russian industries throughout most of the 1990s. With greater demand over the past few years reversing the decline in production, and with firms making better use of their capacity, productivity among Russian firms seems to have improved. Yet vast additional advancements in productivity could be achieved simply by introducing better business organization into Russian firms. Managers still lack 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.

Russia cannot achieve sustainable growth without fresh investment. For most of the 1990s, investment levels in Russia declined, and the age of the capital stock is now at alarming levels. New investment is important not only in itself, but also because it brings about productivity improvements. This is particularly true for foreign direct investment. Regional data show strong positive spillovers from such investment, but the size and impact of these spillovers depend critically on the quality of the region's human capital and the extent of the economic reforms it implements. At this point, the high quality of Russia's human capital, an important component in productivity, can no longer be taken for granted. Recent figures show that although the number of university graduates in Russia is increasing, the quality of education in the country 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, developments that promote improvements in productivity also generate investment. Investments in a country's educational system are critical for sustaining productivity improvements and for increasing spillovers from new investment in manufacturing and services. Poor protection of property rights—and in particular, weak enforcement of laws—undermines the incentives of investors and managers to improve efficiency. And generally, the entire political and legal context of a country—the business climate—matters for incentives. In Russia, the concentration of power at the federal level and within the executive branch has come at the expense of special interests and the Russian regions. Although this concentration of power has brought with it an unprecedented opportunity to implement critical structural reforms, it has also created a commitment problem. Experience from around the world shows that when a country's rules and laws are unclear or when the power of a country's ruler is unchecked, the country's economic growth suffers as a consequence.

Now, the main objective of the reform program in Russia should be to establish the checks and balances necessary for the Russian government to commit to stable institutional rules that are conducive to sustainable economic growth in the country. Russian and foreign entrepreneurs and investors must perceive stronger protection of property rights. In particular, the results of privatization, as deplorable as they have been, should be accepted once and for all. Allowing businesses to own land and streamlining the regulatory environment are important steps in reducing the scope for bureaucratic arbitrariness and corruption. But to be willing to contribute new risk capital, outside investors 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 Russian economy must take priority. Russian industry desperately needs strategic investment and thorough restructuring to increase productivity.

The Russian legal framework can still be improved, but enforcement of the laws is the critical task that needs to be undertaken. Judicial reform should increase discipline through clearer rules and accountability mechanisms; it should also raise judges' pay. Administrative reform should aim to clarify rules for the allocation of resources within the federal structure. Elements of healthy competition between and within levels of administration would promote a better business climate in the country. Predictability of the "rules of the game" is key for this competition to produce desirable outcomes. Sustainable growth requires sustainable institutions.

In the long term, generating investment requires a functioning financial system that both transfers capital from savers to investors and monitors how the transferred funds are used. The Russian financial system, or what remains of it after the financial crisis of August 1998, is underdeveloped by international standards. Russia's banks play little or no role in the supply of capital for investment in the country. Credits to the private sector have increased significantly since 1998, but not much 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 use of funds. Unfortunately, the Central Bank of Russia, which has the backing of the presidential administration, still lacks the political will to challenge the Sberbank monolith and clear up bank balance sheets. As revenues from oil exports level off and the ruble appreciates further, the prospect of a new financial crisis should sharpen minds.

We believe that the key priorities for realizing sustainable growth and investment in Russia are judicial reform, administrative reform, social reform, and banking-sector reform. The first three of these reforms are now underway, even though their implementation is a daunting challenge. The prospects for genuine bank restructuring in Russia are less encouraging. The implementation of the reform program for the banking sector and the long-term credibility of new institutional rules would be greatly aided 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 factors, 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—and the prospect of an even closer association—with the European Union would provide a sense of direction and an "outside anchor" to the Russian reform program. Ultimately, greater international accountability would also help the Putin presidency commit to keeping in check the tremendous powers it has amassed.

Thanks to accumulating experience and data from more than a decade of transition, as well as new conceptual insights, we are now much better equipped to analyze these issues than we were when the process began. A new generation of well-trained Russian economists has also returned to their home country to put the knowledge and tools they have acquired to use in the policy process. The result of their return is a flourishing domestic debate on the key development challenges facing Russia with fewer loose ideological statements and more substantive discussion informed by careful research. This book assembles the rapidly growing body of research on the Russian economy and its political process and presents the new picture of the country's political economy that emerges from this research.

In chapter 2, we analyze trends in output and productivity in Russia since the breakup of the Soviet Union and show that the reversal of the output decline after the financial crisis of August 1998 has been driven primarily by the devaluation of the ruble. To make output growth sustainable, we argue, Russia needs to improve its level of productivity and attract more investment both from within the country and from abroad. This will require substantial reforms aimed at increasing competition and improving the general investment climate.

We then outline specific areas in which urgent reforms are needed. These priority areas include increased protection of property rights (and, associated with this, judicial reform); reduction in government intervention in the private sector, including regulation and taxation; development of the banking system; and social reform. Whether these reforms will happen depends critically on Russia's political institutions, which have suffered in the past from 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 chapter 3.

Chapter 4 evaluates Russia's recent progress in economic reforms critical to improving the country's investment climate, and chapter 5 explores the potential impact of Russia's accession to the World Trade Organization. We conclude and draw policy implications in chapter 6.

2 Accounting for Growth

In the first ten years of transition, Russian economic growth followed the same U-shaped pattern observed in other transition economies (see figure 2.1). As in all European and Central Asian transition economies, the transition in Russia started with economic decline. But Russia's decline was deeper, and lasted longer, than that of most other transition countries. During the 1990s, when the economies of Eastern European countries had been growing for several years, Russia's was still stagnating. Among CIS (Commonwealth of Independent States) countries not affected by wars, only Ukraine performed worse than Russia. In the same period, the economies of the Organisation for Economic Cooperation and Development (OECD) countries grew by an average of 2.4 percent per year, further increasing the gap between Russia and the developed market economies.

Previous research has attempted to establish why some transition countries have underperformed others, but the reasons are still not completely clear in the literature.

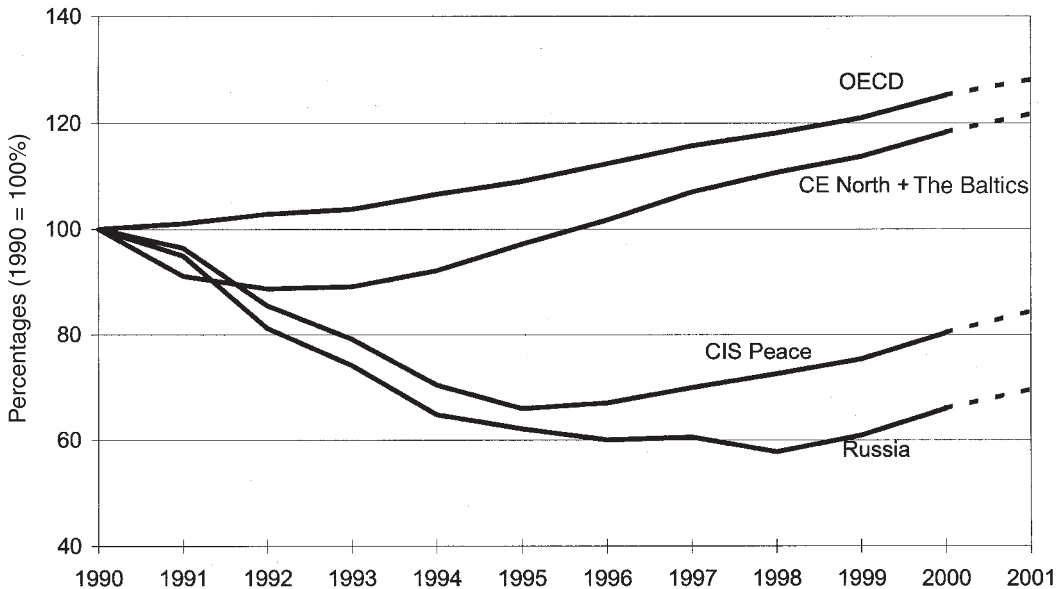


Figure 2.1
Real GDP in transition and OECD countries.
Sources: World Bank, European Bank of Reconstruction and Development, Central Intelligence Agency.

Some studies point to the slow progress (see, for example, De Melo, Denizer, and Gelb 1997; Fisher, Sahay, and Vegh 1996; and Berkowitz and De Long 1998) of reforms in countries with lagging economies. Other research questions this view, claiming that differences among the countries in initial conditions offer better explanations (see, for example, Heybey and Murrell 1997; Popov 2000; and Campos and Coricelli 2000). Still others combine the two views, holding that the differences in the severity of the initial declines in the various countries was due to different initial conditions, whereas the speed of countries' recoveries has depended to a large extent on the speed with which reforms have progressed (see Berg et al. 1999).

In the end, the interplay between initial conditions and policies is likely to be much more intricate than suggested by these studies. Initial conditions, such as the endowment of natural resources and the presence of the European Union as an outside anchor, profoundly influence the desirability and feasibility of particular policies. The interaction between initial economic conditions and economic policies are intermediated by the political process which in itself has both inherited and acquired elements and so on. Much as in the discussion of nature and nurture in biology we are unlikely to get simple answers to the important question of how much and what can be achieved through different policies.

Although differences in initial conditions or speed of reform can explain Russia's poor performance in comparison to the Central European countries, they fail to explain why the recession has lasted longer in Russia than in most other CIS countries. Clearly, initial conditions in Russia were better and reform strategies more ambitious than in countries like Uzbekistan, which experienced a smaller decline than Russia did. Popov (2001) suggests that one of the main explanations for the bigger decline in output in Russia than in most other transition countries is the collapse of the government. Sonin (1999) arrives at a similar conclusion and argues that the bad quality of government in Russia manifested itself in rent-seeking behavior and inability (or unwillingness) to protect property rights.

In chapter 3, we offer a detailed account of how federal and regional governments in Russia functioned in the early years of transition and how this affected economic policy and the business climate in the country. A number of authors have suggested that the collapse of Russian governmental institutions resulted from the absence of an outside anchor for the institutional reforms that were undertaken. In the countries of Eastern and Western Europe, such an anchor has taken the form of prospective membership in the European Union. In chapter 5 we discuss the prospect of World Trade Organization (WTO) accession as a possible external anchor for Russian reforms.

The Russian economy started to grow after the country's financial crisis of 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 percent in 1999—compensating fully for the 1998 decline—by 8.4 percent in 2000, and by 5 percent in 2001. Investment also started to grow substantially during the second half of 1999, and in 2000, the annual growth rate of investment in physical capital reached an unprecedented level of 17.4 percent.

It is commonly believed that the main source of Russia's recent economic growth has been the undervalued ruble (see figure 2.2). In just six months (from July 1998 to January 1999), the ruble lost more than 40 percent of its real value, reducing Russian demand for imports and boosting demand for Russian exports and import-substituting products. According to our estimates, Russian firms that had exported more than 10 percent of their 1997 output experienced a 6 percent higher growth in production in 1999 than nonexporting firms.[1] Across all industries, the highest rates of output growth were observed in the import substitution industries: 20 percent in 1999 and 22 percent in 2000 in light industry and 25 percent and 10 percent in those years respectively in pulp and paper production. Strong growth was also observed in the chemical industry (22 and 14 percent), and even in machine building (17 and 20 percent).

Since 1999, however, the ruble has been continuously appreciating, primarily because higher oil prices have brought substantial inflows of foreign currency in the form of export revenues. By early 2001, the real value of

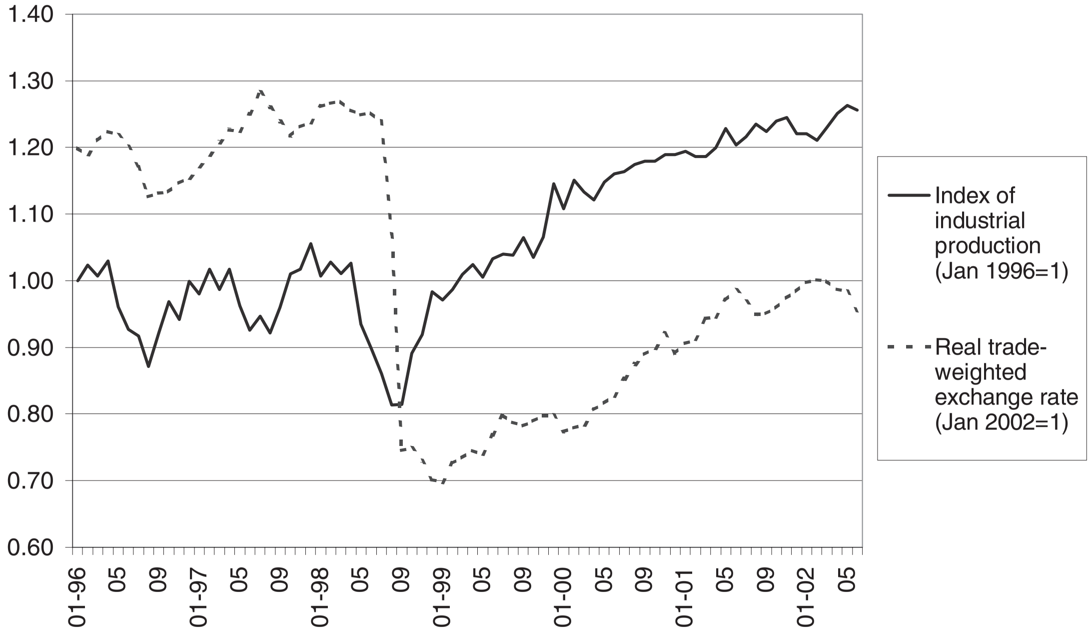


Figure 2.2
Devaluation brought growth: Russia's real exchange rate and output.
Source: Russian Economic Trends.

the ruble was already only 25 percent lower than its pre-crisis level. Real appreciation of the currency is reducing the prices of imports and increasing the prices of Russian exports. As a result Russian growth has slowed, and the country's 2001 and 2002 growth rates were lower than that observed in 2000. The decline in the growth rate in 2001 and 2002 can also be explained by the effect of global recession, which decreased the demand for major Russian exports.

The main question regarding the future developments of the Russian economy is whether the current economic growth is sustainable. Was the 4-year period of growth following the 1998 crisis just a result of favorable demand conditions (devaluation and then high oil prices)? Or does it signal the end of the initial transition recession and the beginning of a new phase of high growth and convergence to OECD countries? Was the slowdown of growth in 2001 and 2002 merely an effect of the global recession, or does it mean a return to economic stagnation once oil prices come down?

At a deeper level, the question is whether the economic and political reforms Russia has implemented so far are sufficient to sustain growth. With such a short period of growth on which to base judgments, it is still too early for a final answer. We note, however, that prior to 1998 Russia lived through several periods of strong demand for domestically produced products: The ruble was undervalued during the first half of the 1990s, while the oil price was often high. Yet Russia experienced a continuous economic decline through the 1990s until late 1998. The fact that the Russian economy reacted to the increased demand for domestically produced goods in that year is a good sign: It shows that the economy has emerged from the initial transition stage of decline and has reformed enough to be able to grow or, at least, to stop declining. Empirical evidence suggests, though, that the speed of a country's economic growth depends critically on the progress it makes toward reform. Yudaeva, Gorban, et al. (2001) show that in 1999 Russian regions with higher degrees of economic liberalization grew faster than others. Russia may need further substantial reforms to build foundations for high and sustainable growth rates. Development of small business has been a critical element of sustainable growth in successful transition economies (World Bank 2001). Russian small business is still in its infancy, and it is not until we see economic growth that involves this sector that periods of growth in the country's economy are likely to last. Small and medium-sized businesses are an important constituency for continued economic and social reforms.

The period of Vladimir Putin's presidency has been characterized by increasing optimism in the Russian and foreign business communities about the prospects for future economic growth in Russia.[2] The Russian central government, which has now strengthened its position, can for the first time in a decade rely on these expectations to build solid foundations for sustainable growth. At the same time, the evidence is growing that regional and local authorities are feeling disempowered and poorly motivated to implement reforms.

In this chapter, we review the main factors that could boost Russia's economic growth and discuss whether a critical mass of these factors has been reached. There are three major sources of a country's economic growth: increases in the labor force; increases in capital (investment); and increases in productivity. Russian demographic prospects are bleak because its birth rate has been declining for the last 10–20 years, so its economic growth must come from either improved productivity or increased investment.

2.1 The Productivity Challenge

It is well known that Russian firms are far 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. The McKinsey Global Institute (1999) reports that productivity levels in ten Russian industries are between 7 and 38 percent of those of comparable firms in the United States. The report concludes, however, that this gap can be narrowed substantially, without major replacement of capital stocks, simply by improving business organization, following best business practices, and introducing minor technological changes.

This section takes a closer look at the McKinsey report's argument and discusses policy changes that could lead Russian firms to improve their productivity. We consider factors that have contributed to raising these firms' *total factor productivity* (TFP), even during the period of overall economic decline. TFP refers to the component of growth that is not explained by changes in the quantity of factors of production used, such as changes in technology, business organization, and human capital.

Using firm-level data, we computed changes in firms' TFP during Russia's transition.[3] As figure 2.3 shows, TFP in manufacturing declined in all major industries throughout 1994–1996 and only recently has begun to rise. Total output fell during this period, and Russian firms were forced to produce at suboptimal levels of output given their stock of capital and labor. Owing to the lack of adjustment of the workforce and wage levels to the decline in demand. Russian manufacturing firms lost competitiveness and thus market share to foreign firms. As a result, their TFP dropped.

Although overall TFP decreased during most of the 1990s, there were big differences in levels of TFP across industries and firms. These differences allow us to identify those factors that helped some firms to function better than others.

Early in the transition of Russia's economy, privatization and competition were considered the most important sources of firm restructuring. It was believed that

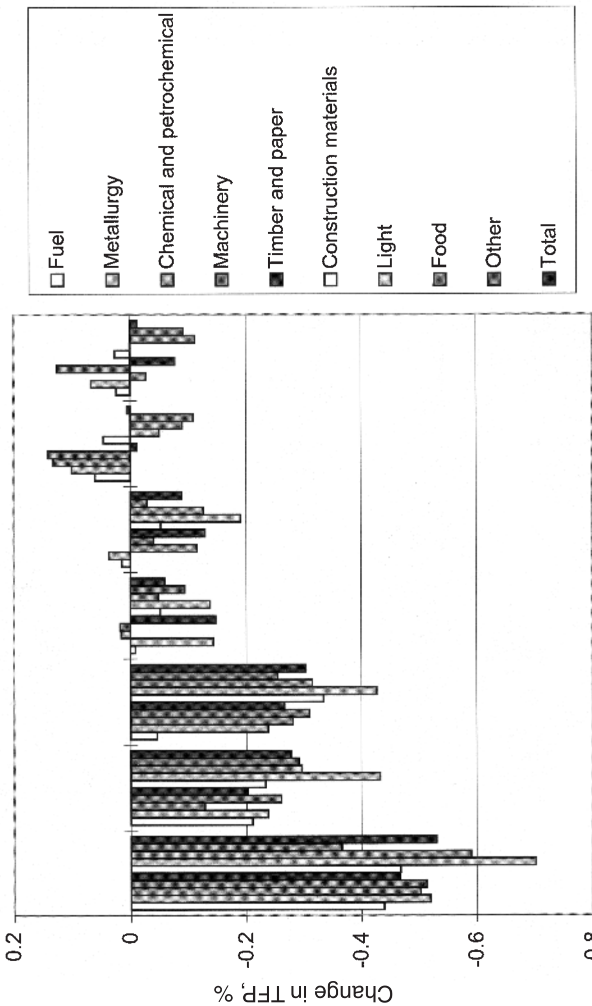


Figure 2.3
Total factor productivity change in 1994–2000 by industrial sector.
Source: Bessonova 2003.

privatization would create appropriate incentives for managers; competition would, in turn, lead to faster restructuring. But the early results of Russian privatization were quite discouraging. Although Russia undertook a comprehensive program of mass privatization very early in its transition, its impact on firm restructuring was small or even nonexistent. When Russian firms were privatized, most were sold to insiders who did not bring with them new capital, technologies, or human capital. Instead, insider privatization often locked firms into far-reaching economic and social responsibilities to their employees, who also owned substantial stakes, resulting in massive hoarding of labor and little restructuring.

To date, Russia's financial markets have not been very successful in facilitating the transfer of ownership stakes in Russian firms, and many observers have argued that the results of privatization should be revisited. But doing so would create considerable uncertainty for current owners, decreasing their motivation to restructure and invest. It would also undermine the security of future owners: If the outcome of privatization is nullified once, what is to prevent it from being nullified again? Moreover, is there any guarantee that another round of privatization would produce a different result?

Despite the weaknesses in the country's financial markets, Russian industry has seen a broad consolidation of ownership in recent years. A survey of industrial enterprises across Russia conducted by the Stockholm Institute for Transition Economics (SITE) and the Center for

Economic and Financial Research (CEFIR) (see Biletsky et al. 2002) shows that substantial transfers of shares in those enterprises—from nonmanagerial employees and the state to managers and outsiders—have taken place since 1994 (the end of the mass privatization program undertaken at the beginning of transition). The number of firms with at least one outside blockholder nearly doubled between 1994 and 1999 (from 27.4 to 48.2 percent of all firms). Many more firms have blockholders who are customers, suppliers, intermediaries, or creditors now than in 1994, attesting to the increased activity of financial-industrial groups (FIGs).

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. Although the methods these FIGs employ are often dubious and the outcomes not always the most efficient, the overall mobility of ownership stakes they have helped to bring about is encouraging. A strengthened financial system in the country would further ensure that expectations of future profits, rather than ability to pay, will determine who is in control of a particular firm.

Competition is critical for putting pressure on the owners and managers who control firms to increase the firms' efficiency. A number of papers demonstrate that competition, where it exists, has indeed had an important positive effect on the efficiency of Russian firms (Brown and Earle 2001a, 2001b; Yudaeva , Kozlov, et al. 2001). Imports and foreign-owned firms have been particularly strong sources of such competition. 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, and eliminating price controls and interregional trade barriers, much effort is needed to facilitate the entry of new firms, an issue discussed in more detail below.

Attracting foreign competition should also be a policy priority. The "pure effect of competition" forces firms to function more efficiently, but foreign competition specifically 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 final products. Bessonova (2003) compares the effects of foreign competition on different industries in Russia. According to her analysis, an increase in import competition has a substantial positive effect on the TFP of Russian firms in most industries. This positive effect can be broken down into two parts: One includes the pure effect of competition and a demonstration effect—the two effects are not separable—and the other consists of the increased availability of imported inputs. Foreign competition and demonstration have the greatest impact in Russia in the less complex timber, paper, and food industries. The availability of imported inputs, on the contrary, has the most significant effect on more complex production processes, such as those used in machine building, construction materials, and light industries.

Comparing the two types of external competition, competition through foreign direct investment (FDI) is even more important for restructuring than competition through imports, because it facilitates spillovers and imitation of technologies and managerial techniques. Our research shows that the quality of human capital is an important factor, determining the extent of the benefits to Russian firms of competition through FDI. Yudaeva, Kozlov, et al. (2001) look at spillovers from FDI. Since inflows of FDI into Russia have been rather limited to date, it is not meaningful to analyze different industries separately with respect to its effect. But an evaluation of the Russian economy as a whole shows that there are substantial positive spillovers from foreign-owned firms to domestic firms, more significant than those from imports. At the same time, spillovers are greater in more highly educated regions than in less educated ones, suggesting that improvements in the quality of human capital would allow Russian firms to extract more benefits from competition through FDI. It should also be noted that the productivity of foreign-owned firms in Russia is higher in regions that have 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.

For Russian firms, the technological and organizational adjustments required for successful competition with foreign-owned firms can come at the cost of temporary reductions in sales and market shares. Kozlov and Manaenkov (2001) show that this effect is dominant in the case of exporting firms. They find that in 1994–1997, an increasing foreign presence had a negative effect on the probability that Russian firms would export. But this negative effect decreased over time and became insignificant by 1997, a development that was strengthened by higher education levels of the regional labor force.

FDI in services is probably even more important for the Russian economy than FDI in manufacturing. The poor development of the Russian services sector has had negative consequences for other sectors of the economy. The weak financial sector in the country fails to fulfill its function of transferring funds from savers to investors and therefore slows down growth in manufacturing. And a badly developed retail trade sector fails to transfer demand signals to producers and therefore delays required restructuring. In this environment, FDI in the service sector can help improve productivity not only in the sector itself, but also in manufacturing.

Greater involvement in world trade and, particularly, increases in FDI in both manufacturing and services are the two key ingredients that will determine whether Russia reaches world-standard levels of TFP. WTO accession, now being actively negotiated by Russian politicians, is an important step towards both greater involvement in world trade and more FDI. We consider the accession issue in more detail in chapter 5.

Overcoming segregation in the labor market is another step in addition to WTO accession that will increase the productivity of Russian firms. As figure 2.4 shows, managers of firms that have faced less competition in the labor market have fewer incentives to improve productivity than those in firms that have experienced greater competition for labor. Instead, they extract rent from their workers: There is evidence that wage arrears have become higher in places where labor market competition is lower (Earle and Sabirianova 2002).

A major item on President Putin's agenda is to overcome the political and economic disintegration of the country, the phenomenon described by Russian journalist Yulia Latynina and U.S. economist Richard Ericson as "industrial feudalism" (Latynina 2002, and Ericson 2000). Industrial feudalism emerged in the Russia of President Boris Yeltsin as a system in which regional governors and managers of large enterprises have been able to reign within their "domains" with a power (and therefore with rents) similar to that enjoyed by medieval barons. Industrial feudalism in Russia is essentially based on the low interregional mobility of the Russian 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

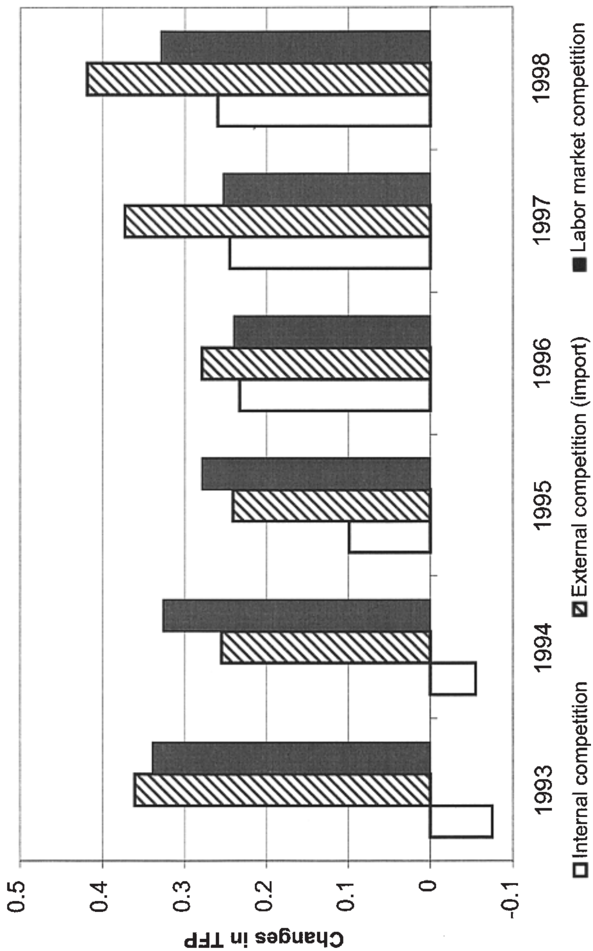


Figure 2.4
The effect of competition on TFP.
Source: Brown and Earle 2001b.

differentials in real wages, living standards, and unemployment rates were huge. More importantly, they have not narrowed over time. But the rates of internal migration have been substantially lower than in comparable OECD countries (see Andrienko and Guriev 2001).

What are the most important barriers to mobility among Russians? Empirical analysis rejects the common view that Russians are not flexible and like lifetime employment. Indeed, a large proportion of Russian workers change jobs or find part-time second jobs locally. The Soviet-style system of obligatory residence permits (propiska) has been abandoned almost everywhere. (In the few places where it remains intact—in violation of the Constitution—it still provides corrupt bureaucracy with yet another source of rents while raising the cost of migration.) Our research shows that the major barriers to mobility in Russia are lack of education and liquidity constraints (see Friebel and Guriev 2000; Andrienko and Guriev 2001). Somewhat surprisingly, empirical analysis demonstrates that, controlling for other characteristics, people with higher incomes tend to move among regions more often. Although people with low incomes are even more *willing* to leave the region in which they reside than those with higher incomes, they are less *able* to go: They do not have money to cover the costs of migration, and there is no way to borrow the money, even if their future wages would be much higher if they moved, making such a loan cost-effective.

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 areas where there is little or no competition among employers for the labor pool. In fact, by lowering workers' cash income, employers attach workers to the land just as the medieval barons did through serfdom. The result is the segmentation of Russia's potentially large national labor market into regional or local markets. Local employers have no competition from outside and therefore few incentives to restructure (see Brown and Earle 2001b). Hence, although highly inefficient, the inherited industrial structure is sustainable over time, and the economy remains locked in the vicious circle of industrial feudalism. Measures to increase mobility include thorough enforcement of the constitution in regard to the removal of administrative barriers to migration, development of mortgage markets to facilitate purchases of residential housing, education reform to promote retraining, reform of the utilities sector to achieve more efficient pricing of services, and land reform to allow for the mortgaging and sale of land.

Continuous efforts to sustain and upgrade the education level of the population are needed if Russia is to extract maximum gains from foreign competition. As we discuss in chapter 4, there are troubling signals that the quality of Russian education has deteriorated over the last decade. The gap between the level of expertise achieved through completion of university programs and the qualifications needed for practical work has widened. At the same time, growing numbers of talented young people in Russia cannot get an education because of financial barriers to doing so. Dramatic changes in the education system are needed to reduce the growing gap between the education levels in Russia and those in developed countries. In addition, a system of retraining and building the skills of adults should be set up to improve professional mobility among the Russian population.

We agree with the McKinsey report that Russia could boost its growth rates with relatively little investment simply by improving productivity through organizational adjustments, switching to better suppliers, making some small technological changes, optimizing production ranges, and so on. But competition alone is not enough to spur the necessary changes: Budget constraints must be hardened, and corporate governance strengthened. And in the long term, sustainable growth is possible only with new investment.

2.2 The Investment Challenge

In the short and medium terms, transition economies can grow without substantial investment (as Poland has demonstrated), but long-term growth requires new investment. This is especially true in Russia, where the average age of capital stock reached 17.9 years in 2000. Of the various types of investment, FDI is particularly important to economic growth in Russia. Foreign investors bring new technologies to the country and exposure to managerial techniques that Russia lacks. Hence, the more FDI Russia can attract, the higher the country's growth potential. Plus, as discussed above, foreign investment has positive spillovers for domestic firms.

The level of investment in a country is strongly influenced by the general environment or investment climate, which in turn is largely determined by levels of government efficiency and, in transition economies, by progress in structural reforms. In this section, we analyze investment patterns in Russian industry and identify policy changes that will encourage (much) greater investment.

The economic decline in Russia in 1991–1998 was accompanied by a continuous decrease in investment. By 1997, investment in most industrial sectors stood at 10–30 percent of 1989 levels; only in the power industry was investment maintained at slightly less than 60 percent 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 higher price of oil. Investment at that time went into both import substitution and exporting industries (see table 2.1). Among export-oriented industries, nonferrous metal, fuel, and timber and paper industries attracted the largest share of investment. By far the highest increase in investment took place in the food industry.

Since financial markets in Russia are undeveloped, investments are channeled from cash-cow industries to the

Table 2.1
Investment in physical capital in real terms by industrial sector, 1995–2000

	1995	1996	1997	1998	1999	2000
Industry, total	100.0	83.2	81.6	65.7	73.8	87.0
Electricity	100.0	95.0	101.6	79.1	62.4	59.2
Fuel industry	100.0	83.0	80.1	56.2	66.6	101.0
Ferrous metallurgy	100.0	76.2	64.9	63.2	68.6	79.4
Nonferrous metallurgy	100.0	68.6	75.7	57.8	88.0	113.3
Chemical and petrochemical	100.0	86.1	82.4	70.0	64.9	73.5
Machinery	100.0	89.4	76.4	70.6	80.9	77.3
Timber and paper	100.0	67.3	59.8	55.6	97.3	118.4
Construction materials	100.0	64.5	56.4	35.3	42.0	50.2
Textile	100.0	77.3	68.1	58.6	67.4	46.9
Food industry	100.0	85.7	95.1	108.2	134.7	92.4

Source: Goskomstat.

rest of the economy via transfer of internal funds within FIGs. In 2000, about ninety FIGs formally registered in the government's FIGs registry and many more informal ones, with formally registered groups producing about 15 percent of the country's industrial output. In addition, there were a large number of integrated trading-industrial and industrial entities with financial ties, in addition to those with production and trade links.

Prior to the 1998 crisis, most of the nonregistered FIGs in Russia were headed up by banks, which in most cases acquired industrial enterprises as a result of the 1996 “loans-for-shares” deal, when the largest banks offered loans to the government with collateral in newly privatized firms. At the same time, bank lending was very low in Russia, even in the case of firms belonging to FIGs. The results in Volchkova (2001) are consistent with the hypothesis that banks in Russian FIGs, instead of lending, helped to solve the problem of contract enforcement in firms that participated in groups: through the exercise of monitoring and control, banks limited the ability of firm managers to steal money from the firm’s owners.

New tendencies in the development of groups have also emerged since the financial crisis of 1998. Devaluation and the government’s debt default led to severe liquidity problems and even failure of large commercial banks. This changed the strategy that FIGs pursued for development. Instead of improving their governance structures, groups cut their asset holdings and tried to weather the crisis. As a result, banks lost their key positions in FIGs.

After the crisis, the weakness of former owners and liquidity problems then brought a new wave of ownership changes in the Russian economy. The active participation of regional authorities in this redistribution was one of the most remarkable features of the ownership changes, especially in the oil industry. Another important factor for FIG development at this time was the government’s attempt to revive state holdings in strategic industries. Both of these actions reveal a strengthening of the state's position in the economy subsequent to the 1998 crisis.

The increase in oil prices and prices of other primary commodities during 1999–2000 brought significant cash flows to FIGs in raw-material industries. Owners of firms producing raw materials became concerned about insufficient diversification of their sources of income. As a solution, they purchased majority ownership stakes in firms in other industries, such as agriculture, medicine, construction, and car production. Banks play a secondary role in modern Russian FIGs. Usually, each FIG has its own bank, which it uses for payments, settlements, and transfers. Decisions about a particular group's investments and management strategies are made by the heads of the key industrial firm that founded the group.

Although the formation of FIGs has helped to channel investment in an environment of poor corporate governance, it has had costs for the development of the Russian economy. The experience of developed countries suggests that financial markets, when well developed, perform the function of income diversification and transfer of funds from savers to investors more efficiently than conglomerates do. The development of Russian financial markets has been stifled by the weak protection of creditor rights and property rights of minority and outside shareholders, as well as by the powerful lobbying of inefficient owners who stand to lose from reforms. The experience from other transition economies suggests that financial markets will take time to develop.

In the medium-term, prospects are more favorable for the development of a functioning banking sector, but this will require wide-ranging reforms of the regulatory environment and restructuring of the current banking industry.

Which policies can help Russia attract investment as well as encourage investment of a better quality? Despite recent increases, the current level of investment, particularly FDI, is well below the country's needs. Although inflows of FDI have grown, Russia still lags seriously behind the most successful transition economies in terms of the level of FDI per capita. As figure 2.5 shows, in 2000, Russia received only $22.60 in FDI 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 quality of government and speed of reform that explain this gap between Russia and other, more successful transition economies. Our analysis shows that economic reforms are the major factor explaining cross-regional variation in investment in Russia. As the Russian reform agenda is too large to be implemented in full in a short period of time, it is important to set priorities among the reforms required to produce sustainable growth.

A perceived ability on the part of investors to get a satisfactory return on the invested funds is a major precondition for investment. To engender such confidence in return on investment in a particular economy, adequate protection of property rights in that economy,

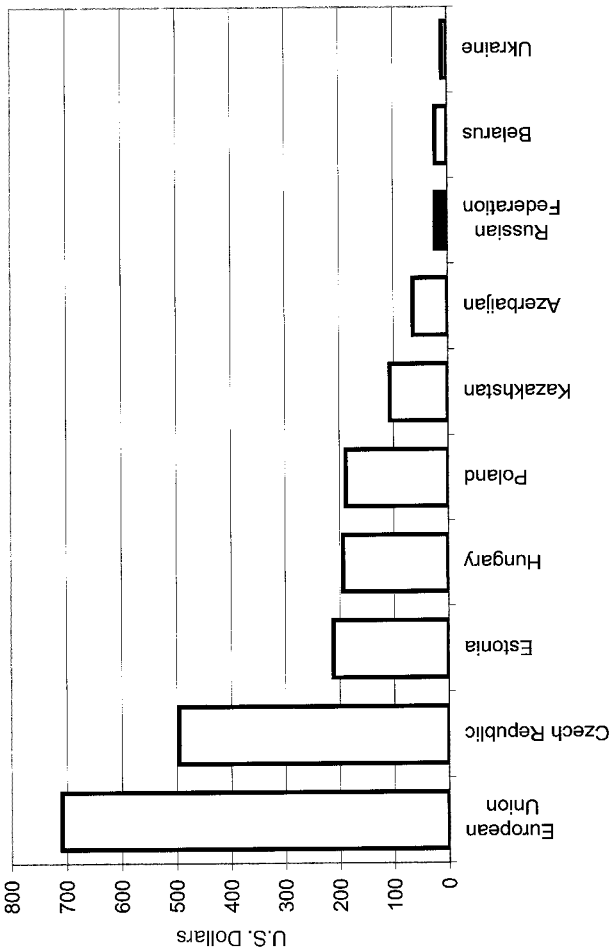


Figure 2.5
FDI per capita in European Union and selected transition economies in 1999.
Source: World Bank.

including the rights of minority and outside shareholders, is paramount. Currently, Russian legislation scores very high in this respect among transition economies. Pistor, Raiser, and Gelfer (2000) report indices of shareholder and creditor rights protection in transition economies: Russia's level of protection of shareholder rights is better than that in Hungary or Poland; and although the level of protection of creditor rights in Russia is somewhat lower than that in some other countries, it is not significantly different from levels in those countries. Yet there is still a major problem: Enforcement of property rights legislation in Russia is very poor. Survey evidence on the rule of law and law enforcement usually ranks Russia in one of the last places among transition countries. Because of law enforcement problems, *effective* protection of property rights, important for attracting investors, is very weak in Russia. Legal reform therefore has top priority among other reforms needed in Russia.

Law enforcement in a transition economy is highly correlated with the development of the financial system in that economy, which facilitates investment activities and channels them into the most profitable areas. The Russian financial system, still in its infancy, fails to perform these functions. In addition to improving the country's protection of property rights, legal reform in Russia will also spur development in the financial system. Such reform will require a very serious effort to be successful, particularly in the area of banking. After losing all their savings—several times—during the 1990s (after the 1992 price liberalization, in the failed investment company, MMM and other financial pyramids, and following the financial crisis of August 1998), Russians are reluctant to entrust their money to Russian banks. Stronger prudential regulation and banking supervision are needed to overcome this understandable attitude on the part of Russians toward the country's banking system. Foreign entry into the banking sector can also help improve the situation, but for foreign banks to enter on a large scale broad banking reforms are necessary. WTO accession would help in creating the necessary commitment to stable rules of the game in the banking sector and in bringing about some restructuring of the sector. Chapters 4 and 5 discuss policy in these areas in more detail.

Finally, the experience of other transition economies shows that small businesses can serve as a dynamic and important source of growth in such economies. Moreover, small and medium-sized businesses form an important potential constituency for the enforcement of the rule of law. In Russia, small business development and entry of new firms have been hampered by excessive government regulation. To improve the conditions for small business development in Russia, regulations should be simplified. The government has already made important steps in this direction by introducing broad reforms aimed at debureaucratization, also discussed in more detail in chapter 4.

The discussion presented in this section suggests that legal and administrative reforms, key tasks from the point of view of both domestic and foreign investors, should be given the highest priority among the items on Russia's list of prospective reforms.

2.3 The 2001 Survey on Reform Priorities

The analysis above largely coincides with that of foreign and Russian investors who participated in a 2001 CEFIR survey on priorities in Russia's reform movement. These foreign and Russian business communities in Moscow were asked to set reform priorities, evaluate the depth of problems in a number of investment-related areas, and identify the major reasons for capital flight from Russia.

On the list of reform priorities that emerged from the survey (see figure 2.6), legal reform came second in the survey. The highest priority was given to fighting corruption and reforming the bureaucracy. In contrast to the results of the 2000 survey, this problem had become more serious among the 2001 respondents than reform of the tax system, which placed third in the 2001 survey. With regard to tax reform, most respondents in 2001 appreciated the Russian government's efforts to improve the country's tax system, although poor tax administration and the unpredictability of the tax regime were still viewed as problematic by a large number of respondents. After tax reform, the fourth-highest priority was given to the transition to international accounting standards, which is very important for foreign investors who

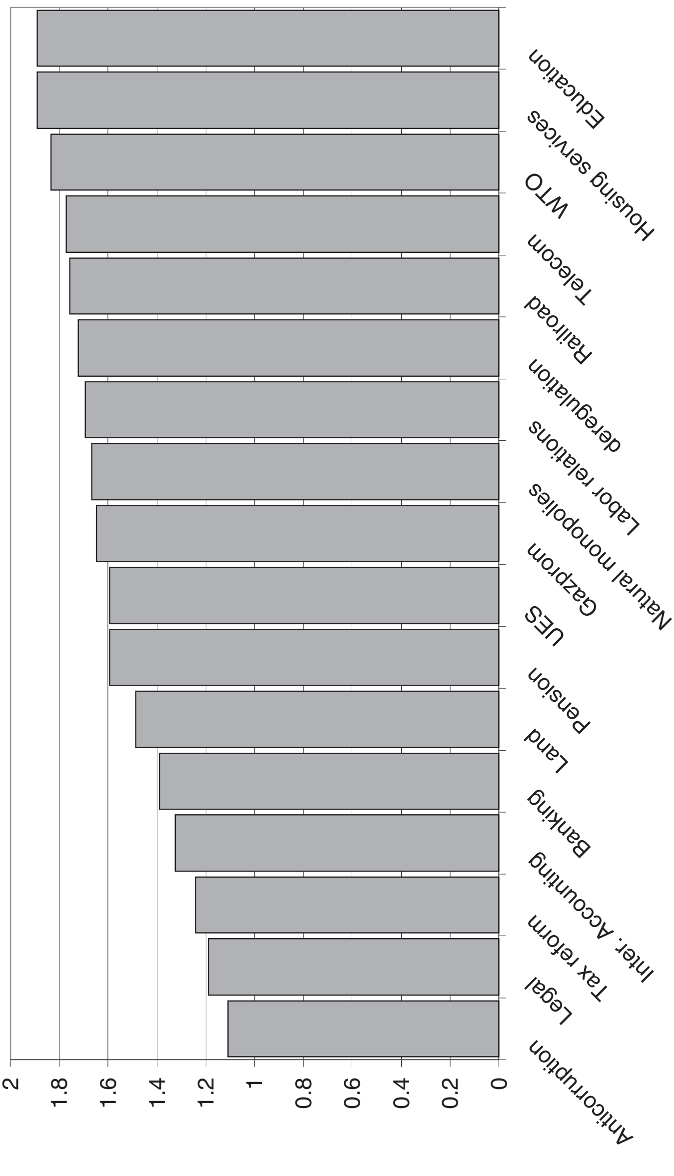


Figure 2.6
Reform priorities according to survey results.
Sources: CEFIR survey of Russian and foreign business.
Note: Reform importance, average mark given by respondents on a scale of 1 to 5 (1 = very important, 5 = not important).

cannot properly evaluate Russian firms using Russian accounting data.

Among other possible problems respondents to the 2001 survey mentioned, land reform ranked high in the list of priorities, but most respondents agreed that government deregulation, regulation of natural monopolies, reform of labor relationships, and housing and community services reform are not immediate priorities and can be part of the second tier of the reform package. Financial-sector problems were seen as important, but the respondents considered banking-sector reform less urgent than legal, tax system, and other reforms.

The survey participants cited poor property rights protection in Russia as the biggest reason for the flight of capital from the country (see figure 2.7), and they named weak protection of minority shareholders and outsiders as the main property rights issue facing the country. Two related areas, the lack of independence of the judiciary (particularly in bankruptcy cases) and of authorities failure to implement court decisions, were seen by respondents as an extremely serious barrier to investment.

As noted above, in addition to the speed and scope of reforms undertaken, potential investors in a transition economy are also concerned with the quality of the government and its ability to implement reforms that facilitate investments, rather than set barriers to investors' activities. Quality of government is therefore highly correlated with inflows of FDI in transition economies. At the same time, concerns about political instability in Rus-

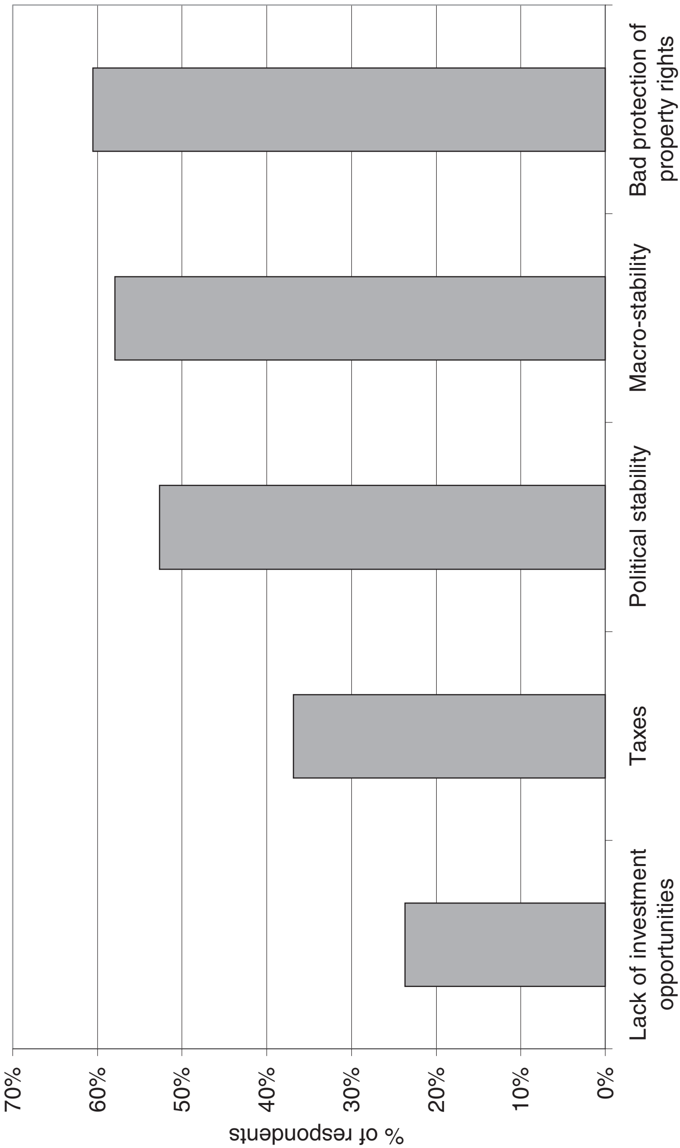


Figure 2.7
Main reasons for capital flight (according to survey results).
Sources: CEFIR survey of Russian and foreign business.

sia are often seen as major reasons for capital flight from the country and for lack of domestic investment. Therefore, the political reforms now underway in Russia can do a great deal to improve the investment climate in the country and help attract both domestic investment and FDI. Politics and political reforms in Russia is the area to which we turn in the next chapter.

3 The Political Context of Economic Reform

Political institutions have a decisive influence on the government's ability and commitment to implement economic reform successfully. The deep structural changes necessary for sustainable long-term economic growth in the country are feasible only if they are supported by robust political institutions that can withstand the pressure of various interest groups. But relatively new democratic regimes differ greatly in the degree to which their institutions are conducive to fostering reforms and sustainable economic growth. The dire experience of many Latin American countries shows how easily some regimes can turn concern about economic growth into a basis for populism, protectionism, and parochialism.

This leads to a 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 with respect to economic and legal reforms through much of the 1990s can only be understood by looking at the weaknesses of the country's political institutions.

The history of democratic development in the world shows that governments tend to improve their performance in terms of the provision of public goods only when they are directly accountable to the citizens via universal suffrage and multiparty elections. Such direct (or *vertical*) accountability of the government to citizens is necessary, but not sufficient, to ensure government efficiency and commitment to key reforms. For these goals to be accomplished, vertical accountability must be accompanied by the willingness of the government to check itself through the creation of independent public institutions that can oversee its behavior and penalize it when necessary. The government imposes this *horizontal* accountability on itself via mechanisms of separation of power (see O'Donnel 1998). When its systems of vertical and horizontal accountability fail, a government's performance tends to deteriorate: Officials steal public funds, bureaucrats demand bribes, and citizens evade paying taxes.

A third type of accountability that can influence government performance is *international* accountability. This type of accountability is established through 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 chapter analyses how recent changes in the Russian political system affect the government's ability to implement reforms that can help the country's economy grow. We focus specifically in the chapter on changes relating to government accountability as a key mechanism for minimizing the abuse of power and successfully implementing reforms. First, we review the political and institutional causes of poor government accountability in Russia and the Russian government's weak commitment to reform during the Yeltsin presidency. We then deal with the political changes occurring during the Putin presidency and analyze some of their economic consequences.

3.1 Government Accountability during the Yeltsin Presidency

In a nutshell, the period of Boris Yeltsin's presidency was characterized by

- the enduring policy conflict between the Yeltsin-controlled executive branch and the Communist-led legislative branch of the government.
- the considerable discretionary power of the president and his close circle with respect to economic policy issues.
- the populism and particularism of the Duma's economic legislation, pandering to public opinion, especially at election times, and to particular interest groups.

- the mounting corruption of the government bureaucracy.
- increasing regional disintegration.

These characteristics justified little hope for effective reform and sustainable economic growth in Russia in the 1990s. They produced a vicious circle of irresponsibility involving the state and the public: The bureaucrats were only weakly accountable to the elected president and the Duma, and the politicians were not very responsive to the taxpayers, who, in turn, eschewed any control by the state bureaucracy. The relationship between politicians and citizens was determined, using the phrase of Stephen Holmes, by "an exchange of unaccountable power for untaxable wealth" (Holmes 1997).

The system of poor state accountability and weak commitment to reform in Russia arose from a number of causes. First, the Russian state, which succeeded the Soviet Union by destroying old institutions of public and administrative control, failed to develop effective democratic alternatives to the institutions it destroyed. Although free democratic elections and a multiparty system were officially introduced after the collapse of communism, the new Russian political elite viewed these new features only as means of control, not as instruments of electoral influence. Every time the outcome of elections (or referenda) 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 threat of the communists' returning to power was advanced to legitimize these actions. The two most visible examples of such manipulation of election results were the 1993 referendum on the new constitution and the reelection of Yeltsin in 1996. In the political environment created by such manipulations, the right to vote was not perceived by the citizens as a means of punishing the executive for poor performance or of improving its responsiveness to the public interest.

Second, when the new Russian constitution was adopted by Yeltsin after the violent crash of the Supreme Soviet, it became a set of "rules of the game" imposed by one side on the other. Its adoption was rumored to have been forged at the December 1993 constitutional referendum. The circumstances of its origin compromised the new constitution's ability to provide a framework within which contending parties could resolve their differences through the peaceful process of politics. In addition, by making the executive branch very powerful, the new pro-presidential constitution made the destiny of political and economic reforms in Russia contingent on Yeltsin's personal will and the discretion of his corrupted bureaucracy. Used as a tool for advancing the president's own political interests and popularity, could the constitution really improve the accountability of his cabinets?

Figure 3.1 was developed from a comprehensive scale for measuring presidential powers suggested by Shugart

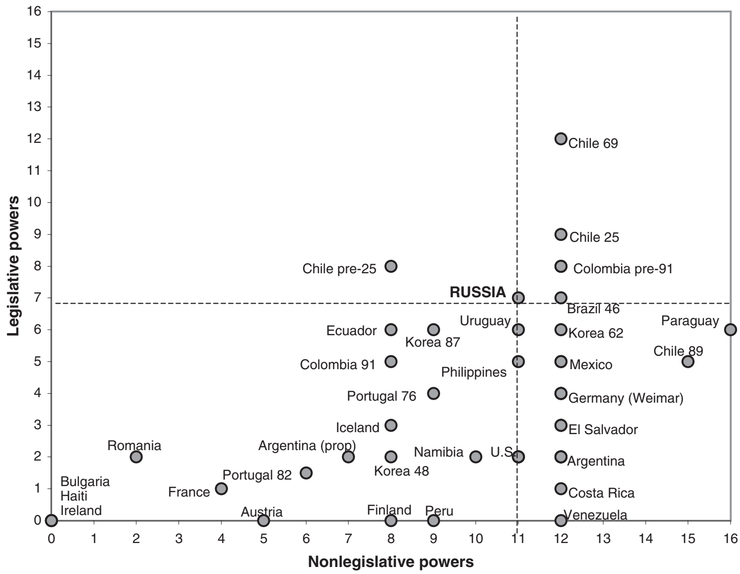


Figure 3.1
Powers of popularly elected presidents.
Notes: The horizontal axis measures nonlegislative powers of presidents as a sum of four powers (each measured on a scale from 0 to 4): (1) Cabinet formation; (2) Cabinet dismissal; (3) Censure; (4) Dissolution of assembly.

The vertical axis measures legislative powers of presidents as a sum of six presidential powers (each measured again on a scale from 0 to 4): (1) Package veto; (2) Decree; (3) Budgetary powers; (4) Partial veto; (5) Exclusive introduction of legislation; (6) Proposal of referenda. The numbers next to some country names (such as Portugal 76) indicate the year of regime change in those countries.

and Carey (1992). It compares the Russian presidency with other presidential regimes along two dimensions: the legislative and nonlegislative powers held by the president. Its simple measurement technique demonstrates that the total amount of power granted to the Russian president under the country's constitution far exceeds the amount granted to most presidents in stable democratic regimes.

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 checks and balances capable of restricting use of economic policies to achieve individuals' political goals. Without appropriate checks and balances, both executive and legislative powers were mutually unaccountable and overly discretionary in the policies they chose to pursue: The executive (and its bureaucracy) repeatedly misused its unfettered control over borrowing and spending public money, and the legislature regularly exploited its power over the size and composition of the country's budget. The resulting annual budget deficit (see table 3.1) was a key factor in eroding investor confidence in the government debt market, which finally collapsed in August 1998.

In addition to failing to provide checks and balances for the executive and legislative branches, the new constitution provided broad scope for the two branches to survive independently of one another, the implication

Table 3.1
Russian consolidated budget (percentage of GDP, 1992–1998)

	1992	1993	1994	1995	1996	1997	1998 (first half)
Total revenue	40.4	40.6	36.3	35.8	36.7	36.5	33.4
Total expenditures	65.1	48.6	47.5	41.1	43	43.1	38.5
Deficit	−24.7	−8	−11.2	−5.3	−7.7	−6.7	−5.1

Sources: Russian Ministry of Finance, Institute for the Economy in Transition.

being that both could hold out for a long time in cases of conflict between them. The ability of the executive and the legislative each to "go it alone" in Russia, coupled with the vast powers of the president in forming his cabinet, led to persistent deadlocks in policymaking. It dealt a great blow to the government's capacity for coherent action and its commitment to reform. By charging the Duma with producing economic legislation and, at the same time, depriving it of instruments with which to control implementation of that legislation by the cabinet, the constitution inevitably turned the Duma into an irresponsible, populist body. The president was given almost a free hand to shuffle and reshuffle his cabinet but had no strong party support in the legislature to ensure the effectiveness of his government's actions.

Government bureaucrats quickly realized that the deadlock created by the constitution made them virtually unaccountable to either the Duma or the executive. The lack of political control and administrative oversight that resulted from this deadlock allowed the bureaucracy to exercise greater discretion in the processes of privatization, price liberalization, and industry regulation than in the initial stages of transition. This increased bureaucrats' capacity for arbitrary decisions, which brought on a new wave of corruption among the government ranks. From 1993 on, the Russian government bureaucracy remained deeply corrupt and inefficient, regardless of whom Yeltsin put in charge of the cabinet. According to Transparency International, a nonprofit agency that monitors levels of corruption across different countries, the Russian bureaucracy enjoyed one of the highest levels of regulatory discretion in the world during the 1990s. At the same time, the Russian government remained among the most corrupted regimes (see figure 3.2).

The constitutional origins of government corruption and inefficiency in Russia can also be traced to the unrestricted power of the president, under the 1993 constitution, to expand his administrative apparatus and even to create new decision-making structures not stipulated in the constitution. In 1995, Yeltsin's burgeoning presidential administration included over forty advisory bodies and policymaking and policy-implementing agencies and a massive support staff of approximately 7,000. Unlike the formal government, the presidential administration in Russia is essentially immune from legislative

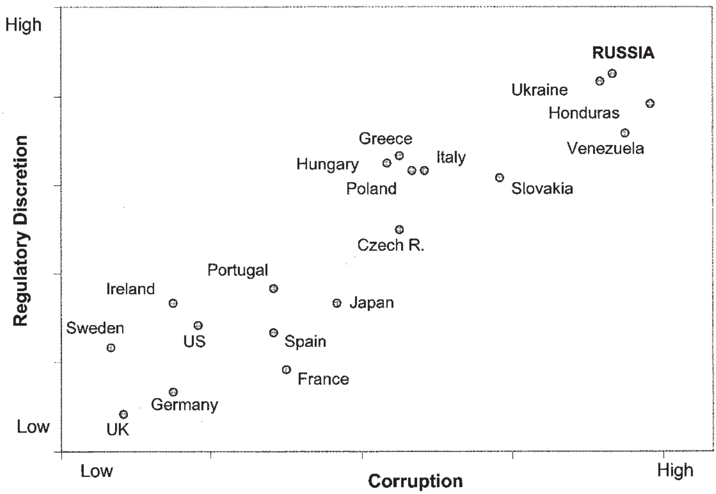


Figure 3.2
Regulatory discretion and levels of corruption in various countries. *Source:* Hessel and Murphy 2002.

oversight. This allowed Yeltsin to shield government activities from legislative review by locating them within the presidential apparatus.

The increase in Yeltsin's constitutional powers came at the cost of unsound federalist policies. In exchange for political support from the regional elites, Yeltsin gave the regions as much political and economic autonomy as they could take on. This brought further regional disintegration, widespread malfunctioning of the system of fiscal federalism and conflicts between regional and municipal authorities. Unfortunately, the policies of subfederal governments in Russia have often hindered the prospects of economic growth in the regions.

The uncontrolled devolution of political and economic power to the regions dangerously weakened the incentives of the regional enterprises to pay their federal taxes. As a result, federal tax collection dropped sharply since Yeltsin's rise to power—from 17.8 percent of GDP in 1992 to 10.1 percent of GDP in 1997.[1] Despite all government efforts to stop growing tax evasion, the federal revenues continued to fall until the financial crisis erupted in August 1998.

Besides Yeltsin's powerless regional policy, there were three additional factors that contributed to the weakening of the fiscal incentives at the local level. First, regional administrators were often acting in the interests of large, powerful enterprises rather than of the nation as a whole, either in exchange for political support, bribes, or different kinds of favors or because of direct political pressure. Through such "state capture" large enterprises could preserve their monopoly power by erecting administrative barriers against growing competition from smaller private businesses. Slinko, Yakovlev, and Zhuravskaya (2001) analyzed in detail this process using the degree of local labor market concentration as a measure of potential for capture by large enterprises. The researchers examined data from over 900 municipalities during 1997–1999 and seventy-seven Russian regions during 1996–1999. They found that, at the regional level, higher potential for state capture in a region caused a decrease in collection of regional taxes, reduced provision of social public goods, increased administrative regulation, and decreased the number of small enterprises. At the municipal level, increased potential for state capture led to a decline in regional investment and a reduction in productive efficiency among large, rent-seeking enterprises.

Second, regional authorities expected, from past experience, that the federal government would bail them out whenever they were short of income. Besides, regional governors had the power to expropriate taxes collected by the authorities in municipalities (especially large ones) in their region through changes in tax-sharing rates or transfers. This provoked rent-seeking, rather than welfare-improving, behavior among regional authorities and destroyed the regions' motivation to pursue a balanced fiscal policy. On the other hand, municipal authorities were left with no incentives to pursue policies aimed at developing small and medium-sized enterprises (Enikolopov et al. 2001).

Third, regional governors often redistributed the revenues they expropriated from the municipalities for the purposes of their reelection campaigns, a process often referred to as a "political business cycle" at the regional level. Ahmedov, Ravichev, and Zhuravskaya (2001), who examined 163 gubernatorial elections over the 1992–2000 period, found that political business cycles were at work in most of the socially targeted economic policies of the Russian regions. In years directly prior to elections, regional budgets typically showed sharp increases in pensions, subsidies, and shares of social ex-

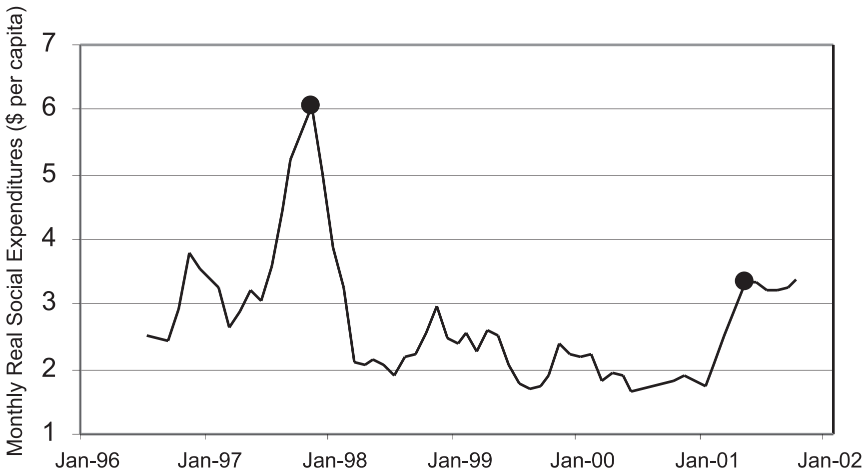


Figure 3.3
Dynamics of real social expenditures per capita in Kemerovskaya oblast. Bullets mark the dates of gubernatorial elections.
Source: Ministry of Finance, Russian Federation.

penditures. At the same time, wage arrears in the public sector decreased. The study also found that when a region engaged in increased populist spending of this type, it led to a deterioration in the macroeconomic situation in the region during the election period. For example, inflation in these regions during the election year was higher than in the middle of the electoral cycle (see figure 3.3 for Kemerovskaya oblast as an example). Regional governors would try to contain the growth of inflation by imposing price controls. In regions where incumbents were challenged by credible alternative candidates during the electoral cycle, the study found, they were likely on average to cause less damage to the region's macroeconomic situation and to respond better to existing electoral pressures.

3.2 Government Accountability during the Putin Presidency

The election of a new Duma and a new president, Vladimir Putin, in 2000 marked a striking reversal in the direction of government policy in Russia. If the Yeltsin period was characterized by political disintegration and policy deadlock, President Putin's term demonstrates the opposite inclinations—toward the concentration of power in the hands of the executive and legislative cooperation between the presidential cabinet and the Duma. This divergence between the two administrations arises from at least three key differences in the positions of the first and the second Russian presidents.

First, whereas Yeltsin depended heavily on the support of various interest groups during his rule and 1996 reelection, Putin started his political career from scratch, with almost no binding commitments to existing lobby groups. Given this, his election made him more committed to the general public, whose overwhelming support gave him a sufficiently large majority to avoid a runoff in the second round of voting and less committed to the particularistic interests that had played a key role in Yeltsin's reelection. Table 3.2 shows the turnout of the votes for the main candidates in the presidential elections of 2000. Vladimir Putin received 53% of all votes, sur-

Table 3.2
Russian presidential election results for main candidates, 2000

Candidate	Vote	Percentage
Vladimir Putin (Acting President and Prime Minister)	39,740,434	53%
Gennady Zyuganov (Communist Party)	21,928,471	29%
Grigory Yavlinsky (Yabloko Party)	4,351,452	6%
Aman Tuleev (Governor of Kemerovo Region)	2,217,361	3%
Vladimir Zhirinovsky (Liberal Democratic Party of Russia)	2,026,513	3%
Other candidates	2,690,894	4%
Vote "against all candidates"	1,414,640	2%
Total	74,369,765	100%

Source: Central Election Commission 2000.

passing his closest rival Gennady Zyuganov (Communist Party) by a comfortable 24% margin.

Second, the global rise in oil prices in 1999 and the economic growth in Russia after the 1998 crisis provided President Putin with resources for launching and sustaining his policy initiatives that were unavailable throughout the Yeltsin period. The increase in tax and export revenues resulting from the higher oil prices and increased economic activity allowed Putin's government to pay off old wage arrears, finance the government's current deficit, and repay the due portion of Russian foreign debt. Table 3.3 compares some key economic indicators during the last two years of the Yeltsin incumbency and the first two years of Putin's term.[2]

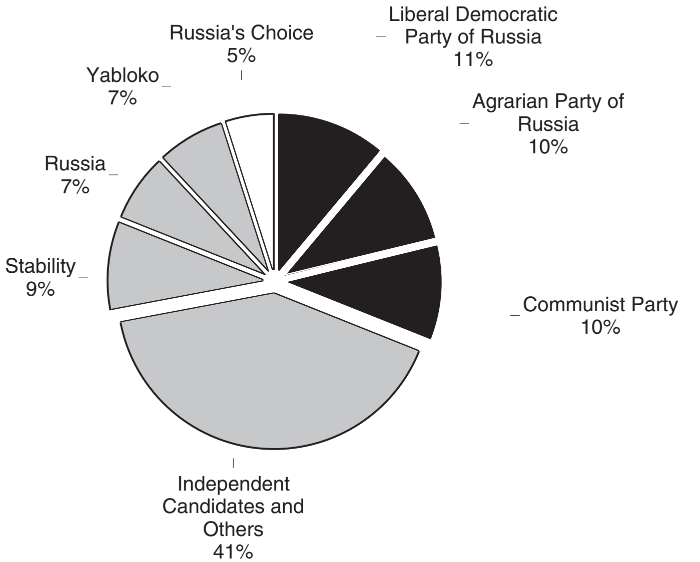
Table 3.3
Selected national economic indicators, 1997–2000

	Yeltsin term		Putin term	
Indicators	1997	1998	1999	2000
Percentage change in GDP	0.009	−0.049	0.054	0.09
Industrial production index (IPI)	102.00%	94.80%	108.10%	109.00%
Government Budget Deficit balance (% of GDP)	−3.80%	−5.30%	−1.10%	1.20%
Exports ($US millions)	87,400.00	72,100.00	74,700.00	105,565.00
Current account ($US millions)	2,060.00	687.00	24,731.00	46,291.00

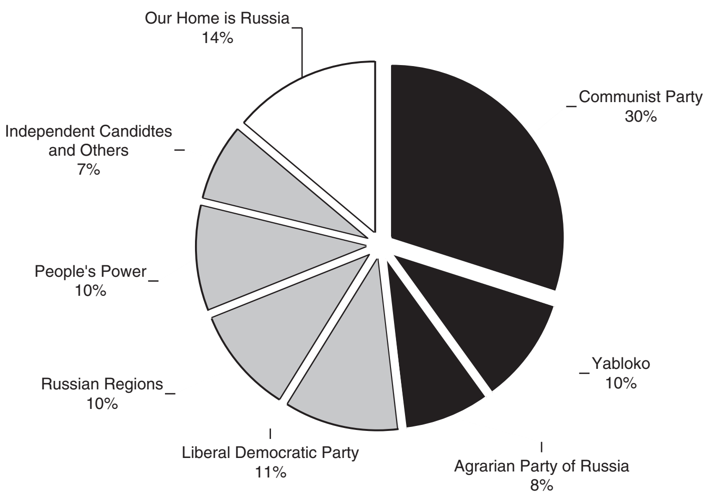
Sources: Central Bank of Russia, Goskomstat, Economist Intelligence Unit.

Third, in contrast to Yeltsin's aggressive anticommunist stance, which provoked staunch opposition in the Communist-controlled Duma, Putin has effectively disarmed the opposition by adopting some of their symbolic values. At the same time, he has promoted his own party (Edinstvo, or Unity) in the Duma, winning nearly one-fifth of all seats. After the 2000 elections, Edinstvo created a wide legislative coalition with other parties to support Putin's reform initiatives. The charts in figure 3.4 show the fraction of Duma seats controlled by the pro-presidential parties during the Yeltsin and Putin incumbencies. Comparison of the three Duma compositions shown in the figure, two during Yeltsin's terms (1993, 1995) and one during Putin's (1999), demonstrates the dramatic increase in pro-presidential forces among Russian legislators after Putin's rise to power.

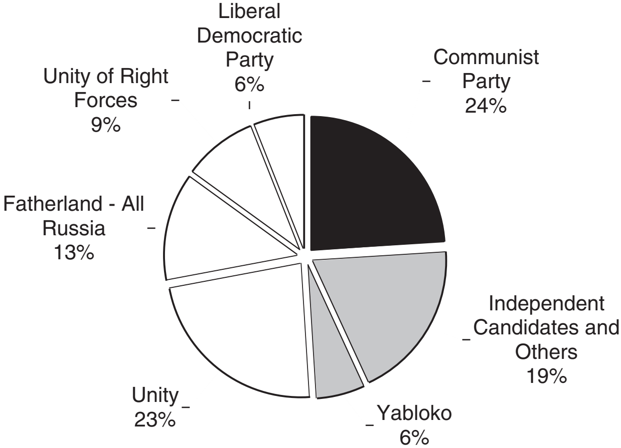
Presidential control of the Duma majority increases cooperation between the executive and legislative branches and makes them mutually responsible to one another: The president cannot justify cabinet ineffectiveness by reference to the legislature's sabotage of government reforms, and the Duma majority has no choice but to provide consistent support for cabinet initiatives. During the spring legislative session of 2001, for example, the Putin government successfully passed about 80 percent of its legislative agenda through the Duma: twenty-nine reform laws in such contentious areas as taxation, land property, pensions, law enforcement, and labor rela-


Russia's Choice
5%
Liberal Democratic
Party of Russia
11%
Yabloko
7%
Agrarian Party of
Russia
10%
Russia
7%
Stability
9%
Communist Party
10%
Independent
Candidates and
Others
41%

a


Our Home is Russia
14%
Communist Party
30%
Independent Candidtes
and Others
7%
People's Power
10%
Yabloko
10%
Russian Regions
10%
Liberal Democratic Party
11%
Agrarian Party of Russia
8%

b



c

Figure 3.4
Party Factions in the Duma after the 1993, 1995, and 1999 elections. Dark areas: legislative factions consistently opposed to legislative initiatives of the presidents. Gray areas: Tactical opposition or undecided. Light areas: Strong presidential supporters.

tions. Most of these laws had been prepared by the government back in 1996–1997 but had no chance of being passed by the former Duma given the fierce conflict between the two branches of government.

All in all, the combination of additional resources and the absence of commitments to interest groups and of parliamentary opposition have allowed Putin to pursue his own strong political agenda and to be personally responsible for its outcomes. But what is Putin's agenda? How will it affect the accountability of the Russian government and its commitment to market reforms?

Four years of Putin's leadership have given a clear indication of his course: *toward liberal economic reforms under strong political control.* Progress in economic reform is the focus of chapter 4; here, we focus on Putin's efforts to concentrate and centralize political authority in Russia.

From the very beginning of Putin's rise to power, the Kremlin has focused its efforts on relocating and strengthening political authority along two dimensions: from the regional to the federal, and from the legislative to the executive. At the regional level, Putin has shown himself to be a proponent of strong federal authority by his resolute approach to the Chechen breakaway republic and the efforts he has undertaken to subjugate the autonomy of regional elites to the will of the federal government. Putin's policy of federal centralization has included an aggregation of eighty-nine autonomous regions and republics into seven districts, with leaders appointed by the president to oversee and restrain the activities of the regional governors. In addition, the Kremlin has effectively stripped the governors of their capacity for collective action by forcing them to step down from membership in the upper house of the assembly, the Federation Council, and sending instead their envoys to the council. The federal government has also renewed its efforts to enforce the authority of the constitution and federal laws over those promulgated by regional legislatures. Finally, the Kremlin has undertaken a critical review of old treaties on 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 attempted to streamline the policymaking process. Within the executive branch, Putin has made full use of his broad constitutional powers to appoint and dismiss members of the cabinet, replacing many Yeltsin appointees in the "power" ministries (including the Ministry of Defense, the Ministry of Internal Affairs, the National Security Council, and the Federal Security Service (FSB)) with his own loyal candidates. But among the parts of the cabinet concerned with economic affairs, Putin has demonstrated a remarkable concern for stability and has refrained, so far, from Yeltsin's practice of discretionary reshuffling of the top personnel responsible for the economic policy. He recently endorsed the recommendation of the commission on government reform headed by the Minister of Economic Development and Trade, German Gref, to better delineate the responsibilities of the ministries and make cabinet appointment policy more transparent and merit-based.

Two other fundamental initiatives of the Kremlin in restructuring the political system involve reform of the government's legislative and judicial branches. Within the former, the Kremlin has decided to transform the current party system, which promotes a multiplicity of weak and fragmented parties, into a system that will favor a few large, strong parties. To achieve that, the

Presidential Administration and the Central Election Commission co-sponsored the adoption of a new law on parties in 2001. The law strictly tightened up demands on political organizations wanting to officially register as political parties and get elected to the Duma. Under its provisions, to qualify as a political party, an organization would have at least ten thousand members and have regional branches with at least one hundred people in more than half of Russia's eighty-nine federal regions. Political parties would also be obliged to participate in elections "at all levels," proposing their own candidates. The new law bans ethnicity-based and religious party building. To force parties to further coalescence, the Kremlin tacitly approved the recent audacious motion by the pro-presidential party Edynstvo to raise the existing electoral threshold, i.e., the minimum support that a party needs to obtain in order to be represented in the Duma, from five percent to seven and a half.

The argument in favor of all these moves is that the new system will make the legislative process more responsible and predictable, with fewer, more disciplined actors. It should come as no surprise, though, that the system will also give the executive more control over legislative bargaining and party building.

Putin's reform of the judicial branch has involved passing a number of laws designed to promote the integrity of judges by increasing their salaries, budgets, etc., and holding them more accountable to bodies responsible for disciplining the judiciary and to the federal government. Another goal of Putin's judicial reform is to remove the contradictions between Russian federal law and regional legislation. The reform has included amendments to the Law on the Judicial System, the Law on the Constitutional Court, the Law on the Status of Judges, and multiple regional laws. The government in 2001 announced a development program that envisaged the allocation of forty-five billion rubles ($1.5 billion) toward improvement of the judicial system's technology and infrastructure over a five-year period. The full realization of Putin's judicial reform agenda is expected to bring the Russian judicial system closer to Western standards by increasing its effectiveness and transparency.

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4 Structural and Institutional Reforms

In discussing growth prospects for Russia, we have emphasized in the foregoing chapters the need for institutional reforms to foster investment. The importance of institutions in terms of fostering economic growth has been confirmed by several empirical cross-country studies, such as Knack and Keefer (1995) and Acemoglu, Johnson, and Robinson (2001) that establish a relationship between output growth and institutional environment. In this chapter, we take a closer look at Russia's judiciary, its regulatory system, its banking sector, and the social safety net in the country, all of which we believe to be critical for Russia's development.

To foster economic growth, a country's institutional environment should ensure that benefits of investments accrue to those who undertake them by protecting firms from potential expropriation of these returns by others, be they other firms, individuals, or the state. Surveys of managers in Russian firms indicate, however, that reliable protection of property rights is still absent in Russia, with both private agents and the state engaging in rent-seeking behavior. There are known instances in which large Russian enterprises have gone unpunished for severe violations of minority-shareholder rights. Russian and foreign banks are reluctant to lend to Russian enterprises for the fear of not being able to recover the credits they extend. Businesses suffer at the hands of state officials who expropriate returns from entrepreneurial activities using numerous (and ambiguous) regulations. Large companies often use their resources and influence to undermine the property rights of small and medium-sized enterprises.

Weak legal protection of property rights in Russia is largely due to the low effectiveness of the country's judicial system. Section 4.1 analyzes some of the problems in the Russian court system and discusses in further detail the progress of the reforms undertaken in this area by Vladimir Putin that were mentioned in chapter 3.

As noted above, numerous, and ambiguous, regulations allow state officials to collect rents from entrepreneurial activities. The large and inappropriately incentivized army of government bureaucrats authorized to enforce these regulations contributes to the problem of insecure entrepreneurial rights in Russia. We turn to Russian regulatory institutions and their reform in section 4.2.

Among institutions designed to facilitate sustainable economic growth directly, is the banking sector. A poorly functioning banking sector without financial discipline can undermine economic growth. In the medium and long-term the role of the banking sector as the financial intermediary between investors and entrepreneurs is critical for sustained economic growth. Despite the large number of Russian banks, such intermediation has virtually been absent in Russia. Section 4.3 discusses further why restructuring of the banking sector is a crucial objective and shows that very little progress has been made thus far in this regard. In addition to facilitating economic growth, a country's institutions should also help ensure economic, political, and social stability, which is critical in fostering growth and investment. In Section 4.4, we discuss the need for a comprehensive reform of the social sector in Russia to mitigate the negative social consequences of economic transition and to build stability in Russian society.

In light of the recent trend in Russia toward greater agglomeration of political power in the hands of the central government, institutional reforms in the areas outlined above take on special importance. In addition to having a direct effect on Russia's business climate, the institutions that emerge from the reform process could provide a balance to the increasing powers of the center and help ensure the irreversibility of the economic and political reforms being undertaken.

4.1 Incentives and Failure of the Post-Soviet Judicial System

Investors in Russia name poor protection of property rights as the number-one reason for capital flight, according to CEFIR's 2001 survey (see chapter 2). Further surveys of Russian businesses confirm that the difficulties in enforcing these rights through the Russian legal system lie at the heart of the capital flight problem. In an in-depth 1997 survey of purchasing department managers of Russian firms, Hendley, Murrell, and Ryterman (2001) find that although recourse to court is the third-most-frequent method in Russia of resolving a dispute with a supplier, only 26 percent of managers employ this approach. Analyzing a 1997 survey of firms in several transition economies, Johnson, McMillan, and Woodruff (2000) find that only 54 percent of those surveyed in Russia believed the country's courts were useful in enforcing contracts. This is the lowest percentage among the five countries surveyed (see figure 4.1). Further, a scant 7 percent of the firms indicated they had used the court system as a recourse in their most recent dispute involving a contract—again the lowest percentage among the countries surveyed.

It is not the lack of appropriate legislation that makes legal protection of property and contract rights difficult in Russia. Many of the laws necessary for such protection have indeed been put in place since the start of transition. Rather, the low effectiveness of the court system in enforcing these laws is the source of the problem.[1]

Russian businessmen often say that corruption among judges is a problem of particular importance. More than a quarter of the Russian firms interviewed for a survey conducted by the World Bank and EBRD in 1999 acknowledge that corruption in the country's court system has a significant impact on their activities, a higher figure

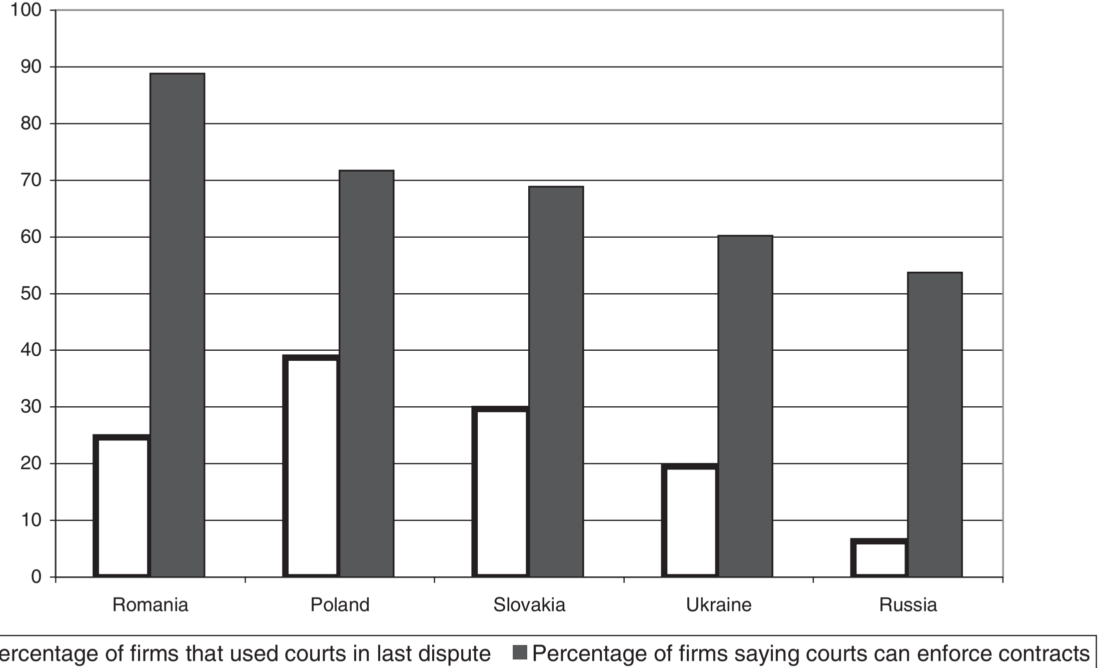

Figure 4.1
Percentage of firms in various transition economies that use court system to enforce contracts and believe in their power to do so (1997 survey data).
Source: Johnson, McMillan, and Woodruff 2000.

than that reported in most transition economies (see figure 4.2) (Hellman, Jones, Kaufmann, and Schankerman 2000).

The main reason for the inadequacy of the Russian court system in enforcing property and contract rights is the fact that the incentives created for judges during the post-Soviet years have been largely incompatible with the effective administration of justice. This system of incentives has been chiefly characterized by the virtual lack of accountability of the judiciary and by very high levels of effort required from judges to perform their duties. In this environment, judges have strong incentives to allow vested interests to influence the course of justice. The extent of subversion of justice has been amplified by vague and underdeveloped legislation giving post-Soviet judges broad discretion in how the legislation is interpreted. Ineffective mechanisms for enforcement of court decisions through bailiffs have also contributed to the malfunctioning of the legal system in Russia.

Although the reform of the Soviet judiciary started almost immediately after the breakup of the Soviet Union, it initially proceeded in a somewhat ad hoc manner and was given low priority, which resulted in costly delays in the reform process. The cornerstone law defining the basic functions, principles, and hierarchy of the Russian judicial system came into effect only in 1995, and that legislation left a large number of gaps. Putin's government brought judicial reform back to the fore in 2001. The main achievement of this stage of reform was that

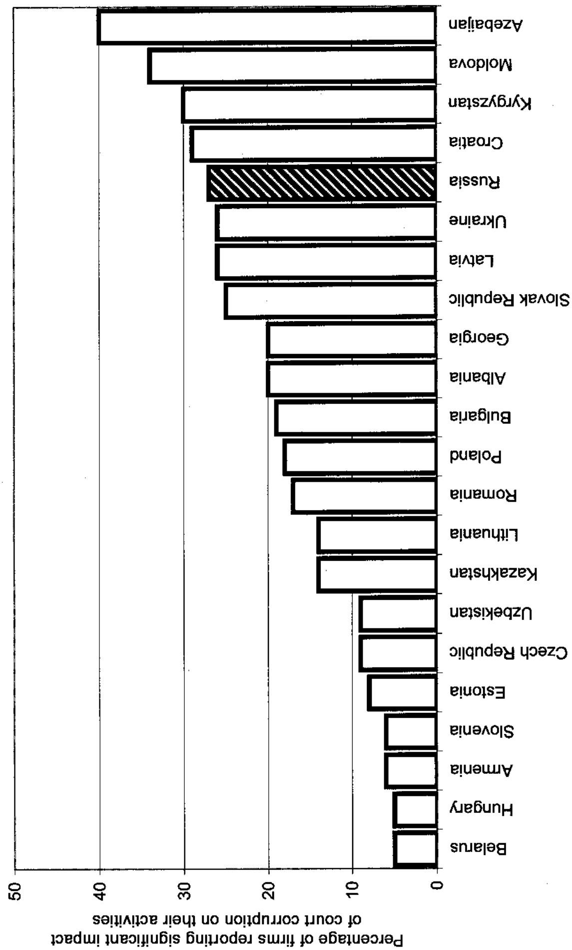

Figure 4.2
Effects of corruption in court system in various transition economies in 1999.
Source: Hellman, Jones, and Kaufmann 2000.

it brought together and synchronized legislation governing the Russian judicial system. It also significantly increased the level of transparency and public scrutiny of judicial appointments and dismissals and raised the extent of judges' legal responsibility, which should help realign incentives in the judicial profession with the public interest. At the same time, the 2001 reforms introduced tighter control of the central government over the judiciary. Although this may protect the legal system against local capture, it may also undermine its independence from interest groups influencing the central government as well as its role as an institution that helps ensure accountability of the central government to the public.

In the following subsection we analyze in more detail the factors that contributed to the malfunctioning of the Russian judiciary prior to 2001. We then look at how the 2001 reforms addressed the problems of the Russian court system.

Judicial Independence and Accountability before 2001

The Russian constitution and legislation attempt to create a judicial system in the country that is independent of other branches of the government. According to pre-2001 Russian law, judges in Russia, with very few exceptions, were appointed for an unlimited period of time. It was very difficult to dismiss a judge. In exceptional circumstances, a judge's tenure could be terminated by a qualifying committee (a body consisting of judges and appointed by the congress of Russian judges) if a judge accepted alternative employment (in any field other than academia and arts, fields in which it was considered acceptable for judges to be employed while maintaining a judicial appointment), if a criminal liability was established against him by a court, or if he committed an act "which diminishes the honor and authority of the judiciary (Federal law of Russia (1995))." A criminal investigation against a judge could be initiated only by the public prosecutor and only upon approval of the qualifying committee. Moreover, a judge was immune from any responsibility under administrative law. By law, a judge's salary could never be reduced throughout his tenure.

These provisions are similar to those found in the constitutions of many countries around the world. They are designed to ensure the independence of the judiciary from politicians by denying the government the opportunity to fire "uncooperative" judges or to reduce their salaries. Judicial independence provides a check on the power of the other branches of the government, which is especially important when politicians are subject to pressure from interest groups, which by their nature are not representative of the broader public interest. The first steps toward introducing such judicial independence in England, for example, can be traced to the early eighteenth century (Currie 1998).

At the same time, it has been widely recognized that provisions that make it difficult to remove judges or decrease their compensation reduce the accountability of judges for their decisions. Judges, like any individuals, pursue their own interests, which at times may be incongruent with the interests of the public at large (see, for example, Cappelletti 1985 and Posner 1998).[2]

Empirical evidence on such issues is difficult to find. Still, Cohen (1991), using data from U.S. district courts, provides some support for the notion that judges may not be free from self-interest when making rulings. Thus, it is possible that the unchecked power vested in judges by independence arrangements designed to ensure fairness of the judicial process may lead to unsatisfactory results. We argue that in Russia, constitutional provisions aimed to ensure independence of judges may have contributed to the malfunctioning of the judicial system.

In many countries, judicial decisions are subject to appeal to a higher court, which, to a certain extent, protects the litigators against judicial wrongdoing. Although the appeal process does not directly increase the accountability of judges, since their tenure and salary are not usually immediately affected by it, reversals by higher courts of a judge's decisions may affect that judge's reputation, and the prospect of this may influence the judge's decision making. For instance, a judge whose decisions are often reversed may be denied promotions or face less attractive reemployment possibilities should he leave the judiciary.[3]

Public pressure, reinforced by an active, independent press, is potentially the most effective informal mechanism of disciplinary judges (e.g., Cappelletti 1985).

The success of any mechanisms that exist for holding members of the judiciary accountable for the decisions they render depends greatly on the transparency of the judicial process to the public and on the values the society shares. In Russia, although court decisions are subject to judicial review by higher courts, proceedings in Russia are usually quite opaque and are rarely subjected to public scrutiny. Cases where journalists were prevented from entering a courtroom abound limiting the potential reputation effects of reversals on judicial behavior.

Furthermore, the media itself should be relatively independent of interest groups in order to play a useful role in judicial accountability. This does not seem to be the case in Russia. A cross-country Freedom House survey awards Russian press and internet sites a grade of 60 (on a scale from 0 to 100, with smaller numbers standing for freer media), which puts Russian press just barely into "partly free" category, with press in countries such as Ghana and Kyrgistan, awarded 61, already being classified as "not free" (figure 4.3). Studies by human rights organizations in Russia show that freedom and access to media vary substantially across Russia's regions, with many regional governments hampering the development of independent media. Regional authorities use a variety of methods including special requirements for journalistic accreditation, multi-step licensing and registration of news agents, and targeted subsidies from the regional budget (Obschestvennaya ekspertiza 2000). Thus, at its present stage of development, Russian media

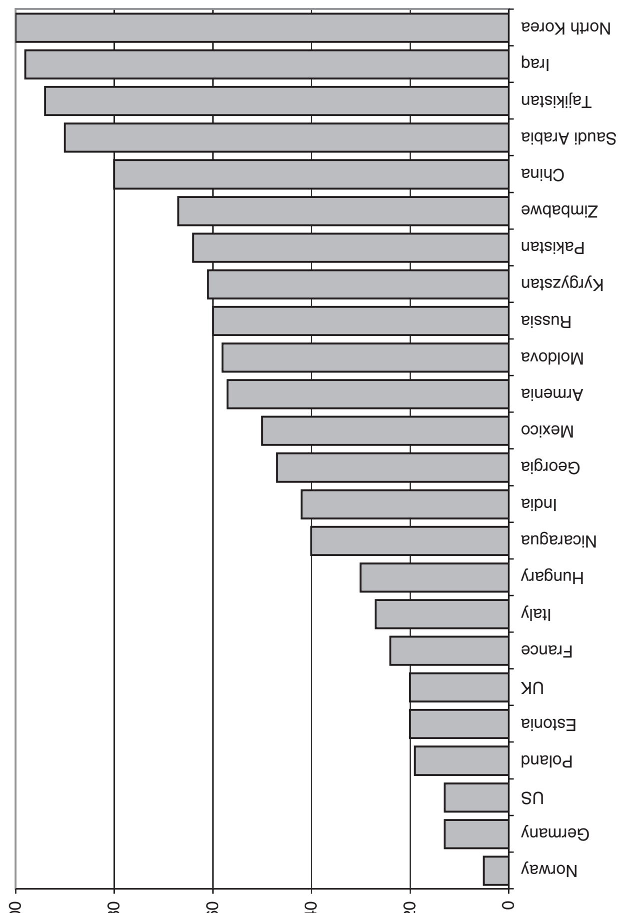

Figure 4.3
Freedom of press around the world (100 = least free)
Source: Freedom House (2000).

is unlikely to provide sufficient scrutiny to improve accountability of the judiciary to the public at large.

Finally, although constitutional provisions such as unlimited judicial tenure inevitably reduce the accountability of judges to the public, several studies show that in reality, they do not guarantee judicial independence from politicians, the very purpose for which they were introduced. Ramseyer (1994) and Ramseyer and Rasmusen (1997) present evidence of substantial political interference with courts in Japan despite its having laws providing for judicial independence.[4] Similar evidence is found for the United Kingdom in Salzbeger and Fenn (1999) and for the United States in Cohen (1989).

Even where salaries of judges cannot be reduced, political control of courts is often possible because the central government has the authority to move judges from one position to another.

In Russia, this channel of influence is also open to the authorities. By law, the candidates for the most prestigious posts of court chairmen and their deputies are either nominated or appointed by the president, depending on the level of the court involved. Although we are not familiar with any studies systematically analyzing the influence of the central government on judicial decisions in Russia, the current legal structure does create opportunities for such interference.[5]

In conclusion, most Russian judges, under the laws existing prior to 2001, enjoyed the privileges of unlimited tenure and salaries that could never be reduced. These provisions did not guarantee that courts were independent from the central government, which was still in charge of judicial promotions to top posts. They did, however, reduce the incentives for judges to act in the public interest by lowering the probability of their being disciplined for unfair rulings. (The low monetary value of the judicial profession [see below] reinforced these effects.) Moreover, reputation mechanisms in the Russian environment, where court proceedings are not transparent, were not strong enough to provide additional incentives for judges to rule fairly and in the public interest. Thus, the upholding of justice in Russia had to rely almost solely on the strength of each judge's moral principles.

Costs of Upholding Justice

Whereas incentives for Russian judges to pass fair judgments have been weak, the effort that judges must expend to uphold justice is quite substantial. This is due, first of all, to the legal framework inherited from the Soviet Union, which in many cases turned out to be inappropriate for making judgments under the new regime. Nevertheless, the framework has taken a long time to change, and the change process has often left gaps in important areas of legislation.[6] Many of the laws passed since the breakup of the Soviet Union have been vague and open to broad interpretation. In many instances, laws adopted at different times have contradicted each other or the constitution. Scores of presidential decrees passed during the Yeltsin era in attempts to circumvent the Duma have cluttered the legislative record. In addition, some important new laws were copied from the legislation of other countries with little modification (for instance, according to Pistor, Raiser, and Gelfer (2000), Russian corporate law was “transplanted” from the Anglo-American version without major changes). Empirical analysis by Berkowitz, Pistor, and Richard (2003) shows that such laws are very difficult to enforce without the necessary adjustments to local conditions. Owing to these weaknesses in Russian legislation, the burden of effort in resolving disputes has been shifted to the courts, which have had to reconcile contradictory provisions, interpret vague laws, and fill in gaps with whatever they believed appropriate.

Secondly, the lack of proper accounting reporting standards in the country has often made it very difficult for the judiciary to collect the information necessary to resolve court cases. For instance, in the context of Russia’s 1998 banking crisis, the courts’ inability to turn over assets of bankrupt banks to their creditors can be partly attributed to the difficulties encountered by the courts in attempting to verify banks’ transactions. Widespread multisided barter transactions among enterprises make it especially difficult for courts to disentangle claims during investigations. The low level of informational transparency in the country has significantly contributed to the costs of legal enforcement, and steps to introduce international accounting standards and public databanks are critical to improving the quality of the judicial process in Russia.

These problems have made the costs of upholding justice in Russia very high and the jobs of Russian judges very demanding. This implies that substantial resources need to be devoted to the judicial process in Russia. The amount of financing allocated to the court system has remained very small, however, making the judiciary's task even more difficult.

Since 1995 the Russian law requires that the courts can be financed only through the federal budget. At the same time, the level of federal budget financing for the judiciary, which is negotiated by the government and the head judges of the Supreme and Higher Arbitration Courts and the Council of Judges[7] every year, remains very small (see figure 4.4). This means that the basic needs of many regional and local courts, such as building and staff requirements, are not even nearly met. (There is also anecdotal evidence of instances in which the federal budget has been in arrears on payments of salaries to judges.) The failure to meet staffing needs results in judges' often being overloaded with the court cases. Over the last four years, Russian arbitration courts, which deal with commercial disputes, have processed an average of 75–80 percent of the cases filed. The efficiency of the court system in dealing with bankruptcy proceedings is much lower: Only 20–42 percent of these cases are resolved each year (see figure 4.5).

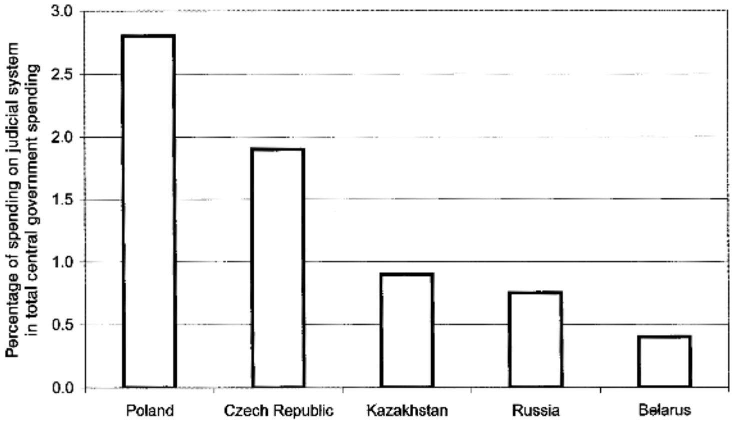

Figure 4.4
Share of fiscal spending devoted to the judicial system, 1999–2000
Sources: Ministries of Finance and Ministries of Justice in the selected countries.

Subversion of the Course of Justice

The very high level of effort required on the part of judges to uphold justice in Russia, combined with the lack of incentives for judges to rule impartially that is imbedded in the design of the Russian judiciary, have created substantial room for corruption in the judiciary and resulted in the unreliability of the Russian legal system. Underfinancing of the courts has exacerbated the problem.

One common example of subversion of justice in the Russian judiciary is the interference of local and regional governments in the judicial process. Local and regional

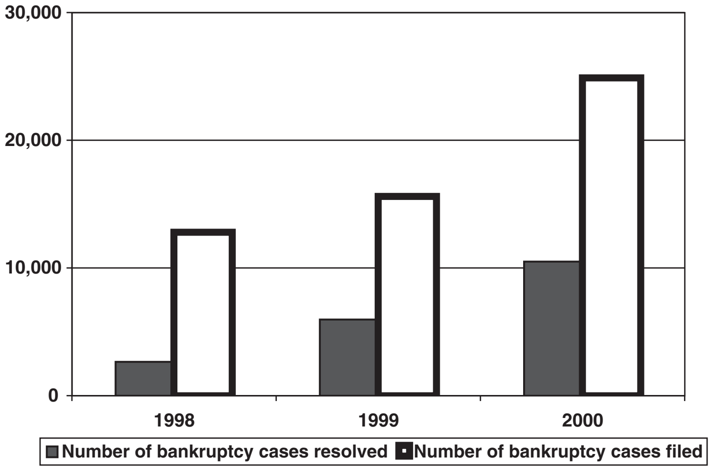

Figure 4.5
Number of bankruptcy cases filed in Russian arbitration courts versus number of cases resolved, 1998–2000.
Source: Higher Arbitration Court, Russian Federation.

authorities can often make judges dependent on them by providing the courts with funds to cover the deficiencies that result from insufficient financing of the judiciary in the federal budget. Although the 1999 law explicitly forbade financing of the courts by local and regional governments, our analysis of official documents shows that such transfers take place in many of Russia's regions (they appear to be particularly common in Moscow and St. Petersburg). Moreover, according to the Russian law, judges are directly dependent on local authorities for provision of private housing and certain benefits, such as child care. In addition, the fact that the courts' geographical jurisdictions often coincide with political territorial divisions strengthens the bond between the local government and the court through their repeated interactions.

Evidence exists that the local and regional governments in Russia readily take advantage of the dependency that these circumstances create. For instance, according to a 1998 survey of small shops in Moscow and Warsaw, only a quarter of Moscow managers believe that they can take the local government to court, which is two and a half times fewer than in Warsaw (see Frye 2001). A CEFIR and World Bank survey of small businesses in 2002 showed that the number of firms who have at least once filed a lawsuit for what they believed to be an unfair administrative decision is small, ranging from 3 percent for licensing to 12 percent for registration. Among the same set of firms, the use of gifts and personal connections to influence the bureaucratic process was reported much more often (see table 4.1).

Table 4.1
Russian firms' use of courts in disputing actions of government inspectors

Have you ever tried to:	Percentage of firms
Initiate an administrative appeal?	13
Initiate court proceedings?	6
Use personal connections?	25
Use gifts?	23

Source: CEFIR/World Bank (2002)

Lambert-Mogiliansky, Sonin, and Zhuravskaya (2000) further demonstrate that the influence of regional governments can be traced in decisions resulting from judicial bankruptcy proceedings. They show that Russian courts are more likely to decide to "restructure" an insolvent firm, rather than close it down, if it has a large number of employees and is located in a region where the governor enjoys substantial political power.

Instances of biases in court decisions are not limited to the interference of regional governments in the judicial process. The problem of overlapping jurisdiction of courts involved in resolving business disputes, addressed in a 2002 legislation, provided additional possibilities for venue shopping and maneuvering of the parties. Although consistent data on subversion of justice in Russia is hard to collect, there is substantial anecdotal evidence that such subversion does occur. The corruptibility of the courts is one of the main reasons for the lack of confidence in the Russian judicial system evident from the surveys cited above.

Judicial Discretion

We argue above that the incentives of judges are such that substantial possibilities for subversion of justice exist in Russia. In circumstances where such incentives prevail, it is sensible to minimize the potential damage by reducing the amount of discretion available to the judges in the process of carrying out justice. This can be achieved by making legislation very specific, in such a way that violation of the legislation can be easily verified. Glaeser and Shleifer (2000), for instance, suggest that when a country's judiciary is prone to corruption, the benefits of such specific laws associated with limiting the power of the judiciary may outweigh the losses to society that arise from the inflexibility and limited expertise of such laws.

As we discuss above, much of the legislation adopted in Russia since the breakup of the Soviet Union lacked this property of specificity. Although it is virtually impossible to design a complete set of laws that covers every circumstance and every contingency, many Russian laws have been especially vague or contradictory or have contained important gaps. In addition to making the process of upholding justice very costly for courts, such laws have also given a substantial amount of discretion to judges.

A major reason Russian laws have been so incomplete is that the Duma, which is responsible for the design of legislation, has also been subject to strong pressure from interest groups. Few would disagree that the huge gaps in banking legislation that remained when the 1998 banking crisis took place were a result of a focused effort by a few large Russian banks to ensure the enactment of impotent banking laws. According to Hellman, Jones, and Kaufmann (2000), who analyze a survey of enterprises in twenty transition economies conducted by the World Bank and the European Bank of Reconstruction and Development in 1999, Russia ranks fourth among the economies studied in the extent of legislative capture, just behind Azerbaijan, Uzbekistan, and Moldova.

Nevertheless, as powerful as some Russian lobbying interests might be, regular elections into the Duma continue to serve as a mechanism (albeit an imperfect one) of parliamentary accountability in Russia. As we discuss above, the Russian judicial sector prior to 2001 lacked any such mechanism of accountability. Given that the Duma, because its members are elected, is more accountable to the public than the judiciary, it would therefore be sensible to shift discretion over the outcome of court cases from the judiciary onto the legislature through the passage of detailed, fairly complete, and simple-to-follow laws, especially in cases in which little special technical expertise is required to adjudicate. The lobbies would object to such a shift, but recognizing that increasing the specificity and level of detail of laws that are passed is a priority is important. Some steps are already being taken in this direction (for instance, the 1997 bankruptcy law is much more complete and detailed than its 1992 predecessor, and the 2002 revision addresses some of the remaining weaknesses in the 1997 law), and it is imperative to continue the process.

The Judicial Reforms of 2001

In 2001, the Duma passed a number of important amendments to existing laws governing the judiciary. These changes are expected to have a positive effect on the functioning of the Russian judicial system. The main contribution of the new provisions is that they fill many gaps in the legislation concerning the appointment and dismissal of judges and their responsibilities as well as the self-governing bodies of the judiciary. The new laws, if implemented, should significantly increase the transparency of the process of appointments and dismissals of judges in Russia and therefore increase the accountability of Russian judges. At the same time, the new legislation significantly increases the control of the federal government over decisions on appointments and dismissals, broadening the scope for undue influences on the judiciary. The increased federal powers could compromise the judiciary's role in ensuring the government's accountability to the public.

Increases in accountability are expected to come from some specific amendments among those the Duma passed. The detailed procedure for selecting candidates for the post of judges, which under the amendments requires that an announcement of vacancies be published and that applicants meet certain prerequisites, should make judicial appointments more competitive and transparent. The responsibilities of head judges are detailed in the new laws, making it easier to hold them accountable for their performance.

After three years on the shelf, the rules for the self-governance bodies of the judicial community, their formation, their responsibilities, and relationships among them, were ratified by the Duma. The law that sets forth these rules provides for members of qualifying committees, which are responsible for the dismissal of judges, among other issues, to be elected by secret ballot of the Congress of Judges. These clarifications of the guidelines for the qualifying committees, who receive and act on complaints about judges, are well overdue: Since their creation in 1993, these committees have remained highly opaque and largely ineffective, at least according to the anecdotal accounts of those involved in complaints about the Russian judiciary.

The new law's provisions should also lead to changes in the incentives of those in the judicial profession, as they make the process for dismissal of judges in cases of violations more simple and transparent. These changes are expected to come, first, from the amendment that makes judges subject to Russia's administrative law. Second, detailed procedures for disciplinary action by the qualifying committee have been introduced that spell out the grounds for taking such action.[8] At the same time, the appeal procedure for judges accused of misconduct is detailed, providing a check on the power of the qualifying committees. The procedure for dismissal of a judge under criminal investigation is also simplified. Third, most judges are now appointed for an initial period of three years, with a possibility of a renewal of the appointment for an unlimited period after the initial period has been completed. If the peer review following the first three years in office is fair, the expectation of undergoing such a review should increase the incentives of judges to carry out their responsibilities in an unbiased way. However, it should be recognized that the additional review process can make judges more dependent on those approving the re-appointment, which usually includes regional legislature and the President of Russia. The new law must therefore not introduce the same requirement for the top judicial posts in the country, leaving life-time appointment practice intact in Russia's supreme courts.

The reforms also include important provisions involving the process of creating legislation. Specifically, for cases in which legislation has been found to violate the constitution, provisions of the new law specify the parties responsible for amending the legislation and deadlines for introducing the required amendments. This is expected to help reduce the number of contradictions and the amount of uncertainty currently present in Russian legislation.

After the weak judicial responsibility of the 1990s, the reform of 2001 is expected to bring greater accountability to the judicial system. At the same time, it must be recognized that opening up the judicial process to greater scrutiny and making dismissal of judges easier will create new channels through which interested parties can influence judicial decisions.

The new law provides for inclusion of laymen (appointed by regional legislatures for two years) and a presidential representative on the qualifying committees, previously made up exclusively of members of the judiciary. It is a normal practice in many countries to have judicial complaint committees consist of both judges and members of the general public. The introduction of one presidential representative and ten appointees of the Federation Council into the higher qualifying committee, composed of twenty-nine members, gives the central government a substantial amount of influence in top judicial appointments and dismissals. The procedures for selecting candidates for these representative posts have not been specified in the law, granting the central government unchecked discretion over these procedures. Being accountable to representatives of the central government can directly affect the incentives of judges in court cases involving interests of the central government and the upper chamber of the Duma or parties with strong influence over these political bodies. The effects of these incentives could then interfere with the fairness of the judicial system in such cases and diminish the potential effectiveness of the judicial system as one of the institutions of government accountability.

Enforcement of Court Decisions

In addition to the problem of the corruptibility of the courts, the Russian judicial system has proven to be unreliable because of a widespread failure to enforce judges' decisions by those charged with doing so (see Hendley 2001 for evidence of poor enforcement of court decisions in Russia). Because of the lack of informational transparency in Russia and the resulting ease with which assets and people can be hidden, a substantial effort is required to implement court decisions. The task of enforcers has been made especially difficult by the vague treatment in Russian legislation of liability for the failure to comply with court decisions. At the same time, until mid-1997, bailiffs, charged with enforcement of court decisions, were governed by the Soviet law, which provided them with little incentive to invest great effort in this task.

Prior to 1997, bailiffs were directly responsible to judges and monitored by them. Bailiffs were appointed and dismissed by the regional governments, which were often influenced by various interest groups. Although the law allowed for the possibility to reward bailiffs based on their success in enforcing court decisions, it was very vague on how to calculate the amount to be rewarded and how to determine whether collection was sufficient, giving bailiffs virtually no motivation to invest real effort in the demanding tasks involved in enforcing court decisions. Virtually unmonitored, bailiffs had strong incentives to accept payments from parties interested in the enforcement (or nonenforcement) of judicial decisions. Some experts believe that corruption among bailiffs was more severe than among the members of the judicial profession.

Two pieces of legislation adopted in 1997 changed substantially some of the circumstances and incentives under which bailiffs operate.[9] A new hierarchy of bailiffs was created, ultimately reporting to the federal Ministry of Justice. This meant an improvement in the supervision of bailiffs compared to the old system of monitoring by local judges with poor incentives to supervise them properly. Moreover, the regional governments were stripped of their power to remove bailiffs, leaving the authority with the Ministry of Justice. The 1997 laws also carefully spelled out the responsibilities of bailiffs. All of these changes made monitoring and dismissal of bailiffs easier and more aligned with the goal of unbiased enforcement of court decisions.

The 1997 law also gave bailiffs new powers, most importantly, the authority to use force and weapons in enforcement of court decisions. In addition to the powers of seizure of property that they previously possessed, bailiffs can now also file bankruptcy proceedings against enterprises (although they do require a clearance from the federal government to do so). To further alleviate the burdens involved in enforcing court decisions, the punishment for agents' failure to comply with courts' decisions was detailed in the 1997 laws and now includes both fines and initiation of criminal proceedings.

Finally, the 1997 laws introduced an incentive pay scheme for bailiffs that allows them to keep 5 percent of the sums they recover in enforcement of court judgments, not to exceed ten times the minimum wage. This is a first attempt to give proper financial incentives to those charged with the enforcement of court decisions.

Nevertheless, a number of problems remain in the institutional setup for implementation of court decisions, and these problems are likely to inhibit the process. Even though the penalties for noncompliance with court decisions were detailed in the 1997 law, some of the fines that law imposed were later declared as contradicting the constitution and previously developed laws. This highlights a bigger problem in the provisions for dealing with failure to comply with court rulings being scattered across several pieces of legislation.

Although the 1997 law requires bailiffs to be financed out of the federal budget, it allows the regional governments to provide them with additional compensation. This may create undue pressure on bailiffs, especially if regional governments are subject to influences from lobby groups.

The new financial-incentive scheme for bailiffs discussed above is unlikely to be very effective because of the low ceiling on their potential compensation. In 2001, ten times the minimum wage corresponded to roughly \$100. This means that in cases where stakes are especially high (i.e., those involving more than \$2,000, the point at which the 5 percent commission is blocked by the ten-times-minimum-wage cap) bailiffs will have little incentive to enforce full payment, as they will receive no additional compensation for doing so. At the same time, these are the cases in which bailiffs would need to expend additional effort in order to collect the full amount due under the judgment, since when large amounts are at stake, the defendant is more likely to try harder to resist the court's decision.

Finally, the current procedure requires claimants in court cases to pay up front for the expenditures associated with bailiffs' enforcement efforts if the defendant in the case does not comply with the court's decision voluntarily. These costs are then recovered from the defendant as a separate item and returned to the claimant. Not only does this scheme provide no incentives for the bailiffs to minimize the costs of enforcement, it also suggests that poorer claimants may not be able to afford the enforcement procedure, especially given tight borrowing constraints in Russia.

Conclusions

Although the 1997 legislation on enforcement of court decisions and the 2001 package of amendments to laws on the judiciary constitute crucial steps toward reforming the ineffective Soviet justice system, more efforts are necessary in this direction to achieve a judiciary that functions at a level that inspires confidence in its impartiality and specifically in its ability to enforce property rights. These efforts should focus on the passage of very detailed and specific legislation by the Duma, which should limit the discretion of judges and make the judicial process easier; increasing federal financing of the courts to make their jobs more doable; ensuring that the jurisdictions of courts do not coincide with political regions; making court proceedings and judicial appointments and dismissals more transparent; giving more incentives to bailiffs to implement court decisions; and finally, ensuring that judiciary's role as one of the institutions of government accountability is not compromised. The latter is an important concern in the current political environment in Russia, in which the trend is toward the amassing of substantial political powers by the central government, as discussed in chapter 3.

4.2 Regulation and Rent-Seeking Bureaucracy

Government regulation, if targeted correctly, can increase the economy's efficiency and foster economic growth when the market fails or when dispute resolution mechanisms malfunction. The Russian regulatory system, however, a monstrosity largely inherited from the command economy, has instead turned into another source of large distortion in the economy.

Regulatory bodies are composed of individuals, and the interests of individuals do not necessarily coincide with those of the public. Therefore, economists have long recognized that for regulation to be effective, regulators must have the proper incentives.

In Russia, the lack of incentives for state bureaucrats to promote public interest has resulted in mostly inefficient regulatory institutions. The low salaries paid in the state sector after the start of transition diminished the value state employees placed on their jobs. This meant that the possibility of dismissal for poor performance, which can be a powerful disciplining device for government officials, was not very potent in Russia.

Empirical evidence also shows the prospects of disciplining a bureaucrat for wrongdoing are rather weak in Russia. Almost 70 percent of Russian firms sampled in a 1999 survey by the World Bank and EBRD indicate that they believe that it is seldom or never possible to successfully reverse an incorrect decision of a state official without recourse to bribery (see Hellman, Jones, Kauffman, and Schankerman 2000). A 2002 survey by CEFIR and the World Bank shows that very few Russian firms resort to court action to deal with state officials (see table 4.1). The ineffectiveness of the Russian judicial system and its frequent capture by the local authorities have made it particularly difficult for firms to hold government bureaucrats responsible for their actions through the courts.

Though lacking in incentives to act in the public interest, Russia's large bureaucratic contingent, a legacy of the Soviet era, has enjoyed a substantial amount of discretion in regulating markets. A large number of administrative measures available to bureaucrats allow them to interfere in the activities of businesses, through excessive and cumbersome regulation of firm registration, licensing, certification procedures, inspections (sanitary, fire department, etc.), regulation of investment decisions, and imposition of regional trade barriers. Many regulatory bodies in Russia have been allowed to set up their own rules and regulations without legislative approval.

To protect themselves from the frequent demands of government officials, many firms make private payments to regulators on a regular basis. Hellman and Schankerman (2000) use a 1999 survey of firms in transition economies, including Russia, to show that firms with more autonomous decision making have to pay for this freedom with higher bribes to government officials. Results from the same survey show that corruption among regulators in Russia is perceived as an even greater problem than corruption among judges (Hellman, Jones, Kauffman, and Schankerman 2000). As discussed in chapter 2, investors surveyed by CEFIR in 2001 name anticorruption reform and restructuring of the state bureaucracy as the number-one priority in the reform process.

Several surveys of businesses show that Russia's performance in this area has been worse than that of Central European transition economies (see figure 4.6). According to Frye (2001), who reports the results of surveys of small shops in Warsaw and Moscow conducted in 1998, the number of government inspections of shops was almost six times higher in Moscow than in Warsaw (see table 4.2). A 1999 World Bank–EBRD survey of twenty transition economies showed that enterprises in Russia paid a much higher amount of bribes to health and fire inspectors than firms in any other economy, with the exceptions of Lithuania, Belarus, and Uzbekistan. According to the same survey, the amount of time Russian managers spend "negotiating" with govern-

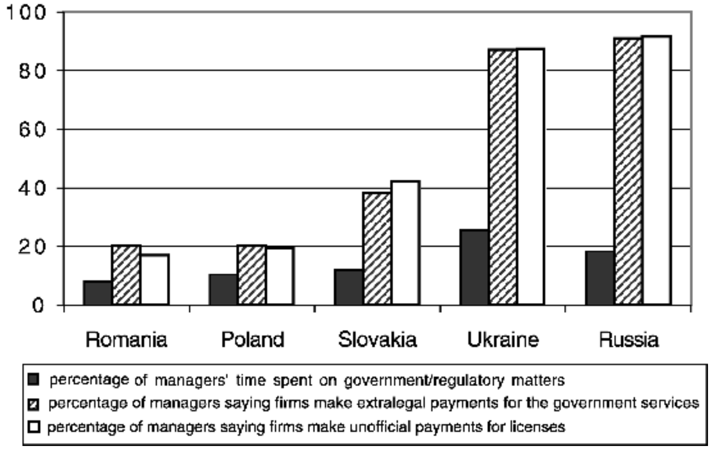

Figure 4.6
The regulatory environment in transition economies: Survey results.
Source: Johnson, McMillan, and Woodruff 2000

ment officials is the fifth highest among the twenty transition countries covered in the survey (Hellman and Schankerman 2000).

Besides its regular distortionary effects, perhaps the most significant consequence of excessive regulation is the hampering of new business development, especially for small start-ups, which have been an essential force driving economic growth in Eastern Europe. Overregulation results in barriers to entry, which can lead to abuse of market power by incumbent firms and preclude entry by more efficient competitors. Bureaucratic discretion leads to increased uncertainty of the ability of entrepreneurs to appropriate future returns, reducing investment in the economy.

Table 4.2
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 (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 (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.

Finally, the bribes generated by excessive regulation create vested interests among bureaucrats, who then may oppose reductions in regulatory scope (see Schankerman 2001). This may help explain why in Russia the Soviet-style regulatory system was left unreformed for years after the start of the transition.

Long overdue steps toward alleviating the problem of rent seeking in the state administration were finally introduced in 2001 on the initiative of Russia's central government, in an effort that became known as the "deregulation" of the Russian economy. The legislation, some of which had already gone into force as this book went to press, is expected to have positive impacts mainly through two of its provisions. First, it reduces the discretion of Russian state officials, diminishing opportunities for rent seeking. Second, it details the responsibilities of regulators and the boundaries of their powers, which should increase their accountability to the public and reduce incentives for rent seeking by making it easier for courts to verify abuse of power by state officials. Various laws within the legislative corpus also simplify many regulatory procedures, which should directly reduce the costs of conducting business in Russia. Finally, to the extent that they help reduce rents to bureaucrats, these laws should make further resistance to reforms less attractive for low-level officials.

More specifically, the new law on licensing seeks to restrict the number of activities in Russia that require licensing and envisages a mechanism for preventing the expansion of this list. Prior to the enactment of this law, more than 500 types of activities in Russia required licensing.[10] Russian small businesses name licensing as the third most disruptive type of regulation after general documentation requirements and the process for purchasing of premises (CEFIR and World Bank 2002). The licensing law also extends the lifetime of licenses granted.

The new law on standardization (still to be approved by the Duma at press time) attempts to make certification of products a responsibility of the producers themselves (through associations of producers) and allows competition to create incentives for observing quality standards. At present, 80 percent of consumer goods in Russia is certified (compared to just 4 percent in Europe): There are more than 20,000 product standards in Russia, most of which are not observed by producers. Small businesses in Russia perceive certification to be the fourth-most-costly regulatory requirement (CEFIR and World Bank 2002).

Importantly, the new law on standardization also attempts to identify the intended goals of requirements governing technical products in Russia (safety, technical compatibility, increased economic efficiency, stimulation of research and development, and so on) and specifies the procedures for creating new requirements and standards in line with these goals. In many cases, new standards and requirements will now require a legislative approval. The law on standardization is most critical for curbing the power of regulators to create ad hoc obstacles for firms, and if it is not approved by the Duma, this would constitute a significant setback for regulatory reform in Russia.

The new law on registration of firms introduces a "one-window principle," only requiring registrants to apply to one agency, thus replacing the previous procedure, which involved many administrative steps and engaged multiple authorities. It gives a deadline of five days to the registration chamber for making a decision on an application for registration. A 2002 survey by CEFIR and the World Bank shows that under the old law this process took on average twenty-six days and a maximum of three and a half months.

The new law on protection of rights of entrepreneurs spells out the rules for state inspections of businesses, including the maximum frequency of planned visits, warning procedures, and requirements for keeping records of inspection results. In addition to reducing the discretion of bureaucrats, this new law should help make instances of abuse of power by state officials much easier to detect, verify in courts, and therefore prevent. Currently in Russia, fire safety and sanitary inspectors pay the highest number of visits to enterprises. Preliminary results on the monitoring of enforcement of this law, however, have been disappointing, with the number of inspections by all agencies increasing since the passage of the law (CEFIR and World Bank 2002).

The reduction in administrative barriers created by this legislation should bring a welcome change to the environment in which small and medium-sized firms are operating. A sound administrative reform program will change perceptions of the government's role in society and raise the returns from doing business in Russia. In addition, Russia's newly approved tax code, which greatly simplifies tax rules, plus the planned privatization of and introduction of competition into the electric, gas, and railway industries should further reduce the power of the Russian bureaucrat and improve the efficiency of Russian markets. Moreover, a properly conducted administrative reform program to curb the arbitrary economic powers of the government would provide an important source of balance as the central government progresses in amassing large amounts of political influence.

Still, the 2001 administrative reform program is only a start for restructuring the state sector in Russia. The reform process should focus on creating incentives for Russian bureaucrats to conduct efficient regulation, rather than seek rents. This will require introduction of performance-related pay and increases in salaries, perhaps by freeing public funds through a reduction in workplaces. The success of administrative reform is also highly dependent on extent to which the new legislation governing administration is enforced, which means that judicial reform has to go hand in hand with deregulation. Moreover, additional changes are required in several other areas of the state apparatus, including the police force, which still has vast powers to interfere with businesses.

4.3 Banking-Sector Failure and Reform

A well-functioning financial sector, which is dominated by banks in transition and developing countries, is an important facilitator of investment activities. Banks channel funds from creditors to borrowers and monitor investment projects on behalf of creditors. Experience from transition countries shows that it is difficult to get banks actively involved in these intermediation activities (Berglöf and Bolton 2002). But in Russia the amount of financing that the banks have channeled into the real sector is particularly small, even by transition country standards, though it has increased since 1998. To promote investment and output growth, substantial reform of the country's banking sector is critical. In this section we discuss the main problems in the Russian banking system and the progress the government has made toward reforming it.

The Structure and Main Characteristics of Russia's Banking Sector

At midyear 2002, there were about 1,300 banks in Russia. Although this number reflected a significant drop caused by a wave of mergers after the 1998 crisis, it is still high in comparison to other countries. Russian banks can be divided into several groups: state-owned banks, large and medium-sized private banks, foreign banks, and "dwarf" banks.

The state owns shares in 424 financial institutions, including blocking stakes (shareholdings exceeding 25% of common equity) in 62 commercial banks, with its most important possessions being Sberbank, Vneshtorgbank, and Vneshekonombank. State-owned banks are either transformed Soviet-era banks, such as Vneshekonombank, which originally existed to settle the Soviet Union's foreign trade payments, or newly created banks for the implementation of "special functions" on behalf of the government, such as Rosselkhozbank, which channels government funds into the agricultural sector. Virtually all state-owned banks are universal banks, meaning that they offer a full range of bank services to their clients. State-owned banks dominate nearly all segments of the Russian financial services market.

As of early 2002, Sberbank and Vneshtorgbank controlled about 30 percent of the total assets in the Russian banking industry, with another 30 percent of the industry's assets under the control of the twenty largest private banks. Many of the latter are "pocket banks" within large FIGs. Pocket banks function primarily as treasuries for the holdings of the group in which they are located, and their role as financial intermediaries between FIG businesses is rather limited. Two hundred large and medium-sized banks, with capital ranging from 100 million to 4 billion rubles, controlled another 30 percent of the assets in the banking sector. About 1,000 Russian banks, however, are dwarf banks, which as a group controlled no more than 10 percent of total assets at the start of 2002. A common view is that dwarf banks have been drawing their earnings mainly from fees for various illegal services, such as money laundering, export of capital, and so on, and it is often argued that shutting down all these banks would likely benefit the economy.

In mid-2002, twenty-three fully foreign-owned and one hundred partially foreign-owned banks were doing business in Russia. They controlled a mere 5 percent of the total assets in the banking sector. These foreign-owned banks concentrate primarily on servicing foreign trade in Russia, including payments, short-term trade loans, and foreign exchange transactions. These numbers should be compared to those for Central and Eastern Europe, where the share of assets controlled by foreign banks in many countries exceeds 80 percent (Berglöf and Bolton 2002). Foreign-owned banks have been cautious about operating in Russia, and their share in total sector equity declined in the three years following the 1998 banking crisis. In 2001, the state removed all restrictions on opening branches of foreign banks in Russia. The ceiling on the share of foreign-owned banks in the total capital of the sector, previously set at 12 percent, was also abandoned (although this constraint had in reality never been binding in any case).

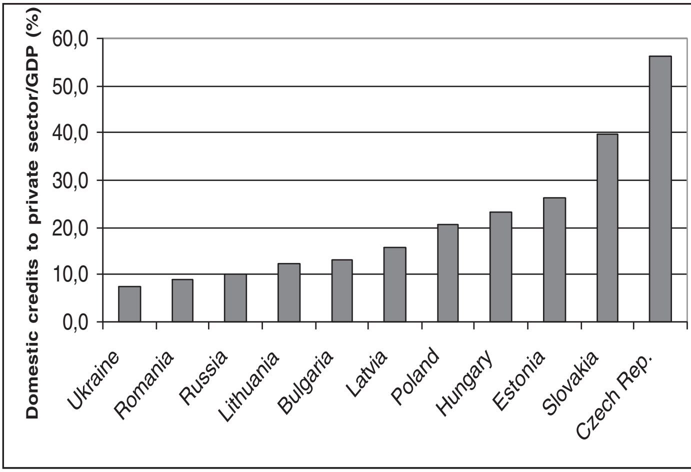

Figure 4.7
Credit to private sector (as percentage of GDP) in various countries.
Source: World Bank 1999, Central Bank of Russia 2001.

Three main characteristics define Russia's banking sector: a small amount of lending to the private sector, very modest retail deposits, and low capitalization levels. As shown in figure 4.7, the amount of bank loans to the private sector in Russia remains small compared to that in other countries. Lending to the private sector has increased since the 1998 banking crisis, but the share of corporate loans was still about 38 percent of total bank assets at the beginning of 2002, compared to 45 percent for Poland and 50 percent for the Czech Republic (as of 2000). Moreover, only 10 percent of loans were for durations of longer than one year; for most market economies, this figure is between 60 and 80 percent (World

Bank 2000). In fact, bank loans financed only 3 percent of investments in the country. So it is fair to say that the Russian banking sector has largely failed to play the role of financial intermediary between investors and firms in Russia.

At the same time, the total amount of deposits held by the Russian banking system is quite small. At the beginning of 2002, the total value of household deposits in Russian banks was about 690 billion rubles (US$23 billion), and for corporate deposits the figure was 580 billion (US$19 billion) (Central Bank of Russia 2001). According to the most conservative estimates, Russian households still keep about US$60 billion in savings "under the mattress," that is, in cash outside the banking system. Plus, most of the deposits banks attract are short-term: More than 90 percent mature in less than one year (Central Bank of Russia 2001). These numbers reflect the low level of confidence the Russian population has in the country's banking sector.

Finally, the capitalization of the Russian banking sector is also small, only $20 billion in early 2002, or about 6.8 percent of GDP according to Russian accounting standards. The numbers go lower still if we recalculate the capital according to international accounting standards.[11] In comparison, the bank capital–to–GDP ratio for Hungary is about 15 percent, and that for the Czech Republic about 10 percent. Low capitalization of a particular bank means that the depositors in that bank bear more risk than those in a bank with higher capitalization. At the same time, since bank shareholders care less about downside risk exposure, their incentives for monitoring loans are poorer.

Problems in the Banking Sector

The characteristics of the Russian banking sector discussed above are symptoms of fundamental weaknesses in the sector. One of the main reasons why the sector is so underdeveloped is the lack of proper enforcement of creditor rights in Russia. Poor enforcement of laws ensuring creditor rights makes it difficult for banks to issue private loans and remain solvent. The 1998 crisis demonstrated that banks that lend heavily to enterprises often do so with the expectation of a government bailout if the enterprises do not repay the loans they receive.

In this context, it is no surprise that bank lending to the private sector in Russia remains low, that the business of banking is unprofitable and attracts little capital, and that confidence in the country's banking system is weak. Strengthening creditor rights protection is a necessary condition for developing a well-functioning banking sector in Russia. To accomplish this, enforcement of laws governing creditor rights is critical.

Competition among Banks

The Russian banking system also suffers from the lack of competition resulting from disruptive government policies, poor supervision of banks by the central bank, and the highly nontransparent informational environment in which banks and enterprises operate. These problems make the profitability of banking in Russia low and encourage banks to engage in risky behavior.

Competition in Russian banking is severely disrupted by government intervention. The state, via either the Central Bank of Russia (CBR) or government at all levels, owns stakes of more than 50% in fifty-three commercial banks. But it is not the mere fact of state ownership, but rather the privileges state-owned banks enjoy, that prevents effective competition in the banking market.

The most important example of discriminating government policies in the banking sector is Sberbank, the only Russian bank with an explicit and unconditional government guarantee on the household deposits it attracts. This guarantee makes it very difficult for other, possibly more efficient banks to compete with Sberbank in the market for retail deposits. Consequently Sberbank is the largest retail bank in Russia, with 85 percent of total household deposits and 50 percent of dollar-denominated household deposits. Moreover, Sberbank has a regional network consisting of 27,800 branches.

The only banks that seem able to effectively compete with Sberbank for retail deposits in local markets are large municipal banks like Petrovsky Narodny Bank in St. Petersburg and the Bank of Moscow, which enjoy the patronage of local authorities. For example, in 1994, Petrovsky Narodny launched a program of servicing pension accounts and acquired 80 percent of the local market for retail deposits. The Bank of Moscow is currently developing a payment system that is expected to help attract the deposits of Moscow pensioners.

Other advantages enjoyed by the state-owned banks include free credit lines from the CBR and the privilege to hold the accounts of regional and/or municipal budgets. Managers of state-owned banks tend to expect bailouts in emergency situations, which weakens their incentives to manage risks and minimize costs. Indeed, the CBR did grant large loans to several de facto insolvent banks during the 1998 crisis (see discussion of central bank policy below). The bailout policy was also pursued in early 2001, when the CBR raised the capital of Vneshtorgbank by eight billion rubles.

The preferential treatment of state-owned banks in Russia thus undermines the benefits of competition in the banking market, provides inappropriate incentives to banks, and discourages entry by possibly more efficient competitors.

Banking Supervision

Incentives for excessive risk taking are endemic to the banking business in general. Bank owners do not face the entire risks of their investments: in case of a bank's bankruptcy the depositors end up bearing the costs of risky investments. This observation and the potentially severe effects that bank failures can have on the economy of any country make a strong general case for regulating the banking sector around the world. In Russia, the CBR, the chief regulator of the country's banking system, has failed to create a supervisory environment that gives banks incentives for prudent behavior. On the contrary, by creating expectations of impunity and bailouts, the current regulatory environment encourages risk taking.

The collapse of Russia's banking sector during the financial crisis of August 1998 underscored serious problems in the supervision of credit institutions in Russia. Prior to the crisis, Russian 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 Russian banking system, including refusals by the second- and third-largest retail banks to remit private deposits.

The CBR adopted a passive stance both during and after the crisis. Most banks that defaulted on household deposits continued to hold their bank licenses for at least a year after the default. Malyutina and Parilova (2001) examine the CBR policy toward banks by analyzing an extensive data set that includes quarterly balance sheets and profit and loss accounts for 1,500 banks during 1997–1999 as well as data on employment and license withdrawal. They find that the CBR pursued a policy of forbearance both prior to and following the 1998 crisis. Many banks violated prudential ratios specified in the CBR's regulations without losing their licenses. Consequently, the CBR applied its own discretion rather than a clear set of rules when deciding whether or not to close individual banks. Banks closely affiliated with the state received liquidity support from the CBR, and banks involved in the short-term government bond market were bailed out after the debt default. The "too-big-to-fail" consideration was an important one for the CBR in choosing which banks to support. Banks in poor financial condition exposed themselves to credit risk to a greater degree than viable banks. In the absence of personal responsibility to creditors, bank managers had no incentives to save failing banks.

Unfortunately, little has changed in the supervisory environment since the 1998 crisis. There is evidence that shows a large percentage of banks still violate such basic regulating norms as capital adequacy on a regular basis (see, for example, the statement from the Deputy Chairman of the Central Bank, Andrei Kozlov, made at a recent banking congress ("TsB Lishaet Banki Deneg," 2002). Very few licenses have been withdrawn, and insolvent banks have been allowed to stay in business. In addition, it is widely believed that the CBR is not very well aware of the true state of many commercial banks, as the number of banks it has to monitor seems too large for its monitoring capacity.

Accounting Standards

The absence of proper accounting standards in Russia makes the role of the CBR as the regulator of Russian credit institutions more difficult. The Russian accounting standards (RAS), in comparison with international accounting standards (IAS), give the public very little information upon which to evaluate the financial stability of a bank. For example, the RAS often make it possible for banks to hide problems such as bad loans and falling asset prices and overstate their net worth. The lack of transparency affects not only depositors, but also the banks themselves, since the banks appraise potential borrowers based on financial statements prepared according to the RAS. With little reliable information about borrowers, banks find it hard to distinguish good risks from bad ones.

Proposed Reforms

The Russian government has been very slow to address the fundamental problems in the country's banking sector. A restructuring program implemented after the crisis through a special agency for restructuring of credit organizations (ARKO) amounted to nothing more than injections of small amounts of liquidity and know-how into twenty-one (mostly small) banks. Two larger ARKO projects, the restructuring of retail banks Rossiysky Kredit and SBS-Agro, have been complicated by the fact that most of their assets were stripped by their owners in the aftermath of the 1998 crisis.

Three years after the crisis, at the end of 2001, the Russian government finally adopted a program for reforming the banking sector, in a compromise between the cabinet, the CBR, international financial institutions, and the banking lobby. In late 2002, much of the program remained subject to legislative approval and to the test of implementation, which government programs in Russia often fail to survive. Below we discuss some of the areas in which reform has begun.

First, a law requiring the CBR to sell off its stakes in credit organizations, which de facto operate as universal commercial banks, was approved by the Duma. Yet no detailed program for privatizing these credit institutions has been drawn up. A long-planned sale of a 20 percent stake in Vneshtorgbank to the European Bank of Reconstruction and Development fell through in 2002 after the state interfered with the bank's management and assets during the negotiations. For many observers, this interference in the bank's affairs signaled the authorities' unwillingness to let go of the bank. Another weakness of this new law is that it does not deal with banks owned by local governments, which are significant in number.

Despite the new law Sberbank is not expected to be privatized anytime soon. There also seems to be very little progress on the proposed deposit insurance program, which could help curb Sberbank's unfair advantage in the retail market. A new draft of the law creating this program, which has been the subject of disagreement between the government and the Duma for a number of years, is under discussion by the cabinet.

Second, some changes in the regulatory framework have been introduced. The new minimum capital requirement for banks of five million euros, the same as that adopted by the European Union, came into force for newly created banks in 2002, and all existing banks will have to meet this level of capitalization by 2007. The capital-adequacy requirement for banks is set at 8 percent of the risk-weighted sum of the bank's assets starting in 2002 and will rise to 10 percent in 2007. By the start of 2004, all Russian banks will have to adopt IAS. These changes complement those contained in a detailed law on bankruptcy of credit institutions passed in 1999.

Although the importance of these changes in regulations should not be underestimated, enforcement of them remains the bigger task of banking supervision in Russia. The CBR is working on a new plan to simplify and increase the effectiveness of its regulation procedures, but progress in this area has been very slow. To increase the accountability of the CBR, a new law attempts to revive the National Banking Council, which was established in 1990 to oversee the activities of the CBR but has been largely inactive. It is comprised of representatives of the legislative and executive branches of the government and the CBR, who are nominated by their respective bodies and subject to approval by the Duma. The new law requires the CBR's budget, including the salaries of its employees, to be approved by the council, which will also have the power to appoint auditors for the CBR. These provisions are aimed at increasing the accountability of the CBR, but improvements in this area are far from guaranteed. The chairman of the council is the head of the CBR, leaving room for doubt as to the council's ability to hold the central bank credibly accountable for its actions.

Conclusions

The Russian banking sector suffers from a number of serious structural problems. Many observers believe that it may be heading toward another system-wide crisis within a couple of years. The combination of ruble appreciation and a leveling off of oil prices could quickly dry up liquidity in the banking sector and trigger a new collapse. A new crisis in the banking sector could, in turn, seriously derail the implementation of the rest of the country's economic reform program. Even though this may not be the most likely scenario, it is a possibility policymakers must take into account.

Incentives for banks have not changed much since the massive default of 1998. To create incentives for banks to behave efficiently and to curtail their expectations of impunity, the Russian system of bank supervision requires a great deal of reform. Although critical changes are being made—detailing bankruptcy procedures for banks, making regulations more precise, introducing a minimum capital-adequacy ratio, and requiring adherence to IAS—the main obstacle to an efficient banking sector in Russia remains the lack of proper enforcement of these regulations. The primary task in banking-sector reform is to curb political and banking lobby pressure on the central bank.

An equally important ingredient of banking reform in Russia is the overhaul of the country's judiciary, discussed earlier in this chapter. Empirical studies show that countries with weak law enforcement have little bank intermediation. To make financial intermediation an attractive activity to Russian banks, enforcement of creditors' rights in courts must be stronger. A reliable court system is also essential for proper implementation of prudential control.

The key decision makers in the Russian government are well aware of most of these problems and the available solutions, but there has been little political pressure to take action. The recent surge in economic growth has aggravated the situation, as the increased liquidity in the financial system seems to have breathed new life into previously moribund banks in a weak supervisory environment. Addressing the lack of political will to press for banking reform 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.

4.4 Social-Sector Reforms

In a modern society, effective social safety nets that alleviate poverty and inequality in the distribution of wealth are a prerequisite for social stability, and hence, for sustainable economic growth. Evidence from a broad range of countries and time periods also suggests that inequality in wealth distribution negatively affects macroeconomic stability and law enforcement.

The situation in Russia's social sphere worsened during the transition decade. The poverty rate rose from about 10 percent in the mid-1980s to about 30 percent today. In the poorest regions of the country, more than half of the population lives in poverty. Shorrocks and Kolenikov (2000) find a substantial increase in poverty rates in Russia between 1985 and 1999 that can be decomposed into contributing factors: An increase in mean income raised the poverty rates by 38 percent, and increased inequality in income distribution added another 12 percent. An adjustment of the poverty line determining who is defined as poor helped moderate the increase in the share of the population falling below this line to 26 percent. In a subsequent paper, Kolenikov and Shorrocks (2001) examine how various factors ("richness" in natural resources, geography, reform indices, political economy, characteristics of social programs, and so on) affect poverty trends in Russian regions. They find that the sets of factors explaining poverty differences across regions, with the strongest factors (accounting for up to 15 percent of the difference) being geographical location, social protection, and natural resources.

Russia has also experienced a doubling of reported crime during the transition, mostly accounted for by lower-tier, easily investigated crimes. Still, the actual crime level could be as much as one hundred times the reported official figure. Poverty, weak law enforcement, and blossoming higher-level crime (embezzlement and corruption) are usually considered to be the main reasons for the overall high crime level in Russia. According to Andrienko (2001), rising levels of common crime and violence in Russian regions are directly related to economic hardships. In addition to severe impoverishment and high unemployment, very large inequalities of resources (comparable only with that in African countries) and alcohol and drug abuse are associated with the rise in crime.

The current Russian social system is, by and large, the one inherited from the Soviet era. It requires a comprehensive overhaul to better fit the needs of a market economy, but the Russian government has evaded this task since the start of the transition. Rather, for the sake of balancing the budget, it has resorted to shrinking the size of real benefits by not indexing them adequately to inflation, flattening benefits payable to different groups, and accruing benefits arrears. These changes created chaos that made the system of social programs absolutely unpredictable.

At the same time, the collapse of government institutions gave rise to ad hoc spending cuts (via sequestrations), arrears of benefits payments (payments usually targeted at the poor), and substantial tax arrears on the part of the rich. All of this, in turn, prevented social policy from performing its key functions, namely, redistribution of wealth and social insurance.

Only within the past two years has the Russian government initiated a comprehensive social reform program. Some of the changes are still on the drawing board, and some are in the legislative process, with the relevant institutions under construction. The major goals of the reform program are to provide effective social protection for the poor and needy and to secure the population's access to basic social services, in particular, general education and health care.

Implicitly, the reform program also aims at reducing fiscal pressures on federal and regional budgets. Total expenditures for social programs in the consolidated budget and off-budget funds accounted for 19 percent of Russia's GDP in 1998 (see table 4.3). This figure is smaller than in the OECD countries and East European transition economies, but it is substantially larger than in developing countries with comparable levels of income. Expenditures of the pension fund and expenditures on housing and education are the largest spending items, followed by health care and social insurance. Although a large share of social spending in Russia is financed by

Table 4.3
Social expenditures around the world (percentage of GDP)

Russia (1998)	18.6
Eastern Europe	24.9
OECD	27.1
Latin America	10.0
South Asia	5.5
East Asia	8.4

Sources: United Nations Development Program 1994; authors' calculations.

regional budgets, social spending is still a burden on the federal budget, since any gaps in financing of social programs remaining after the regional contribution are covered by the federal budget.

Although Russia's budget allocation for social expenditures is still reasonably large, the structure of incentives in the social system is not designed for accountable implementation of public programs, and there are no competitive mechanisms to encourage efficient use of funds. So the priority for reforming the social sector, just as for the other sectors we discuss in this book, is less cutting expenditures for social programs and more introducing appropriate incentives into the country's social system.

In our view, the key social reforms that need to be undertaken in Russia are pension reform, reform of social assistance programs, and education and health care reform. The main tasks in these reforms are to

- eliminate exemptions and special provisions in the assistance programs, unless there is a strong economic argument in favor of them.
- generate a shift from overall universal support to targeted assistance for the poor.
- distinguish between social assistance and social insurance programs.
- attract (cautiously) the private sector to the provision of social programs.
- grant more discretion to regions in defining rules governing social assistance provision while meeting minimal federal standards.

Much that is involved in these reforms breaks with tradition in Russia, and the work will be made more difficult by the opaqueness, lack of administrative capacity, and the low ethical standards that characterize the federal and regional bureaucracies entrusted with carrying out the reforms. Below, we take a closer look at the tasks ahead and assess the progress that has been made so far in overcoming these obstacles.

Pensions

At the core of the current pension reform in Russia is a switch from a defined-benefits system to a three-tier system. The first tier in the new system is the defined-benefits system, used to redistribute income and provide social and disability pensions. The second tier is a compulsory (state-managed) defined-contributions system, and the third tier is a voluntary and privately managed defined-contributions system. The change creates a direct relationship between contributions and benefits, so there are no distortions to labor supply incentives, and incentives to contribute to the system are stronger. In addition, since a defined-contributions system creates an additional saving instrument, the new system will help increase savings and (under certain conditions) private investment in Russia.

The need to create additional saving instruments, however, can be addressed directly and outside of reform of the pension system, and a defined-contributions pension system is not necessarily a prerequisite for a developed financial system. Moreover, a defined-contributions system has a number of shortcomings. First, managing a defined-contributions fund involves high administrative costs. Experience from other countries shows that a defined-contributions plan can be as much as twenty times as expensive to administer as a defined-benefits plan. Second, the defined-contributions system provides too little risk sharing as compared with a defined-benefits plan, which allows risk sharing across generations and across individuals in the same generation. In contrast, under a defined-contributions plan, the individual assumes all the risks of interest rate volatility, the risk of longer than expected life, and the risk of mismanagement and poor investments. This last factor can be particularly important in Russia even if (or especially if) the fund in which the individual's plan contributions are invested is administered by the government. Outright fraud and corruption are so common that it is difficult to imagine that they will not appear in the defined-contributions pension fund, whether publicly or privately managed.

As an intermediate solution to the problem of establishing a viable pension system, a defined-benefits system with a trust fund could be considered. Currently, Russian pension funds could experience financial problems because of widespread evasion of payroll taxes. If the government manages to improve payroll tax collection (possibly by reducing the social tax, to give firms more incentive to get out of the shadow sector) and to fight corruption and fraud successfully, the pension fund will gain additional resources that could well compensate for the higher administrative costs of the proposed defined-contributions system. Part of the emerging surplus could be used to set up another trust fund, this one to buffer the system against uncertainty and output fluctuations.

Social Assistance

Reform of social assistance programs must aim at creating a general system of assistance to the poor both by organizing the existing benefits better and by reforming the principles that govern the provision of these benefits. In particular, exemptions from social taxes and special provisions for social services must be eliminated or replaced with assistance programs, unless there is a strong economic argument in favor of retaining them. The system needs to shift from offering universal social support to providing targeted help for the poor and from a categorical principle of provision to one that involves means testing. An example of the universal social support Russia offers is its housing subsidies: More than 50 percent of housing costs in Russia are covered by subsidies from regional and local budgets. In 1998, housing subsidies constituted on average 3.5 percent of the country's GDP, or 23 percent of total regional budgets.

Means-tested subsidies to individuals are a way to reform governmental housing support programs, but they may involve substantial administrative costs. In addition, perfect monitoring of income in Russia is not feasible given the high level of shadow employment as well as of corruption and fraud. Therefore, if introduced, means testing should be compatible with incentives of both program participants and program administration. The methods for means testing should be as simple as possible and require a minimal number of documents from applicants; reapplication should not be required more often than once a year. Still, even a relatively low amount of red tape will deter those with high incomes from applying for and receiving targeted subsidies. Even if a well-to-do individual has no legal income and is nominally eligible for a housing subsidy, she may not apply simply to avoid queuing and red tape.

While ensuring that minimum federal standards are met, the current reforms in the area of social assistance are also supposed to grant more discretion to regions in defining the rules under which such assistance is provided. It is worth mentioning that prior to the 1998 changes in federal regulations regarding the provision of certain types of social assistance, regions started introducing discretion in benefits provision to meet the demand for social assistance despite reduced financial resources. Denisova, Kolenikov, and Yudaeva (2000) give an example of such discretion in the case of provision of child benefits.

The system of child benefits suffered dramatically from accumulated arrears in the social sector. In 1994, 34 percent of Russian families with children in a sample survey who were eligible for the benefit did not receive it; by 1998 the proportion had increased to 80 percent. In 1996, regions began to exercise discretion in the rules for providing child benefits. Denisova, Kolesnikova, and Fedchenko (2000) analyze the effects of changes in the policy of child benefit provision on child poverty. In particular, they examine whether the introduction of means-testing schemes in the regions of Russia has improved targeting of child benefits. It turns out that the probability of getting paid child benefits conditional on being poor improved between 1996 and 1998, particularly in regions that introduced a simple income test. But the changes in child benefit provision had a negative impact on child poverty overall, that is, it contributed to increased child poverty, with the decrease in payments being the main cause of the trend.

Health Care

The objective of health care reform in Russia is to secure access to care for all citizens, while controlling the quality of services. But medical services are becoming increasingly expensive around the world, and most countries have discovered that they cannot guarantee the entire population access to all medical treatments. In Russia, free health care is formally guaranteed by the state, but there are almost as many paid services in the system as free ones. According to some surveys, the proportion of public to private financing in the industry is currently around 56:44 (see Boykov et al. 1998).

The government's program for health care reform suggests designating the services to be provided free of charge to everyone by the public health care system. All services not designated as free will be provided by the private (although regulated) system, financed through a combination of private and public insurance. The main problem with private provision of medical insurance is universal access. Poor people, people with health problems, and the elderly may not get access to private medical insurance. If the government cares about universal access to health care, it has to come up with special insurance programs for the poor, which are much more difficult to finance without a nationwide health insurance program. For redistributive reasons, it is essential to guarantee that the rich contribute to the nationwide health care system, as well as obtain additional private medical insurance if they wish.

Education

According to Russia's constitution, every child is to receive at least nine years of general schooling, which can be provided free of charge by state-financed schools. Vocational training is also free of charge. State universities are theoretically required to provide education free of charge for students in the upper 80 percent of their class in terms of performance. In practice, however, this requirement is not enforced in departments that provide the most marketable skills, such as economics, management, and law, which collect payments from most of their students.

Despite general financial hardship in Russia, the number of students at all educational levels has increased since the early 1990s. The growth in the number of university students has been particularly fast: In 1998, there was a record level of 246 university students in Russia per 10,000 people. There are also more teachers and university professors, which is somewhat surprising, given that wages in this sector are the fourth lowest of any sector in the country and often subject to arrears. This suggests that, as in health care, a substantial share of education services is provided informally at market prices.

Drougov (2001) studies factors that explain the expansion of higher education in Russia in the 1990s, using Goskomstat regional data and university-level data from the Ministry of Education. The latter data set contains information on the number of students admitted for 1994–99 and the number of applications for 1995–99 for various concentrations. Drougov finds that higher education adapts to changes in the economy and, in particular, to changes in sectoral structure. Contrary to expectations, demand-side factors are the major forces driving the expansion of higher education in Russia, rather than inertia or supply-side factors.

The aim of Russia's education reforms is to ensure all citizens access to general education, taking into account the tighter financial constraints of the Russian state now compared to during the Soviet years of a centralized economy. The reform program proposes to strike a socially acceptable balance between privately financed and publicly financed services, with free and publicly available general secondary education. To overcome obstacles facing some individuals and groups (liquidity constraints, parents' egotism, social traditions such as resistance to women's education, etc.), the state will have to intervene at all levels of the education system. Targeted distribution of special education grants and loans under the program is intended to overcome students' financial constraints, though the mechanism of allocation for these grants and loans has not yet been clarified. It makes sense to allow universities more freedom than they currently have to attract private financing in the form of grants and donations. In the meantime, some elements of a loan-financing system can be developed in specializations that are in particular demand, such as economics and business. For example, firms could fund education for students who agree to work for them for a set number of years after graduation.

But even if financial access to education in Russia is improved, there remains another big problem: The skill structure provided by the country's education system is far from what its economy needs. Denisova, Kolesnikova, and Fedchenko (2001) study the factors that influence the duration of periods of unemployment in Voronezh oblast (1994–2000), using individual-level data on registered unemployed collected by the Federal Employment Service. It turns out that there are substantial variations in the duration of unemployment periods based on educational differences: Those with junior professional education have significantly higher exit rates from unemployment compared to those with secondary general education. More surprisingly, secondary professional and university degree education do not increase an individual's chances of leaving unemployment. This suggests that there is a mismatch between the skills required by the economy and the skills provided by professional and university programs. To address this problem, public funding for educational institutions should be tied to students' employment success after graduation, rather than paid out in lump-sum transfers that in no way hold educational institutions accountable for how they are preparing individuals for the job market.

Conclusion

To conclude our discussion of social-sector reforms in Russia, we would like to stress that along with microeconomic efficiency, several other factors should be taken into account when new social expenditure programs for Russia are designed: the administrative costs of setting up and running the programs; the high level of informal economic activity, corruption, and fraud in the country; and poor law enforcement. The general rule for the reform of the social programs in Russia should be to work toward as much simplification and transparency as possible to save on administration costs and decrease distortions in agents' motivation and, in the end, allocation of public resources. Given the fiscal constraints faced by the government, the emphasis in Russian social-sector reform should be on poverty issues, moving away from universal assistance and insurance toward targeted subsidies. But there should be an absolute commitment to providing the poor with the benefits for which they are eligible and ensuring that they receive the benefits in full and on time.

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

A country's participation in international agreements and/or organizations can be a source of international accountability for the government and an external anchor for domestic reforms. Given the many failures of development and transition, policymakers and academics alike are increasingly interested in vehicles for creating external accountability. It is widely held that one of the essential factors explaining the divergence in growth and development between the Central and Eastern European countries and the CIS countries is the availability of such an outside anchor, in the form of the accession process to the European Union. Public support for EU membership in Central and Eastern Europe provided a mechanism that helped coordinate expectations of institutional reforms, greatly facilitating their implementation. To most CIS countries EU accession is not even a remote possibility. China made commitments beyond standard obligations in its

WTO accession package, presumably to exploit the commitment power of the organization with its enforcement capacity.

It has become a popular belief that WTO accession can serve as an external anchor for Russia, that is, that Russia should include a number of nonstandard measures in its accession package to anchor its reform process and establish a source of international accountability. In this chapter, we review the potential costs and benefits of WTO accession for Russia and discuss the prospects and usefulness of WTO accession as an external anchor for the process of reform.[1]

5.1 Costs and Benefits of WTO Accession

Since there is as yet no final agreement on the conditions of Russia's WTO accession, one can only speculate about the potential costs and benefits to Russia of WTO membership. We believe that major benefits can be achieved along the following lines:

- better status for Russian exports
- improvements in productivity and further development of the service sector, and more generally, integration of Russia into the global economy
- increases in inflows of FDI
- simplification and standardization of procedures related to foreign trade activities (customs operations) and simplification of licensing requirements

- less uncertainty about tariff policy
- potentially, the anchoring of some reforms not directly related to WTO requirements

At present, Russia is involved in roughly one hundred antidumping suits around the world with a total potential cost of around $2.5 billion. Accession to the WTO will allow Russia to improve the status of its exports, reducing the costs of antidumping suits and increasing business opportunities for firms that are not currently exporting. In addition, deeper integration with the world economy and a greater exchange of goods, technologies, and managerial practices with trading partners would lead to significant improvements in the productivity of Russian firms.

But these benefits may be outweighed by the exit from the economy of inefficient firms, at least in the short term. Although the exit of inefficient firms is by itself a positive phenomenon, it is perceived to have substantial negative social consequences in Russia because of the low geographical mobility of Russian labor. What is the relative importance of these two effects?

Table 5.1 provides some data on the Russian economy's degree of openness to trade. 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

Table 5.1
Protection of industries and share of imports

	Average tariff, 1999	Share of imports, 1999
Chemical and petrochemicals	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

Source: Author's calculations.

one, so we are not expecting a substantial increase in international trade as a result of WTO accession.

After accession to the WTO Russia can expect greater FDI inflows than it attracts now. Accession should spur a liberalization of inflows of foreign investment—particularly in the service sector, granting the most-favored-nation regime to foreign companies and goods—and a reduction of uncertainty in economic (mainly trade) policy. These changes should make Russia more attractive to foreign investors and therefore increase the potential for technological and managerial spillovers from foreign to domestic firms.

Yet the benefits of increased access to FDI are not fully understood in Russia. There is a strong lobby against liberalization of entry conditions for foreign companies in the financial sector, which uses a standard infant industry argument in its defense. The lobby's position is strengthened by the government's worries that liberalization of the financial sector will facilitate capital flight from Russia and make the economy more vulnerable to financial crises.

Improvements and simplification of trade-related procedures are important steps toward creating a better investment climate in Russia and stimulating FDI inflows into the Russian economy. Many foreign investors complain that customs issues are among the most serious obstacles to doing business in Russia. Effort should be directed at reducing the discretion of, for example, customs officials, improving customs procedures, and simplifying licensing and standardization requirements.

It is unclear, though, whether and how fast Russia will be able to implement the changes required by WTO accession. The task of checking legal documents for their consistency with WTO requirements seems enormous: There are 300,000 to 500,000 legal documents issued at the level of the federal government that must be checked, not to mention legal documents issued by the eighty-nine regions. But the problem of law enforcement is probably an even more serious obstacle to Russia's enjoying the full benefits of WTO accession. As we discussed in length in chapter 4, laws in Russia are often not enforced because of the lack of a legal culture in the country and the poor functioning of its judicial system. Moreover, some accession requirements may conflict with the aims of regional governments, which can impede or sabotage implementation at the regional level. Without proper enforcement of laws, Russia will not be able to realize the major benefits of accession, those related to improvements in the business climate. For instance, poor enforcement of the most-favored-nation principle, customs valuation procedures, and poor intellectual property rights protection can impede inflows of FDI, particularly those aimed at re-exportation of their products.

Potentially, Russia can include reforms in the accession package beyond those required by the WTO for membership. As an example, energy reform is widely discussed nowadays as one of the conditions of WTO accession. Measures like this will boost the government's international accountability and lend more certainty to the reform process. We doubt, though, whether it would be possible to include any such amendments. In Russia, requests to include accession conditions in the accession agreement that are not directly required by WTO membership are interpreted as a loss of sovereignty. Since the country is now trying to reestablish itself in the international political arena, the inclusion of special accession conditions seems politically impossible.

5.2 Russian Accession Strategy and WTO Accession as an External Anchor

Russia's initial move towards WTO membership was based on the desire to improve its international political position and to increase its influence in future international trade negotiations. Both the Russian Empire and the Soviet Union were strongly protected economies; Russia has no tradition of free trade and thus no cultural experience of its benefits. The experience of the 1990s, when trade liberalization coincided with a severe transition recession, created a belief among the Russian public in the recessionary nature of trade liberalization. Today, the only group in Russia that is expressing strong interest in accession is exporters, who want to improve their position in international markets. In this political context, Russia until recently tried to negotiate accession conditions that would preserve, or even raise, the current level of protection against imports and entry of foreign firms. Russia's position on deregulation of services was particularly strict because of the strong lobbies in the Russian service sector. Although arguments have been advanced that not liberalizing trade in any particular sector might inflict negative effects on other sectors, they were ignored and the benefits of speeding up structural reforms were discounted because of the threat of higher unemployment posed by such reforms.

Given the strengthening of protectionist movements in Russia and the general unpopularity in the country of binding internal policies in international agreements, we doubt that it would be politically feasible to use WTO accession as a general external anchor for Russian reforms beyond what is directly required by the WTO. But to do so, at the very least accession would have to wait until reforms become successful, growth is strong and sustained, and the desire to boost exports outweighs concerns about restructuring and capital flight (or, put more cynically, until the exporters and consumer interests outlobby the protectionists).

On the other hand, WTO accession might not be the right kind of anchor for the Russian reform movement anyway. Russia really needs reforms aimed at strengthening institutions, whereas most WTO agreements are about liberalization. Thus, WTO accession would anchor Russian reforms mainly through additional requirements, for which it would be politically difficult to gain acceptance in the current Russian climate. This makes WTO membership a less desirable type of anchor than EU membership was for the Central and East European countries.

5.3 Accompanying Policies

We expect Russia to see a net benefit from WTO accession. Nevertheless, there are likely to be initial costs involved, related both to the ability of uncompetitive firms in Russia to restructure and to the capacity of the Russian economy to make rapid structural changes. Increased mobility, particularly geographical and professional mobility of labor and the mobility of capital facilitated through the development of financial markets, is essential for accelerating structural changes and building Russia into a dynamic economy with high growth potential.

The costs of accession, however, may be unequally distributed across regions. This brings the issue of increased geographical mobility of labor to the top of the agenda. In chapter 2, we discussed the obstacle that a system of industrial feudalism poses to geographical mobility in Russia. WTO accession can be viewed as a way to dismantle this system and create a true national market. All of the measures suggested in chapter 2 for increasing labor mobility should be implemented. The same applies to educational reform (see chapter 4). Building a system that makes it easier for people to get second educations and retraining will boost professional mobility and help ease the social costs of the accession.

More generally, the measures needed to decrease the social costs of WTO accession are the same ones needed to improve Russia's business climate. The better the business climate in Russia is, the faster the necessary restructuring of the economy can occur—and the greater the benefits and the smaller the costs of accession become. For example, a strong financial system will help Russian firms finance modernization and make them more competitive in the global economy. Debureaucratization, in turn, will help alleviate social consequences by facilitating reallocation of labor to small businesses. There are many such examples, but the main point is clear: Only if WTO accession takes place as part of a larger reform package will it bring major benefits to Russia. If the Russian government understands this, it might be able to use accession as an external anchor by including in the accession offer some of the reforms most critical to realizing the benefits of accession.

6 Conclusions

Over the last four years, Russia has achieved economic growth for the first time since the huge decline in output it suffered at the start of transition. This recovery has been fueled by a substantial devaluation of the ruble, which stimulated the growth of import substitution industries. But growth can be sustainable only if Russia successfully increases the productivity of its industries and manages to attract domestic and foreign investment. For it to do so, a number of key structural reforms must be implemented.

In emphasizing the regime shift between the Yeltsin and Putin presidencies, we run the risk of exaggerating the differences between the two and playing into the mythology currently promoted in Kremlin. But our main message concerns the challenges facing the Putin administration. The Russian government has shown clearly that it recognizes the importance of reform: through its extensive three-year economic program focused directly on structural reforms and through its recent efforts to centralize political and judicial powers in the country.

Although these seem to be significant steps in the right direction, we see two major causes for concern. First, the government's economic program for 2001–2004 is very broad. It includes reforms in almost every area of society, from health care to the railway network to customs policy. A broad approach is required, given the needs and many linkages between policy areas. Many of these reforms are vital and have been thought through in detail, but in order to make implementation realistic, the government must set priorities among the various items in this broad agenda.

In this book, we have tried to suggest how the Russian government should set these priorities to lay the foundations for sustainable economic growth of the country's economy. We have emphasized the need to strengthen property rights protection in Russia, reform the country's judiciary, restructure the Russian banking sector, and reduce the arbitrary powers of government officials to intervene in private businesses as key to improving 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; this is a good indicator that enacting the reforms would help attract much-needed foreign investment to Russia. We also stress that increasing the quality of human capital in Russia is potentially an important source of productivity growth in the country. In this context, educational reform and reforms that reduce barriers to geographical and sectoral mobility of the population are critical for sustained growth in the country's human capital. Given that sustainable growth requires social stability, we give reform of the social sector in Russia high priority at this stage.

But the recent centralization of power in the hands of the president has serious implications for the course of economic reforms in Russia. Much of the failure of the Yeltsin presidency to implement economic reforms can be attributed to the lack of presidential political power to pursue initiated changes. The current centralization of power around President Putin should make implementation of reforms proposed by the center easier and more effective, but it also introduces a danger of weakening the accountability of the central government. Should the government's agenda change, recent shifts in political institutions would make it more difficult than before to influence policy. President Putin suffers from the classic dilemma of the absolute ruler: Whatever powers he or she uses today to enforce the rights of citizens can tomorrow be used to undermine these rights. It is this fundamental uncertainty, stemming from a general lack of accountability, that makes investors, domestic and foreign alike, unwilling to commit resources. The same uncertainty also undermines initiatives within the government bureaucracy at all levels of the Russian federation. Reducing this uncertainty is the fundamental challenge facing Russia if it is to embark on a path of broad, sustainable development and growth.

In a parallel development, ownership and control over corporate assets are becoming increasingly concentrated, and Russian industry is going through a remarkable consolidation. Large financial-industrial groups, often with connections to the natural resource sector, are expanding their empires, emerging as the only potential countervailing political force to the presidency. Whether it is in the interests of this oligarchy to promote entry of firms, foreign and domestic, and the development of the legal and social infrastructure commensurate with a developed market economy, or whether the oligarchs will rather protect their monopoly rents and block genuine reform while cultivating their images as philanthropists, are still open questions.

At the moment the president and large business have found a *modus vivendi,* where stabilization of Russia's particular form of capitalism has brought a more long-term perspective to both politics and business. As Treisman (2002), among others, points out, the oligarchs currently have an interest in raising the value of their assets acquired at heavily discounted prices, not always through illicit means, but often in contests where the number of bidders was severely limited by the heavily skewed distribution of wealth and weakness of the financial sector.

Better laws and stronger enforcement will indeed raise the value of these assets, but at some point these improvements will also come into conflict with the particular interests of individual oligarchs. Stronger enforcement of competition policy is a good example. The debate over WTO accession illustrates how interests may diverge, and how professed liberals have come to support protectionist policies. And dealing with a Russian government with a broad democratic base advocating large-scale redistribution is unlikely to be an attractive scenario for many in the oligarchy. In other words, there may be severe limits to the oligarchy model of economic and social development.

The bulk of experience from other parts of the world suggests that democracy and civil society are much more likely to thrive when financial and human capital are more evenly distributed (Engerman and Sokoloff 1997). In this view, for Russia to embark on a truly sustainable path of development and growth, small and medium-size businesses must gain a much firmer foothold in the Russian economy and an organized middle class take over control over the country's political process. If the proponents of this view are correct, Russia has a much longer, and more treacherous, journey before it can claim an end to its transition.

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Notes

Chapter 2

1. Authors' calculations, based on the registry of Russian firms.

2. In summer 2001 we conducted a survey that asked Russian and foreign businesspeople working in Russia how fast they expected Russia's economy to grow in the next five to ten years. Most of the respondents expected growth rates of 3–5 percent per year.

3. TFP was estimated using the firm-level data from the Russian Industrial Firms registry by means of the following two-stage procedure. In the first stage, we estimated the trans-log production function for each industry using the following formula:

$$\begin{aligned}\ln Y_t = {} & \alpha_0 + \alpha_L \ln L_t + \alpha_K \ln K_t + \alpha_t t + \alpha_{KK}(\ln K_t)^2 + \alpha_{LL}(\ln L_t)^2 \\ & + \alpha_{tt} t^2 + \alpha_{LK} \ln L_t \ln K_t + \alpha_{Lt} \ln L_t \cdot t + \alpha_{Kl} \ln K_t \cdot t\end{aligned}$$

We used a fixed-effect estimator, because the Hausman test rejected the hypothesis of consistency of the random-effect coefficients. Then, we computed growth rates of TFP for each firm in the following way:

$$\ln(A_{t+1}/A_t) = \ln(Y_{t+1}/Y_t) - \bar{\eta}_K \ln(K_{t+1}/K_t) - \bar{\eta}_L \ln(L_{t+1}/L_t),$$

where

$$\bar{\eta}_K = (\bar{\eta}_{K,t+1} + \bar{\eta}_{K,t})/2,\ \bar{\eta}_L = (\bar{\eta}_{L,t+1} + \bar{\eta}_{L,t})/2,$$

$$\eta_{K,t} = \frac{\partial \ln Y_t}{\partial \ln K_t} = \alpha_K + 2\alpha_{KK} \ln K_t + \alpha_{LK} \ln L_t + \alpha_{Kt} t,$$

$$\eta_{L,t} = \frac{\partial \ln Y_t}{\partial \ln L_t} = \alpha_L + 2\alpha_{LL} \ln L_t + \alpha_{LK} \ln K_t + \alpha_{Lt} t,$$

where Y is output (sales), K is fixed capital, and L is labor. Unfortunately, the data do not allow us to compute value added, so we use total output in the production function estimation.

Chapter 3

1. World Bank and the Russian ministry of Finance, 1997, as cited in Shleifer and Treisman (2000), p. 91.

2. Although Putin was not formally elected president until March 2000, he became the unofficial head of state in the summer of 1999 when Yeltsin appointed him a prime minister of the cabinet and approved him as a successor to the presidency.

Chapter 4

1. It would be wrong, however, to say that Russian legal protection is rendered completely ineffective by the deficiencies of the courts in the area of enforcement. Hendley, Murrell, and Ryterman (2001) show that sales managers who have better knowledge of Russian law and spend more resources on checking the legality of contracts are more satisfied with the contractual performance of their customers, suggesting that the legal system does have an impact on the enforcement of agreements.

2. Currie (1998) describes early calls for limiting judicial power in the cases of three judges appointed to the District Court of New Hampshire who went mad in the early years of the nineteenth century. It is also plausible that perfectly sane individuals may engage in abuse of power.

3. Higgins and Rubin (1980), for example, provide evidence that U.S. district court judges are more likely to be promoted if fewer of their past decisions have been reversed.

4. The authors thank Katharina Pistor for drawing their attention to these studies.

5. Landes and Posner (1975) suggest that politicians are more willing to leave the judiciary independent when future election results are less predictable so as to protect the legislation they pass from being overridden when a new political party comes to power. If the reform of the party system initiated by Putin's administration reduces uncertainty over election outcomes in Russia (see chapter 3), it may encourage increased political interference with the judicial system, according to this view.

6. For instance, the law on bankruptcy of enterprises, passed at the end of 1997, stated that bankruptcy of banking institutions was governed by a separate law, but the law on bankruptcy of banks was not adopted until more than a year later.

7. The Council of Judges is the main governing body of the judicial profession elected by the congress of judges. It represents the judicial community in interactions with central, regional, and local governments and other public organizations.

In addition to electing the Council of Judges, the Congress of Judges also elects representatives into the qualifying committees, produces professional guidelines for the members of the judiciary and serves as a platform for judges to air and resolve various issues related to the functioning of the judiciary.

8. This specification of the grounds that justify disciplinary action replaces the vague stipulation in the old Soviet law that a judge could be dismissed if he was found to have committed an act "which diminishes the honor and authority of the judiciary."

9. The fact that new laws governing bailiffs designed to replace the 1985 Soviet law were signed in 1997, but the old law was not declared obsolete until 1999, illustrates the type of inconsistencies in legislation that have commonly occurred in Russia since transition.

10. WTO accession would also require Russia to streamline its licensing procedures. We discuss this issue in more detail in chapter 5.

11. Some estimates even suggest that according to international accounting standards, the capital of one-third of all Russian banks is negative.

Chapter 5

1. In cooperation with Club 2015, CEFIR produced a document summarizing the main points of the Russian and international debate over WTO accession (CEFIR and Club 2015 2001). This chapter is based on the ideas presented in that document and on subsequent discussion of the issue.

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