Unleashing Russia's Business Potential
Lessons from the Regions for Building Market Institutions

Edited by
Harry G. Broadman

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(Continued on the inside back cover)
Unleashing Russia's Business Potential
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Harry G. Broadman

The World Bank
Washington, D.C.
Contents

Foreword ................................................................................................................................. v

Abstract ................................................................................................................................. vii

Acknowledgments ................................................................................................................ ix

I. The Regional Dimensions of Barriers to Business Transactions
in Russia: An Overview ........................................................................................................ 1
   Harry G. Broadman

II. Competition in the “Old” and “New” Economy in
Russia’s Regions .................................................................................................................. 17
   Harry G. Broadman, Mark Dutz, and Maria Vagliasindi

III. The Regulatory Regime in Russia:
The Telecom and Internet Sector in the Regions .............................................................. 42
   Mark Dutz, Maria Vagliasindi, and Harry G. Broadman

IV. Corporate Finance in Russia’s Regions:
Demand and Supply Constraints .......................................................................................... 58
   Stijn Claessens and Esen Ulgenerk

V. Dispute Resolution in Russia:
A Regional Perspective ......................................................................................................... 76
   Kathryn Hendley and Peter Murrell
Foreword

A major challenge facing Russian authorities today is how to improve the business climate to one where the private sector thrives and the country’s growth is sustained. Meeting this challenge requires actions on several fronts. Key among them are removing impediments to competition among businesses in the real sector, modernizing the regulatory regime governing infrastructure services providers, fostering the development of a financial system that effectively intermediates savings into investment, and strengthening the system for settling commercial disputes through the courts.

The government is increasingly focusing on the diagnosis and resolution of these issues at the regional level, where such problems are most acute. In 2000 and 2001 the World Bank undertook a project that focused on a series of more than 70 business case studies across 13 regions to help shed light on these issues. This volume, edited by Harry Broadman, who managed the project, contains the results of those regional case studies.

In publishing this volume we very much hope it proves to be of interest to policymakers in Russia and to the international community that focuses on Russia’s economic transition.

Julian F. Schweitzer
Country Director for Russia
Resident Representative in Moscow
Abstract

This analysis, based on more than 70 company case studies across 13 Russian regions during the spring, summer and fall of 2000 and the summer of 2001, examines four key issues that Russian firms face in carrying out business transactions in Russia's regional markets: (i) the state of inter-enterprise competition; (ii) the regulatory regime governing the delivery of infrastructure services (with a focus on the telecom and Internet sector); (iii) the sources and use of corporate finance; and (iv) the efficacy of the court system in fostering the settlement of commercial disputes. The study formulates policy recommendations for each of the areas analyzed. In so doing it sheds light on salient inter-regional differences in existing policy frameworks and in the structure and nature of the country's enterprise sector, as well as on how regional governments and firms both respond to and shape these differences. The study also highlights the evolution of inter-regional policy and economic changes over time, assessing the extent to which, two years after the 1998 crisis, enterprise restructuring at the local level has been affected by the devaluation of the ruble.
Acknowledgments

The field missions, case studies and data analysis on which this study is based are the product of a team comprised of: Harry Broadman, Julia Chekaljuk, Stijn Claessens, Simeon Djankov, Mark Dutz, Kathryn Hendley, Peter Murrell, Tatiana Nenova, Jeff Procak, Francesca Recanatini, Elena Shtykanova, Esen Ulgenerk, and Maria Vagliasindi. The team would like to express its sincere appreciation to the many businesses, banks, government officials, chambers of commerce, and courts in Krasnodarskii Krai, Leningradskaya Oblast, City of Moscow, Moscovskaya Oblast, Omskaya Oblast, Novgorodskaya Oblast, Novosibirskaya Oblast, Primorskii Krai, City of St. Petersburg, Samaraskaya Oblast, Saratovskaya Oblast, Sverdloskaya Oblast and Volgogradskaya Oblast who contributed to this study and from which the team learned much about Russia's local economy. This monograph benefited from comments by: Asad Alam, Michael Carter, Jackie Coolidge, Joel Hellman, John Nellis, Guy Pfefferman, Karl Skansing, Peter Thomson, and Debbie Wetzel. Sandy Craig assisted in typing the study.
I. The Regional Dimensions of Barriers to Business Transactions in Russia: An Overview

Harry G. Broadman*

Introduction

Growth is finally underway in Russia. But is this new-found growth—initiated largely by the import-substitution effects from the devaluation of the ruble and increased world oil prices—sustainable? Russia still faces the daunting challenge of restructuring its enterprises and engendering new business investment. While privatization initiatives successfully changed the ownership of many of the country's firms, they have not led to major restructuring of most incumbent enterprises. The mode of privatization most commonly used relied on worker-management buyouts and the resulting insider-controlled firms faced weak incentives to restructure, especially against the backdrop of a policy framework that, up until relatively recently, permitted soft budget constraints. At the same time, the growth of de novo private sector businesses in Russia, especially small and medium enterprises (SMEs), is strikingly low, particularly when compared to other transition countries in Central and Eastern Europe. Moreover, the vast majority of new businesses that have taken root are located in the largest, wealthiest cities, such as Moscow and St. Petersburg, exacerbating the already skewed pattern of development of Russia's regional geography.

An incentive framework that engenders efficiency and predictability in business transactions is crucial for sustained enterprise development. In developed market economies, these incentives are conditioned by a set of basic market institutions that work to facilitate and reduce firms' costs of transacting, whether in terms of new investments or restructuring of existing operations. These institutions include vigorously enforced competition policy to keep in check market power exercised by dominant incumbent firms and facilitate the entry of new enterprises; a regulatory regime that ensures that tariffs for and access to infrastructure utility services are market-oriented while protecting the public interest through a decision-making process that is transparent, rules-based and independent; an efficient system for the intermediation of savings into investment capital and the provision of finance to businesses on commercial terms; and an effective legal system to foster the settlement of commercial disputes.

There is little question that Russia has made significant progress in dismantling the central planning system, which, during the Soviet era, had directly governed Russia's industrial structure, conduct and performance. But, to date, the development of these basic market institutions to take the place of central planning remains nascent—especially in regional markets, where day-to-day business transactions are conducted. This is the principal factor making the costs of doing business in Russia excessively high and impeding enterprise formation and restructuring. While there has been much debate as to why at the national level the restructuring of Russian enterprises has been partial and new private sector start-ups are struggling to emerge, little systemic analysis has been carried out to assess the state of basic market institutions in Russia's regions. This study helps to fill this gap.

Assessing the development of market institutions at the regional level is of paramount concern to the Russian authorities as they increasingly focus on ways to reform the fundamental underpinnings for fostering business investment and sustaining growth and move beyond the narrow and less intractable issues such as how to reduce administrative barriers to firm registration and licensing. Indeed, deeper economic diagnosis of how basic market institutions create incentives and constraints on business transactions at the regional level in Russia is essential for the design of "second generation" medium term structural policy reforms. The focus on local market institutions is thus a

key and novel aspect of this study, given that, in practice, reform in the regions will have the most
direct impact on Russian enterprise behavior and growth.

This study is based principally on the analysis of original in-depth company case studies and
interviews of general directors and other senior managers of more than 70 enterprises, infrastructure
monopoly utilities, and banks, as well as of senior regional government and chamber of commerce
officials, carried out in the field during the spring, summer and fall of 2000 and the summer of 2001
among thirteen Russian regions: Krasnodarskii Krai, Leningradskaya Oblast, City of Moscow,
Moscovskaya Oblast, Omskaya Oblast, Novgorodskaya Oblast, Novosibirskaya Oblast, Primorskii
Krai, City of St. Petersburg, Samaraskaya Oblast, Saratovskaya Oblast, Sverdloskaya Oblast and
Volgogradskaya Oblast. In order to foster a frank discussion of the prospects and problems of the
business environment, all individuals and institutions that participated in the case studies were
guaranteed anonymity. The study team has supplemented the results of the field case studies and
interviews with data from secondary sources and from earlier firm-level surveys with which they have
been associated.

The objective of the study is to facilitate the formulation of new policy initiatives in order to
improve Russia's business environment—especially in regional markets. In so doing, it sheds light on
salient inter-regional differences in existing policy frameworks and in the structure and nature of the
country's enterprise sector, as well as on how regional governments and firms both respond to and
shape these differences. To give added focus in developing these policy recommendations, the study
focuses on certain industry sectors. In the analysis of competition, for example, the study compares
the evolution of competitors in the "new" versus the "old" economy sectors; and in the analysis of the
regulatory regime, the focus is on the telecommunications and Internet sectors. The study also
highlights the evolution of inter-regional policy and economic changes over time. Thus it assesses the
extent to which, two years after the 1998 crisis, enterprise restructuring, import-substitution, export
expansion, and job creation/destruction at the local level has been affected by the devaluation to the
ruble.

The structure of this study—and the thematic focus of the following chapters—is organized
around the four areas of institutional development highlighted above: (a) determinants of inter-
enterprise competition and market structure and the policy framework governing them at the local
level; (b) the regulatory regime governing the price, supply and access to local infrastructure services;
(c) access to corporate finance in regional markets; and (d) the legal system for resolution for
commercial disputes. Policy recommendations for each of the respective areas are outlined at the end
of each chapter.

This chapter presents a brief description and analysis of the various regions under study. It
then provides an integrated overview of the main points of the thematic chapters.

Description of the Studied Regions

Among the thirteen regions under study, there is substantial heterogeneity in their basic
attributes, as illustrated in Tables 1 and 2. The regions span most of the key geographical dimensions
of Russia, from the cities of Moscow and St. Petersburg in the West and North West, respectively, to
Volgogradskaya in the South, Primorskii in the Far East, and Novosibirskaya in Central Siberia.

As Table 1 indicates, some of the regions are very densely populated (Moscow and St.
Petersburg Cities), while others are relatively sparsely populated (Volgogradskaya, Novgorodskaya,
and Primorskii). All the regions are relatively urbanized, with more than half of their populations
living in urban areas—although Moscow and St. Petersburg are at one extreme, with 100 percent
urbanization, while just over 50 percent of Krasnodarskii’s population lives in urban areas. Moscow
City stands out as the wealthiest region, as measured by Gross Regional Product per Capita, followed
by Samaraskaya and St. Petersburg; most of the rest of the 13 regions are in the same range, except for
Saratovskaya, Volgogradskaya, and Omskaya, which are the poorest regions under study. While there is a fair amount of regional uniformity in terms of share of the population that is of working age, there are much greater differences with respect to proportion of the population completing higher education. Self-financing for budgetary expenditures from locally-raised revenues also varies greatly among the regions.

Table 2 contains data describing various enterprise-related aspects of the regions. Sverdlovskya and Samaraskya are the most industrialized of the regions under study, as measured by the share of workers employed in the industry sector. Owing to the prominence of the service sector in Moscow City and of the agriculture sector in Krasnodarskii, these two regions rank as the least industrialized of the 13 regions. The share of the employed population working in SMEs is highest in the cities of St. Petersburg and Moscow (at levels between 20 and 25 percent), which is not surprising inasmuch as these two locales account for the overwhelming bulk of SMEs for the country as a whole; for the other 11 regions, the share of employment accounted for by SMEs is at most around 7 percent or less.

There are dramatic differences among the regions with respect to the extent of registered foreign direct investment (FDI), both in terms of the absolute stock of FDI and the stock of FDI normalized by population levels. Enterprise performance, as measured by share of firms exhibiting losses, also displays wide variation among the regions, with Moscow and St. Petersburg registering the fewest proportion of loss-making firms, and Omskaya, Krasnodarskii, Primorskii and Sverdlovskya registering the greatest proportion. However, in terms of measured unemployment, apart from Moscow City, which registered the lowest unemployment rate by a substantial margin, the unemployment rates among the remaining regions does not vary significantly.

**Competition in the “Old” and “New” Economy in Russia’s Regions**

In their analysis of competition, Broadman, Dutz and Vagliasindi undertake an approach that assesses the incentives and constraints on inter-enterprise competition. They focus on factors that give rise to barriers to new competitive entry and that permit restrictive business practices by incumbent firms able to exercise market power, as well as by state executive bodies who undercut competition through powers they possess by dint of their legal authority. An important feature of their analysis is comparing firms in Russia’s “old” and “new” economy. This approach allows them to explore the extent to which businesses belonging to the “old” economy continue to be shaped by, or have overcome, the planning legacy of the Soviet era, influencing the extent to which they have been able to restructure into competitive enterprises. At the same time, the taxonomy enables an assessment of how much “new” economy businesses have been able to exempt themselves from the Soviet inertia, the influence of vested interests and transition-related distortions; in short, how much they have been able to grow and prosper more in line with competitive forces, unencumbered by the problems that have plagued their older counterparts. While there are—necessarily—many “old” economy sectors in Russia on which such an approach can focus, the authors concentrate on construction materials, food and beverages, wood processing, fishing, machine building, metal fabrication, electronics and textiles. As a representative of the “new” economy, they selected the software industry.

The authors’ case studies result in a variety of findings on the state of competition in Russia’s regional markets. The extent of state/government involvement in business affairs continues to make a significant difference in the strength of competition—particularly in the “old” economy sectors. In most of the regions visited, there is a continuing—albeit metamorphosized—direct role of government in the marketplace, which more often than not has a negative impact of diminishing new business entry, largely benefiting the “old” economy firms. In particular, the case studies reveal incestuous “captured” relationships between government agencies and incumbent businesses, where their joint actions directly influence the extent to which new competition can thrive.
Table 1: Socio-Economic Comparisons of the Regions

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<tbody>
<tr>
<td>Krasnodarskii Krai</td>
<td>5,007</td>
<td>65.9</td>
<td>21,525</td>
<td>53.7</td>
<td>55.5</td>
<td>115</td>
<td>52</td>
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<td>25,396</td>
<td>66.0</td>
<td>58.2</td>
<td>108</td>
<td>69</td>
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<td>City of Moscow</td>
<td>8,537</td>
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<td>78,488</td>
<td>100.0</td>
<td>58.2</td>
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<td>140.8</td>
<td>24,510</td>
<td>79.8</td>
<td>58.3</td>
<td>161</td>
<td>63</td>
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<td>Omskaya Oblast</td>
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<td>15.5</td>
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<td>57.8</td>
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<td>50</td>
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<td>22,418</td>
<td>71.1</td>
<td>56.2</td>
<td>104</td>
<td>47</td>
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<td>2,740</td>
<td>15.4</td>
<td>21,218</td>
<td>74.0</td>
<td>58.5</td>
<td>135</td>
<td>44</td>
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<td>Primorski Krai</td>
<td>2,172</td>
<td>13.1</td>
<td>25,071</td>
<td>78.3</td>
<td>62.3</td>
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<td>34,334</td>
<td>100.0</td>
<td>59.7</td>
<td>247</td>
<td>67</td>
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<td>36,736</td>
<td>80.5</td>
<td>59.2</td>
<td>135</td>
<td>62</td>
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<td>73.2</td>
<td>57.6</td>
<td>141</td>
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<td>26,685</td>
<td>87.5</td>
<td>58.4</td>
<td>109</td>
<td>54</td>
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<td>2,677</td>
<td>23.5</td>
<td>18,603</td>
<td>74.1</td>
<td>56.8</td>
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Some regional administrations employ protectionist policies to insulate "local champions" from competition—not only competition from within an oblast but from firms domiciled in "foreign" oblasts. For example certain oblasts have devised local registry stamps—under the guise of "ensuring quality control"—that have to be purchased and placed on beverage containers for the beverages to be sold within the oblast. Regional air transport provides another example. Collusion between local airlines and airports gives rise to effectively exclusive landing rights for local carriers: runway repairs are temporarily halted for local airlines to land, but for non-local airlines, the repairs are either stopped at inconvenient hours or not at all. Clearly, the cozy relationships between local firms and local administrations hamper inter-regional trade and investment flows, reducing the prospects for competitive pressure. But there are cases where government is playing an indirect, competition-reinforcing role in the market. More progressive and reform-oriented regional administrations, such as Novgorod's, have promoted new business entry, enterprise restructuring and a more flexible labor market through judicious economic and fiscal policies, bolstered by greater policy stability and transparency.
Table 2: Enterprise-Related Regional Comparisons

<table>
<thead>
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<td>3.7</td>
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<td>76.7</td>
<td>110</td>
<td>14.5</td>
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<td>Novosibirskaya Oblast</td>
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<td>7.4</td>
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<td>371.8</td>
<td>133</td>
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<td>4.6</td>
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<td>36.6</td>
<td>199.5</td>
<td>154</td>
<td>12.5</td>
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</table>


In the “new” economy, Broadman et al find that government has yet to catch up with the market; as a case in point, the software industry benefits from the lack of sector-specific regulation. Lingering social obligations burden enterprises—especially those in the “old” economy—and serve to undermine the free play of competitive forces.

Yet unanticipated distortions are being engendered through some of the more celebrated enterprise reforms in Russia—particularly the policy to foster SME development. This industrial policy is, in fact, artificially constraining business growth. For example, certain SME tax incentives create palpable inducements for businesses to remain at certain scales, lest they not enjoy tax concessions. These distortions are hampering exploitation of SME economies of scale.

The 1998 debt default, economic crisis and ruble devaluation have prompted significant enterprise restructuring and changes in competitive strategy—especially in the “old” economy sectors—that are likely to change the face of certain market structures. Many firms interviewed for the case studies—particularly those in the tradeables sectors, such as wood processing, textiles and food—have embarked on restructuring (and expansion) strategies to take advantage of the void created by now-expensive imports and new opportunities of hitherto “off limits” export markets and are targeting sales to increase market share and profits. Restructuring is manifested in significant diversification of product lines, rationalization of production and integration and conglomeration through mergers and
acquisitions (both vertical and horizontal), reduction in the share of barter and offsets as means to effecting commercial transactions, diversification of sources of supply, seeking out and responding to institutional investors (both foreign and domestic), and changes in the skills mix in staffing the workforce.

In general, Broadman et al find that firms face few effective competitors in their markets and that concentration seems to be increasing. At the national level, the degree of concentration of industrial output in Russia appears to suggest an absence of a structural competitive problem. The average national 4-firm concentration ratio (the sum of the market shares of the top four producers) is about 60%. For many industries, Russia and more industrialized countries (such as the U.S.) have similar 4-firm concentration ratios, and the largest Russian manufacturing enterprises (measured by number of employees) are not unusually large compared to firms in more industrialized countries. However, this aggregate-level analysis masks important underlying attributes of Russia's industrial landscape. Large Russian enterprises tend to be configured as single integrated multi-plant establishments, often located in or near a single city. In contrast, in industrialized economies a given enterprise usually has multiple establishments and they are located across domestic regions and often abroad. On an establishment basis, the largest Russian enterprises are significantly larger than their counterparts in other countries. Survey data from 1997 indicate that the average market share at the oblast level is 43%. Recent data on concentration indicate that at the oblast level, the average 4-firm concentration ratio is above 95%. Many of the dominant enterprises in Russia are also highly vertically integrated. Excessive levels of vertical integration superimposed on (horizontally) concentrated product markets can foreclose the entry of rival firms. The high degree of observed vertical integration largely reflects inertia of the uncertainties and chronic shortages of the old Soviet supply system. But vertical integration is also increasing, occurring usually through mergers and acquisitions rather than through de novo expansion.

In the case studies, concentration in market shares appears to be more frequently due to few firms rather than many firms of very unequal size. While it is difficult to generalize, in almost every sector analyzed, businesses indicated they faced a maximum of 3-6 competitors in their oblast/regional market. Not surprisingly, many of the firms indicated they had relatively sizeable market shares (at the regional level), indicating a moderate degree of horizontal dominance, often brought about through horizontal integration, i.e., horizontal mergers. The case studies also reveal an appreciable degree of vertical integration—particularly in "old" economy sectors; for example, some construction firms made bricks and other construction materials and were building and selling apartment buildings (to regional governments). In most cases, if there was not vertical integration, there were exclusive buyer-seller relationships through contracts.

Our case studies suggest that firms' ability to exercise market power is enhanced with concentration. One manifestation of this is that many of the firms we studied had plants that appeared to be above "minimum efficient scale" (i.e., the production level where unit costs are lowest). Indeed, during site visits our attention was often drawn to facilities that a general manager would proudly proclaim as being "the biggest in Europe". The fact of the matter is that such excess productive capacity serves as a credible threat to deter potential rivals from entering the market.

Much has been written about the problems posed by so-called "administrative barriers" to businesses in Russia, and policy-makers have given sizeable attention to these issues. To be sure, these problems are real. But Broadman et al find that a systemic examination of business transactions in Russia's regions reveals far more fundamental and sometimes less visible impediments to business start-ups and expansion in the underlying competitive fabric of markets. The case studies suggest that the competitive success of many (though not all) of the firms investigated was significantly determined by privileged relationships they enjoy with governmental authorities—especially local administrations, less so federal agencies—rather than their ability to serve effectively customers. Indeed strong political economic power is wielded by regional authorities. This power manifests itself, in part, by preventing entry from firms in neighboring oblasts in order to protect the market shares of local champions. Among other means, entry is deterred through local government practices involving
subsidies, anti-competitive disposition of marketing rights, access to land and real estate, and so on (recall also the example above regarding local air transport exclusivity). A key constraint new startups and expanding medium sized firms face in the industrial sectors is the market power exercised by large, dominant incumbent enterprises that occupy concentrated market segments through their pricing, investment and marketing strategies. By the same token, a critical bottleneck constraining entry is the market power exercised by infrastructure service providers and the regulatory regime governing their service offerings. In addition an important barrier to entry and expansion that stands out from the majority of case studies in the “new” economy software sector is the uneven playing field determined by lack of enforcement of intellectual property rights that lead to piracy. Problems of excessive inspection intervention, indeed the political economy use of inspections, in business activities by various governmental bodies—especially federal agency branch offices in the regions—are highly problematic.

Broadman et al’s case studies show that that lack of competitive access to warehousing and distribution facilities, due to monopolization and corruption, also is stifling competitive entry in Russia’s local markets. In addition, the inability to secure competitively priced financing and for a sufficiently reasonable term is a significant impediment. There is also a difficulty in finding expert workers. Indeed, many of the managers in the studied firms indicated that despite stronger demand for their products following the ruble devaluation, their attempts to expand production capacity are hampered by the lack of labor trained in modern management techniques and in specialized areas such as use of computer programs. Although most firms acknowledge that a large part of the problem is that they are unable to offer competitive wages, the shortage also is the result of institutional constraints that engender limited regional mobility within the country.

In devising policy recommendations, Broadman et al note that although business competition in Russia’s regions has intensified significantly in the wake of the 1998 crisis, the incidence of competition varies considerably across sectors and across regions, which is not surprising in an economy undergoing transition and as heterogeneous as Russia’s. Still, it is not clear the extent to which the new competitive pressures are enduring.

The case studies suggest that it is important for Russia’s competition policy regime to place emphasis on dealing with horizontal and vertical structural market imperfections among incumbent industrial firms to create economic space for new entrants. Priority attention and resources—both human and political—would be best directed toward those markets where there is already significant concentration and structural dominance; other markets can be dealt with subsequently. Moreover, policy emphasis on preventing further horizontal and vertical consolidation through mergers and acquisitions in markets where concentration and structural dominance are already excessive would be highly desirable. In this regard, more explicit and well-defined merger guidelines could be developed to establish general policy parameters for distinguishing between pro-competitive and anti-competitive mergers based on similar guidelines used in industrial countries, such as the EU and the US. But a balance must be struck between, on the one hand, prohibiting excessive enterprise integration that engenders the exercise of market power, and on the other, fostering sufficient integration that permits the realization of technical economies of scale and scope.

Equally important is the need to create bona fide economic competition both within and among regions. This would include the removal of regional government barriers to inter-regional trade and investment. Indeed, the use of licenses, taxes, loans, debt forgiveness or other instruments to favor some local enterprises over others should be harshly penalized under the existing provisions disciplining anti-competitive acts by state executive bodies. To facilitate trade and investment within the country, all requirements that unduly obstruct economic activity, such as bans on the import or export of goods and services across localities and oblasts, unequal price controls or taxes for local versus non-locally produced goods, or the granting of other unequal privileges to some enterprises and not others should be removed based on enforcement of the provisions related to state executive bodies. The current SME tax concession regime needs to be reformed so as to reduce the incentives for firms
to remain at small scales so as to qualify for tax benefits. Consideration might be given to provide the SME tax credits along a sliding and less graduated scale.

The regional branches of the Ministry of Antimonopoly Policy and Support for Entrepreneurship (MAPSE) needs to play a stronger role. Clearly stronger enforcement is needed at the regional level against anti-competitive conduct by incumbent dominant firms. As part of their competition advocacy mandate, regional MAPSE offices would do well to undertake more regular educational activities aimed at ensuring that the public at large as well as all enterprises, especially start-ups, are aware of the importance of the competitive process in practice, and the objectives and content of the competition law. Consideration should be given for a new policy of making federal transfers to the regions conditional on progress in removing barriers to inter-regional trade and investment. This could help counteract the captured relationships between local government agencies and incumbent businesses.

At the same time, in order to foster new business entry, it is essential to improve access to distribution, warehousing and infrastructure services. Facilitating access to distribution channels and warehouses requires the competitive restructuring of powerful incumbent monopolies (often government sanctioned) and combating the corruption that is prevalent in these sectors. With respect to infrastructure services, regional transport facilities—especially road, rail and air networks—need to be modernized, prices need to be set in accordance with cost, and access allocated competitively. With a more competitive telecommunications network will come increased availability and affordability of data and information services, and the development of e-commerce, which can significantly lower transactions costs across oblasts and facilitate downstream entry. Facilitating private access to real estate is a policy priority to enable new entry. To this end, rapid implementation of the new Land Code at the local level is needed. Now that the legal constraints on private ownership have been removed, local governments need to realize that the commercial, fiscal and economic benefits of divestiture far outweigh those from continued government ownership.

Breaking the nexus between incumbent firms and regional governments to foster competition will require fundamental reforms, such as in the civil service, so that salaries are appropriately increased and performance-based reward structures are introduced. But other reforms will be necessary, for example, prohibiting the use of fine-generated resources to fund inspection bodies or preventing tax inspectorates from using the revenues from fines to meet their tax revenue quotas. There is a need to establish independent monitoring systems as a check on reform implementation. As an example, monitoring mechanisms in the area of business inspections could thus include: (i) quarterly public reporting by inspection/supervisory agencies about their inspection activities; (ii) introduction of inspection logs at enterprises and organizations; and (iii) establishment of coordinating boards to organize inspection activities (these boards would be responsible for monitoring and summing up the results of all inspections, as well as for maintaining a database of such inspections). An important lesson from international experience is that transparent and participatory regulatory impact assessments (RIAs) should be institutionalized for new regulations, in order to subject any proposals to cost-benefit scrutiny.

Clearly, continuation by the government of its current well-designed efforts to de-bureaucratize and reduce administrative barriers, such as reform of the registration and licensing regime for new firms, would be helpful. These will surely help reduce one component of the impediments business start-ups face in Russia. Of course the key to success of such legislative initiatives is the extent to which once they are enacted, they are implemented and their provisions are actively enforced. Appropriate incentives and disincentives thus need to be created in order to ensure satisfactory results. This is particularly challenging at the regional level, where there is a long history of discretionary actions by local officials and collusion between them and incumbent firms.

Finally, Broadman et al argue that more effective protection of intellectual property rights is required to address the R&D market failures and uncompensated benefits and costs. This should stimulate entry and expansion, especially by producers in the "new" economy through the recapturing
of market shares stolen by pirates. Russia is making steps towards protecting companies’ intellectual property rights as it strengthens its legal framework in preparation for WTO membership. Indeed, more generally, competition in Russia’s markets will be significantly enhanced from the liberalization of the trade and investment regimes that will come with accession to the WTO, and thus this objective should be a policy priority for the government.

**Infrastructure Regulation in Russia’s Regions:**
**The Telecommunications and Internet Sector**

The operations and structure of the network infrastructure services sector in Russia—encompassing the energy utilities, transport operators, and telecommunication providers, among others—condition the development of the country’s “real” sectors. Indeed, there is accumulating evidence that one of the principal burdens on efficient enterprise entry, expansion and innovation in Russia is the extent to which infrastructure service providers pose bottlenecks to broader commercial activity. In principle, one of the tasks of the economic regulatory regime governing infrastructure firms is to minimize such bottlenecks. Of course, as in all economies, while such “utility” regulation should enable government to provide important economic and social protections to the users of the services—both the population at large as well as businesses—it invariably also imposes costs. In Russia these costs arise not only from inappropriate *rules* (for example, prices not being in line with market incentives and social cost valuation), but also inappropriate *application* of utility-related rules (for example, some enterprises within the same industry are entitled to special privileges, whether in terms of access and/or pricing). There are several benefits for Russia of fostering liberalization of the infrastructure sectors, accompanied by transparent and clear “rules of the game.” First, these sectors are important sources of employment and innovation in their own right. Moreover, more efficient provision of infrastructure services, in turn, will allow the development of the downstream (real) sector, as the latter depends crucially on more efficient infrastructure. Finally, transparent regulation will help to reduce incentives and opportunities for corruption and preferential privileges for certain operators both at the upstream and downstream sector.

Much has been written about the regulatory problems—both political and economic—and about the debate concerning reform initiatives in the “traditional” infrastructure sectors in Russia, such as electric power, natural gas, and rail transport. But there has been relatively little analysis of arguably the most dynamic Russian infrastructure sector—the telecom network, especially enhanced telecom services, such as Internet services. *Dutz, Vogliasisindi and Broadman* focus on the role of the telecommunications and Internet sector and its regulation in Russia. The sector is increasingly becoming a key facilitator of inter-regional—and international—trade and investment in the country, and how it develops will be crucial in reducing business transactions costs and allowing for exchanges that otherwise would not take place.

The Russian telecommunications industry structure is generally characterized by market and competitive fragmentation, largely due to the lack of a transparent and clear sector strategy. Although consolidation is rapidly underway, the traditional fixed-line market is currently organized into 89 regions, each of which has an incumbent operator. All of these operators provide local, long-distance and international voice services, and many also offer data transmission, mobile and Internet services. The telecom holding company Svyazinvest controls the majority of these. Only three regional operators (MGTS, which serves the city of Moscow; PTS, which serves the city of St. Petersburg; and Moscow Electronsvyaz, which serves Moscow region apart Moscow itself) have more than 1 million access lines accounting together for approximately 27% of total access lines in Russia. Competition to the traditional incumbents is starting in many regions, particularly in Moscow and St. Petersburg. The announced sector consolidation through the creation of seven new enlarged supra-regional telecom operators is proceeding ahead of schedule, with the merger terms already announced for all companies. In particular, the swap terms for all seven enlarged regionals have been approved by all shareholders.
The Regional Dimensions of Barriers to Business Transactions in Russia

except for those in the Central region, where the process is expected to be formally completed before the spring of 2002.

The Russian Internet sector is still in the early stage of development, with penetration just around 3% compared to an average of over 20% in Europe. On the other hand, the Russian market is now growing at exponential rates, comparable to the fast growth in the US after 1995. Still, the Internet business in Russia is highly fragmented. There are around 300 companies licensed to provide Internet access services. More than half of the Internet Service Providers (ISPs) are based in Moscow and St. Petersburg. Quality of the service varies significantly throughout Russia depending mainly on the public network involved in the transmission process.

The telecom industry is generally overseen by the Ministry of Communications (MoC). However, the Ministry of Antimonopoly Policy and Support for Entrepreneurship (MAPSE) and the regional administrations also exert some power, such as the setting of tariffs. In September 2001 President Putin signed a decree setting in motion the creation of a new Unified Tariff Body (UTB) with sectoral jurisdiction over regulation of effectively all infrastructure prices in Russia, including telecommunications. The UTB would be based on the existing Federal Energy Commission (FEC), and in the case of telecom rate-setting, absorb the authority currently vested in MAPSE.

In their analysis of the regulatory framework, Dutz et al highlight several problems emerging from the case studies. The key issue identified by the telecom operators is the lack of transparency on the procedural aspects of licensing, aggravated by the lack of formalized and specific appeal procedures. For example, formal technical requirements are very unclear and, in some cases, inconsistent with each other. The unpredictability in terms of changes in licensing terms at the time of renewal is extremely high. This dramatically reduces ex-ante incentives to invest in view of the ex-post renegotiation of licensing conditions. In addition, users and operators are given the right to interconnect their network and terminal equipment to the public switched telephone network (PSTN) if they meet the "interconnection requirements" set out by the government, which are provided by the common carriers or stipulated in the license. Since the list of conditions under which access can be denied includes lack of technical capabilities, many carriers experience delays and difficulties. There are provisions of non-discrimination among operators when issuing technical requirements for interconnection, but the criteria to assess discriminatory behavior are not defined, nor is the role for the regulator to detect and deal with discrimination. Lack of transparency and reasonableness with respect to fees prevail as well. These problems appear to be particularly severe in less developed oblasts, very likely due because of the quasi-monopolistic structure for interconnection providers.

Given the fixed nature of regulatory costs imposed on enterprises irrespective of company size, the burden of administrative and utility regulation falls most heavily on smaller start-ups. Costs can be substantial relative to revenues generated by a small enterprise, generally in the range of 10% of annual revenues. There is also the continuous uncertainty of new regulations. The uneven playing field penalizing smaller ISPs is aggravated by the problems on the demand side. Such problems include targeting less attractive customers that also view the Internet as less essential for their work, as the largest customers are served by the few privileged ISPs. However, very limited problems of non-payment are experienced, because of pre-paid tariffs—increasingly used after the financial crisis (especially in the case of riskier customer groups)—and due to the practice of dealing only through agencies that guarantee for the payment of associated enterprises. Another problem is lack of proper support for the equipment. Some telecom operators switch suppliers despite the considerable costs. Even the largest clients, despite being in a very privileged position—by receiving favorable discounts, credit terms, and distribution agreements—complain about the lack of customer care of equipment.

As to policy recommendations, Dutz et al note that delays by regional administrations in introducing more rational policies towards the telecoms sector stifle urgently needed investments in network infrastructure, adversely affecting all operators. The fact that tariffs for local calls for residential customers are so low has starved regional operators of funds for urgent investments, in turn exacerbating the problems surrounding access to the network infrastructure. Starting from November
1999, MAPSE started to raise telecom tariffs. The increases exceeded inflation and ruble depreciation, with tariffs starting to grow in real and dollar terms. However, tariff regulation continues to lack predictability, as there is no clear tariff formula and increases are authorised sporadically. Moreover, the process of tariff changes is open to political interference. In practice, regulation of private operators means including them on the government's list of "natural monopolies". However, it is not clear that the laws on natural monopolies and on competition provide for the inclusion of private telecom operators into the natural monopoly list in the way that MAPSE intends. If the government wants to find investors for Svyazinvest and its seven pan-regional subsidiaries, it will have to convince them that there will be less political interference in the sector.

A priority for reform of the telecom and Internet sector would include promoting further private sector involvement, with specific measures to stimulate competition. Options include unbundling Svyazinvest by separating and liberalizing international long distance and local calls; consolidating local telecom operators and allowing them to compete with each other; and licensing additional wireless local loop operators as alternative access providers. Of equal importance is the need to establish an improved, independent, transparent and publicly accountable regulatory oversight process and institutions, and bringing Russia closer to meeting WTO and EU requirements. In this context, Russia should consider giving the regulatory power for interconnection to the same institution responsible for price regulation, ideally vesting both functions in a new sector-specific regulatory agency. With the creation of an independent sector regulatory agency, MAPSE would no longer be responsible for tariff-setting processes and supervision, leaving technical and pricing regulation to the specialized agency. On the other hand, MAPSE could play a more forceful role in the determination of the appropriate scope of the regulatory authority, of the appropriate market structure of the telecommunications markets, and focus on controlling anti-competitive conduct by dominant enterprises. It is still too early to assess the likely impact of the establishment of the Unified Tariff Body, but it raises several key issues that need to be resolved. One is the potential benefits and costs coming from the establishment of a single cross-sectoral regulator. Worldwide, sectoral agencies are considered to be more desirable because of the presence of strong economies of specialization and because they diversify the risk of institutional failure. Another key issue to be resolved is the definition of the (sub)sectors that can be considered as "natural monopolies" and should as such be subject to regulation at all. In telecommunications, technological progress has rapidly eroded monopolistic practices and "protected markets", even for fixed line local providers, so no segment of the sector can any longer be considered a natural monopoly.

There is also a need to strengthen coordination among the institutions charged with oversight of the sector, such as the Ministry of Communication and MAPSE, especially the latter's oblast branches that appear to lack authority in addressing cases of abuse of dominant position and discriminatory licensing or providing access to the network. In addition, uniform inter-regional guidelines are needed for licensing, along with clear terms for licensing renewal. At the same time, non-discriminatory terms are needed for interconnection. All public network operators should be obliged to interconnect their networks with one another. Those operators with the ability to abuse their market power should be subject to special rules (ex ante regulation) to ensure that they do not abuse their dominance.

**Corporate Finance in Russia's Regions: Demand and Supply Constraints**

Many of the bottlenecks that businesses face in Russia to get started and grow are finance related. Finance is aggravating regional business development in several ways. On the supply side, the volume of financing is very limited, as banks have small deposit and capital bases. A series of crises, most particularly the 1998 crisis, has eroded the confidence of the public in the fledgling banking sector, with only Sberbank and a few large banks enjoying any trust today. Short-term bank credit is scarce and highly priced, and requires liquid collateral of up to two times loan amounts. The
limited contract enforcement environment discourages banks to lend, except to those enterprises in which they have shareholdings or another relationship. Most banks and other financial institutions—especially in the regions—do not have the expertise or skills to properly assess risks and structure financial products and services which meet the needs of the real sector. Furthermore, the banking sector is highly concentrated in urban centers, further limiting the access of many enterprises to finance.

Against this backdrop, Claessens and Ulgener analyze the various constraints to business finance on the supply side and show how demand from potentially viable enterprises at the regional level is often not met. Their examination highlights how the formal financial system has little to offer to most firms, especially to de novo firms. They note that the Russian financial system is small in absolute and relative terms and underdeveloped compared to countries with similar per capita income. The small size of the Russian financial system can largely be attributed to a lack of trust of households and enterprises in the financial sector, a lack that arises from past experiences with hyperinflation, the government’s default on its domestic currency debt, and a weakly governed and fragile domestic banking system. The Russian banking sector is also very small in absolute size. The numerous, small banks have limited deposit and funding bases to lend to the new and existing enterprises. Most of the banks are too small to cater to the financing and investment needs of the large and medium Russian enterprises in energy, telecommunications, chemicals, transportation and utilities. The banking system also has a very limited outreach. As of end 2000, banks operating in Russia had only 2.8 branches per 100,000 inhabitants. This compares to an average for the EU of 48 per 100,000 inhabitants. The government-owned savings bank, Sberbank, dominates the branch network, with 1,564 branches and over 34,000 small outlets throughout the country. The majority of the banks are concentrated in Moscow and St. Petersburg.

Claessens' and Ulgener's assessment from the regional case studies reveals a ranking as to what are the most important forms of financing available for de novo firms and capital investments for existing firms. There is clear evidence that the most important source of capital for investment is internal financing. Leasing has been used to some extent to finance equipment. Indeed, one of the few formal financing structures, which are used more broadly in Russia, is leasing. Lease terms are more affordable than bank loan terms for comparable sums and maturities, as well as more flexible, faster, and simpler in terms of arrangements. After own financing, leasing is the second most popular source of equipment financing. Still, leasing activity in Russia is relatively very small, financing only 1.5% of capital investment, compared to some 30-40% in OECD countries.

Government-supported credit lines have had a mixed record. Where they have been most effective are initiatives for start-ups on the regional and municipal levels. Novosibirsk's regional authorities are discussing the implementation of business incubators, as well as the setting up of a system for transfer of state and regional property to start-ups at favored conditions. In Vladivostok, the regional government has set aside a notional sum for financing a Fund for Support of Small Business. Donor credit lines remain small as well, but they show that there is scope for viable lending. Private and donor-funded initiatives have also been a source of finance for the small and medium enterprises.

Normal trade credit is virtually non-existent in Russia. Today, businesses in Russia rarely use normal forms of trade financing. To the extent, trade credit is being offered, it is either for within the same business group or to buyers with whom there is a long-term relationship. In an environment of limited bank finance and no formal trade credit and liquidity, non-monetary forms of payment provide the liquidity and credit for the exchange and sales among enterprises. To a large extent, enterprises build-in premiums or discounts into the prices of the goods or liabilities exchanged, thus substituting trade terms (payment and interest) for price gains, and where the exchange of goods or offsets serves as immediate collateral. Although declining, non-monetary payments are still much used in Russia, especially in the remote regions for conducting trade transactions, to resolve arrears or for continued non-transparency reasons as well as to sustain non-viable enterprises.
In their discussion of policy recommendations, Claessens and Ulgenerk note that the weaknesses in Russia's creditors' rights and enforcement are important determinants of its ill-developed financial system. Similarly, Russia's capital market development is impeded by very weakly enforced equity rights. Adopting market economy accounting standards and applications in both the real and financial sectors would decrease the non-transparency and allow financial institutions to start intermediating funds more productively. Tax and audit reforms are also necessary to encourage transparency and full disclosure of information by the corporations. Increasing confidence in and capitalization of the financial system is a must for the longer term.

The development of a fully functioning financial sector in Russia will be a long-lasting effort. One crucial prerequisite for any meaningful reform is the full political commitment of the Russian government, including the Central Bank and the Ministry of Finance, to banking system restructuring and financial reform. This will be a necessity to create greater confidence over time among households and investors in the Russian financial system, thereby increasing the available financial savings and capital, and thus make greater financing available for the corporate sector. Indeed, building confidence requires that the government enforce its own set of rules. Enforcement of existing rules includes the closure and liquidation of insolvent banks according to already set procedures. Up to the present, instead of liquidating insolvent banks the government has, through various means, supported favored banks and through generally limited actions allowed other insolvent banks to remain in business as “zombies.” The government also has only made limited efforts in stopping asset stripping in defunct or even officially intervened banks. Before any active restructuring, the liquidation of insolvent banks has to proceed first.

Recent changes in banking legislation are steps in the right direction, but questions still remain about their implementation. The State should be the regulator and supervisor of the financial sector, rather than a direct participant. The large state dominance in the banking sector continues to stifle competition and encourages directing the funds of the state banking sector into politically important projects. Encouraging further foreign bank entry in general would also increase the available capital and confidence in the banking sector.

Dispute Resolution in Russia: A Regional Perspective

In their chapter on the role of the courts in facilitating resolution of economic disputes, Hendley and Murrell argue that the arbitrazh courts play a beneficial role in the Russian economy that is widely underestimated. They are used extensively and they are viewed relatively benignly by business. Of course, the authors do not find that the arbitrazh courts are without problems, indeed far from it. But this is to be expected, since the courts are embedded in a society in which the historical legacy is far from helpful for legal processes, in which many of the institutions that are complementary to the arbitrazh courts function poorly, in which the central government has frequently reneged on financial commitments, and where conflicts between central and regional governments can cause problems even for the best designed institutions.

Russia's arbitrazh courts, which are the state-sponsored tribunal charged with resolving economic disputes, hear two types of cases: disputes between legal entities (including bankruptcy) and disputes between legal entities and the government. As market reforms have progressed, the disputes submitted to the arbitrazh court have grown more complicated, and not surprisingly, cases now take longer to process. Moreover, the increased use of penalties means that the amounts being demanded are no longer symbolic; yet the inability to enforce judgments is the single biggest shortcoming of the arbitrazh courts. The large number of cases that come before the arbitrazh courts is striking, and if enterprises are shunning the courts in favor of private enforcement, as is commonly stated, then the authors’ data on use of the courts do not seem to reflect a lack of demand for the courts. While the number of cases decided decreased significantly from 1992 to 1994 in all of the studied regions, by 1997 the level of demand for the courts had risen above the 1992 level on a national basis, and by 2000 the level of demand was above 1992 levels in all regions under study. The number of claims brought
by enterprises against state agencies has increased steadily, suggesting that suing the government is not regarded by enterprises as futile or quixotic.

The law requires that court cases be resolved within two months of being filed. Contrary to conventional wisdom, Hendley and Murrell show that delays have not been commonplace. Nationally, delays have never exceeded 5%. Of course there is regional variation in the levels of delays. The disparate levels of delays likely result from poor management and/or inadequate staffing and/or the complexity of the cases heard. Indeed, court personnel constantly complain about meager funding, and the difficulties in filling vacancies on the arbitrazh courts are well-known. Complexity is a likely explanation for the higher level of delays that are observed for Moscow City courts. Still, since the popular image of private enforcement is speed without concern for due process and procedure, it is remarkable that in three of the regions under study the arbitrazh courts are rated as superior to private enforcement even on speed. Russian enterprise managers usually emphasize the advance filing fees as a key obstacle to using the courts (second in importance after problems with enforcement), despite the use of a sliding scale for the fees (based on the amount being sought in the case). The authors' data show, however, that firms are increasingly successful in getting judges to waive the requirement that the fees be paid when the case was filed in favor of collecting these fees from the losing party at the conclusion of the case. While the weak competence of judges is a barrier to the use of the courts, the evidence suggests that competence of judges is less of an obstacle to using the court than either lack of speed or expense. The difficulty of enforcing judgments is regarded as the greatest barrier to using the courts in all the regions studied. Of course, although the problem of enforcement is often laid at the door of the courts, the reality is that, in Russia (as in most countries), judges have no responsibility for enforcing their decisions. Indeed, judges share the frustration of litigants, complaining that their hard work is in vain if the end result is a decision that is never enforced. From 1998 on, enforcement has essentially become the province of state-sponsored "bailiffs," who are subordinate to the Ministry of Justice. There is a decided lack of attention to the special skills and knowledge needed in the Russian bailiff system in order to get enterprises to pay judgments, which no doubt contributes to the less-than-stellar record of enforcement.

Hendley and Murrell conclude their analysis with guidance for reform of court procedures. First, proposals to introduce a new mandatory stage in the judicial process for preparing a case for a hearing, such as having the parties meet with the judge to explore the possibility of working out a settlement, is unlikely to be effective in Russia. The majority of civil cases in Russia (at present) involve non-payments and most are often settled at the first hearing. So mandating a pre-hearing step will not achieve much. Second, the ability of the arbitrazh courts to operate effectively has been undermined by the tendency of litigants and their counsel to appear for hearings without being fully prepared. Other countries have found that imposing fines on those who appear unprepared serves to discourage such behavior. Third, the "bailiffs" charged with implementing arbitrazh court decisions ought to be institutionally distinct from their colleagues charged with implementing the decisions of courts of general jurisdiction and/or protecting judges. Finally, while substantial expansion in arbitrazh court personnel is needed, at the same time it is critical to make sure there is adequate funding for salaries and office space. To mandate an increase in the number of such officials by statute, and then be unable to carry through, would likely have the effect of undermining confidence in the courts.

Conclusion

We posed the question at the outset as to whether Russia’s new-found growth is sustainable? The analysis undertaken in this study suggests that the prospects for robust business development and, in turn, enduring economic growth in Russia depend on strengthening a set of fundamental market institutions—at the regional level. To be sure, the notion that building strong market institutions in Russia is key to growth is not novel, and most federal policy makers in Russia and observers of the country’s economic reform process at the national level over the past decade will not be surprised by this finding. But what is new is the study’s insights that the most critical market institutions in need of
reform (in terms of development impact) are those in the regions. Insufficient competition among enterprises, both within and across local markets, blunt incentives for efficient allocation of new investment, sound corporate performance and innovation. The strong political economy nexus that often binds regional governments and incumbent enterprises plays a large role in inhibiting business startups. The regulatory regime governing infrastructure services providers at the regional level (in this case, the telecom and Internet sector) lacks transparency, is not subject to systematic application, and development of its procedures lags the market. The commercial banking sector remains underdeveloped, with little intermediation of savings into investment taking place. The sector is also lacking in competition, especially in local markets. For most Russian firms, the banking system is virtually irrelevant in satisfying investment needs. Russian businesses are increasingly using arbitrazh courts, which have become more effective over time, to settle commercial disputes. But, enforcement of judgments remains problematic. The training of judges and the scale of institutional resources made available to the court system, especially at the regional level, are substantially inadequate.

While some reforms to rectify these problems have been underway, the findings from this study indicate that in most cases, second generation institutional and structural policy changes are now needed. And such reforms need to be implemented locally (of course nested within consistent reforms made at the federal level). For example, reducing so-called administrative barriers through streamlining business registration and licensing procedures will help facilitate new business startups. But in the absence of resolving regional anti-competitive market structures or removing deep-seated incentives for anti-competitive conduct by incumbent firms—often in collusion with local governments—such administrative reforms will be for naught and may well be counter-productive. Indeed, the illusion that alleviation of administrative barriers will bring forth new investment is already breeding cynicism about the drive for reform among some businesses and policy makers. It is increasingly clear that only by tackling more fundamental institutional reforms will policy credibility be ensured. Similarly, improvements in the procedures of arbitrazh courts will surely facilitate the processing of commercial disputes. Yet only if the bailiff system at the local level is strengthened will enforcement of arbitrazh court decisions become truly effective and instill widespread confidence among businesses that it is worth taking the risk of making investments in Russia. Overall, the specific policy lessons distilled from the variety of business case studies analyzed in this monograph can greatly inform and shape both the agenda for, and content of these types of second generation reforms.

Of course the challenge of changing long-lived behaviors and building the proper institutions should not be underestimated. As our analysis shows, some vested interests—in business and in government—are strong and, at least in the short run, will likely view needed reforms in public policy to run counter to their own private interests. In this respect the reform agenda is likely of a medium-term nature. But as the case studies also demonstrate, there are in fact parties that are cognizant of strong incentives for reform now—and are acting on them. For example, some local government officials recognize the tax revenue and job creation benefits of allowing for greater enterprise competition and thus are reducing protection of local champions. Similarly, some regulators of infrastructure services, especially in the telecommunications and Internet sector, have gotten the message that realization of the potential dynamism and scale economies of the geographically large Russian economy hinges on modernization of network systems and that only if tariffs are set in line with market signals will needed investments be made by the private sector. As the resonance of these types of incentives grows and more actions are taken producing positive benefits, the greater the momentum will be for further reform.
Bibliography


Endnotes

1. We use the term “Russia” for the “Russian Federation” throughout the monograph.

2. The terms “local” and “regional” are used interchangeably throughout this study to denote sub-national or sub-federal activities and entities.

3. As all researchers working on Russia know, systematically comparable data on Russia’s regions are generally not available contemporaneously; indeed, there is usually a two to three year lag. Hence, the data presented in Tables 1 and 2 are not as recent as one would like, but they are essentially the most recent data available.


5. In light of the crisis that occurred in 1998, this is hardly a representative year for which to measure enterprise losses. However, more recent data on a cross-regional basis are not available and the losses depicted here are as of mid-1998, prior to the eruption of the crisis.
II. Competition in the “Old” and “New” Economy in Russia’s Regions

Harry G. Broadman,* Mark Dutz,** and Maria Vagliasindi***

Introduction

Vigorous inter-enterprise competition is essential to the sustainability of Russia’s growth. Although a substantial portion of previously state owned firms in Russia has been privatized since the early 1990s, to date, the changes in ownership have not been commensurate with improved competitive performance. In part this is because Russia had not undertaken sufficient institutional reforms to propel competitive restructuring of its existing dominant firms or eliminate policy barriers to new entrants as privatization was being instituted. Especially at the local level, where the drive of central planning engendered regional autarky, self-sufficiency and “duplication of facilities”, horizontal and vertical market power among incumbent firms, and barriers to entry by new businesses, have remained considerably pronounced in Russia’s industrial sector, especially when compared to comparable economies. The absence of business startups, including small and medium sized enterprises (SMEs), in Russia has been particularly striking. Indeed, the composition of Russia’s industrial private sector is noteworthy for the low level of new entrants. The experience of many other transition economies is that the presence of new business rivals in the marketplace—or even the credible threat of their entry—provides strong competitive discipline on incumbent enterprises to restructure and perform more efficiently, and new business entrants are often the main engines of growth and job creation.

To be sure, some Russian firms have restructured and become more competitive, and new business ventures have been established; see Table 1. Much of this restructuring is likely a consequence of the import-substitution effects of the 1998 ruble devaluation. Other Russian enterprises have the prospect of performing more competitively with relatively modest improvements in their equipment, technology, the skills of their workers, and management practices. But in the main, it appears that Russia’s overall industrial configuration has yet to give way to a regime of enterprise structure, conduct and performance subject to vigorous market-based competition. The result is that a major policy challenge facing Russian authorities is how to improve the competitiveness of the nation’s businesses.

In attempting to meet this challenge, Russia’s policy makers are increasingly focusing on the local determinants of competition across the country’s geographically vast marketplace. Accordingly the approach we undertake in this paper is to assess the incentives and constraints on inter-enterprise competition in various industrial sectors at the regional level. The prism that we adopt in conducting our assessment are the main prongs of competition policy—focusing on factors that give rise to barriers to new competitive entry and that permit restrictive business practices by incumbent firms able to exercise market power, as well as by state executive bodies who undercut competition through powers they possess by dint of their legal authority.

Our analysis is based on a series of firm-level case studies designed to capture regional and sectoral differences in local competition. We conducted in-depth interviews of general directors and senior management of more than 70 enterprises, as well as of local banks, chambers of commerce, government officials and investment funds and advisors. These case studies were carried out in the field in the summer and fall of 2000 and summer 2001 across several regions--Krasnodar Krai,

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Table 1: Russian Enterprise Restructuring and Performance: 1996 – 1999

<table>
<thead>
<tr>
<th>Industry</th>
<th>Number of Registered Firms</th>
<th>Average Size (average number of employees)</th>
<th>Sales Revenues (average in '000 rubles)</th>
<th>Rate of Return (profits over assets)</th>
<th>Rate of Return (profits over assets)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>As of end 99</td>
<td>Δ(99-96)</td>
<td>As of end 99</td>
<td>1999</td>
<td>1996</td>
</tr>
<tr>
<td>Ferrous metallurgy</td>
<td>973</td>
<td>-2.6%</td>
<td>2366</td>
<td>1999</td>
<td>1.6%</td>
</tr>
<tr>
<td>Non ferrous metallurgy</td>
<td>1584</td>
<td>15.8%</td>
<td>1245</td>
<td>113855</td>
<td>19.9%</td>
</tr>
<tr>
<td>Chemical industry</td>
<td>3827</td>
<td>18.1%</td>
<td>1026</td>
<td>22895</td>
<td>-1.1%</td>
</tr>
<tr>
<td>Mechanical engineering</td>
<td>2930</td>
<td>1.0%</td>
<td>718</td>
<td>23309</td>
<td>5.8%</td>
</tr>
<tr>
<td>Machine tool and tool industry</td>
<td>1030</td>
<td>-14.2%</td>
<td>356</td>
<td>6286</td>
<td>1.8%</td>
</tr>
<tr>
<td>Precision tool industry</td>
<td>1309</td>
<td>-12.6%</td>
<td>508</td>
<td>7078</td>
<td>2.1%</td>
</tr>
<tr>
<td>Tractor and agricultural</td>
<td>463</td>
<td>-1.9%</td>
<td>908</td>
<td>25379</td>
<td>4.6%</td>
</tr>
<tr>
<td>mechanical engineering for light industry</td>
<td>950</td>
<td>-6.3%</td>
<td>348</td>
<td>6643</td>
<td>0.2%</td>
</tr>
<tr>
<td>Electronic industry</td>
<td>983</td>
<td>-20.4%</td>
<td>411</td>
<td>4888</td>
<td>-2.8%</td>
</tr>
<tr>
<td>Metal construction and articles</td>
<td>3878</td>
<td>-0.5%</td>
<td>239</td>
<td>3742</td>
<td>5.1%</td>
</tr>
<tr>
<td>Woodworking industry</td>
<td>4155</td>
<td>27.7%</td>
<td>211</td>
<td>4908</td>
<td>-7.9%</td>
</tr>
<tr>
<td>Wood processing industry</td>
<td>9587</td>
<td>-5.2%</td>
<td>230</td>
<td>3316</td>
<td>-3.3%</td>
</tr>
<tr>
<td>Pulp and paper industry</td>
<td>734</td>
<td>31.9%</td>
<td>788</td>
<td>54402</td>
<td>-2.3%</td>
</tr>
<tr>
<td>Timber-chemical industry</td>
<td>39</td>
<td>2.6%</td>
<td>433</td>
<td>11389</td>
<td>1.5%</td>
</tr>
<tr>
<td>Building material industry</td>
<td>6614</td>
<td>-9.5%</td>
<td>249</td>
<td>6537</td>
<td>2.1%</td>
</tr>
<tr>
<td>Glass and porcelain industry</td>
<td>647</td>
<td>-0.5%</td>
<td>540</td>
<td>10580</td>
<td>4.6%</td>
</tr>
<tr>
<td>Textile industry</td>
<td>2417</td>
<td>-14.9%</td>
<td>359</td>
<td>7277</td>
<td>-1.8%</td>
</tr>
<tr>
<td>Clothing industry</td>
<td>7529</td>
<td>-25.4%</td>
<td>125</td>
<td>1358</td>
<td>2.2%</td>
</tr>
<tr>
<td>Tanning, fur and shoes industry</td>
<td>2752</td>
<td>-32.5%</td>
<td>193</td>
<td>2524</td>
<td>-0.6%</td>
</tr>
<tr>
<td>Other light industry</td>
<td>75</td>
<td>-40.0%</td>
<td>170</td>
<td>2210</td>
<td>0.8%</td>
</tr>
<tr>
<td>Food gustatory industry</td>
<td>10420</td>
<td>14.1%</td>
<td>238</td>
<td>15917</td>
<td>14.0%</td>
</tr>
<tr>
<td>Meat and diary industry</td>
<td>4806</td>
<td>14.2%</td>
<td>184</td>
<td>16500</td>
<td>5.8%</td>
</tr>
<tr>
<td>Fish industry</td>
<td>2562</td>
<td>36.4%</td>
<td>294</td>
<td>10169</td>
<td>-4.8%</td>
</tr>
<tr>
<td>Information and computer services</td>
<td>3961</td>
<td>11.8%</td>
<td>57</td>
<td>1556</td>
<td>21.9%</td>
</tr>
<tr>
<td>Russia (average)</td>
<td>74225</td>
<td>1.30%</td>
<td>355</td>
<td>12794</td>
<td>2.9%</td>
</tr>
</tbody>
</table>

Sample of approximately 75,000 enterprises from Goskomstat database. Source: Broadman and Recanatini (2000).

Leningrad Oblast, St. Petersburg City, Moscow Oblast, Moscow City, Novgorod Oblast, Novosibirsk Oblast, Primorski Krai, and Sverdlovskaya Oblast. The diversity of these regions provides for a rich variation of Russia's industrial characteristics, geographic location, reform orientation, among other factors. All individuals and institutions that participated in the case studies were guaranteed anonymity in order to foster frank discussions.

An important feature of our analysis is that the taxonomy we use for assessing sectoral differences centers on comparing firms in Russia's "old" and "new" economy. This approach allows...
us to explore the extent to which businesses belonging to the "old" economy continue to be shaped by, or have overcome, the planning legacy of the Soviet era, influencing the extent to which they have been able to restructure into competitive enterprises. At the same time, the taxonomy permits us to gauge how much "new" economy businesses have been able to exempt themselves from the Soviet inertia, the influence of vested interests and transition-related distortions; in short, how much they have been able to grow and prosper more in line with market forces, unencumbered by the problems that have plagued their older counterparts.

There are—necessarily—many "old" economy sectors in Russia on which such an approach can focus, and whatever ones are selected invites an argument about their representativeness of the backbone of the Russian economy. Our "old" economy case studies generally focused on the following sectors: construction materials, food and beverages, wood processing, fishing, machine building, metal fabrication, electronics and textiles. We believe these sectors reasonably span the spectrum of Russia's "old" economy. Like most of the sectors Russia inherited at the beginning of its transition, many of these sectors were characterized by large plants and companies relative to actual (market) demand, resulting in diseconomies of scale and scope. Moreover, because of socialist objectives, many "old" economy firms often were designed to produce product mixes that were not necessarily in line with market preferences, and investment and production decisions were dictated more by state orders than by the forces of supply and demand. Taken together, these factors contributed to an anti-competitive structural inheritance for many of the largest businesses in these sectors.

Happily there are fewer "new" economy sectors from which to choose. As a representative of the "new" economy we selected the software industry for a number of reasons. First, software is one of the world's largest and fastest growing industries. In 1999 the sector sold programs worth US$157 billion. In the Russian context, the software industry has a strong potential for growth because of the large number of talented and cheap workers. Second, developing high tech industries and the "new" economy is a key policy priority in Russia, as highlighted in President Putin's recent message to the Federal Assembly. Finally, the software industry represents an intensive user of enhanced telecom services, including the Internet. Focusing on the software sector thus provides a useful assessment of the linkages between the real sector and the regulated infrastructure sector—the latter being a focus of analysis in the next chapter of this study. Box I outlines key features of Russia's software industry.

The paper is organized as follows. The next section presents our findings from the case studies as to the general trends in the local determinants of competition for all sectors we investigated, highlighting the effects of the 1998 crisis and ruble devaluation. Subsequently we report on our findings as to the most critical barriers to entry and expansion in regional markets, highlighting differences as between "old" and "new" economy sectors. The final section provides policy recommendations.

Trends in Local Determinants of Competition

Regional Governments as (Non-) Competitive Actors

The rise of the private sector in the Russian economy, accomplished largely through privatization, has been one of the hallmarks of the country's enterprise reform program since 1992. The existence of a substantial private sector at the regional level—as illustrated in Table 2 for Primorski Krai—is usually a prerequisite for the operation of competitive forces. Despite this, however, the extent of state/government involvement in business affairs continues to make a significant difference in market competition—particularly in the "old" economy sectors. Among the regions visited, there are significant differences in the state of competition and enterprise restructuring that appear to be related to the reform orientation of the regional administration. In many cases we observe a continuing—albeit metamorphosed—direct role of government in the marketplace, which
more often than not has a negative impact of diminishing competitive entry, largely benefiting the existing "old" economy firms. In particular, some case studies reveal incestuous "captured" relationships between government agencies and incumbent businesses, where their joint actions directly influence the extent to which new competition can thrive. These relationships especially involve the largest firms in a sector, which were often previous arms of a sector ministry or department. Box 2 epitomizes the problem in the case of the Far East fishing sector.

**Box 1: The Russian Software Industry**

The software industry is a new market sector for Russia and is only about 10 years old, although in the Soviet era some software related activities were performed by software related branches of state enterprises or institutes. In 1990 a large number of small software co-operatives appeared in Moscow, St. Petersburg and Novosibirsk. Also in the early 90s the first representative offices of multinational software and services companies were established. The Russian Academy of Sciences reports that sales of Russian developed software are equal to US$60-70 million of software a year. The Russian software industry has been characterized by high growth, with the most successful firms reporting annual growth rates at 50-60%. Many companies specializing in software development survived the 1998 crisis, and in 1999 the sector experienced considerable growth. By the end of 1999 many companies reached their pre-crisis levels. The software industry has also been a source of high value jobs and it currently employs approximately 8,000 people with 6,000 in project services. There are 450-470 local software developing companies and more than 4,000 regional dealers. The price of Russian software products is between 5 to 20 times lower than for similar products developed by Western companies and the cost of applying large software applications into client enterprises is from 30 to 100 times lower.

Several factors led to the emergence of this industry in Russia. Among these the most important ones include the high number of graduates in mathematics, physics and electronics and the significant scaling down of the military leading to the release of IT professionals into the market. The most common strategy applied by software companies is to open sales and marketing offices overseas while keeping creative, development and production work at home, where salaries are low. In many ways, Russia's software industry resembles that of India in the mid-1990s, when it had started to gain international acknowledgement as an IT center.

**Table 2: Ownership Distribution of Enterprises and Organizations in Primorski Krai**

<table>
<thead>
<tr>
<th></th>
<th>1995 number</th>
<th>1999 number</th>
<th>2000 number</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Number of Enterprises and Organizations</td>
<td>30,625</td>
<td>38,886</td>
<td>40,454</td>
<td>100</td>
</tr>
<tr>
<td>Public Sector</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>State owned enterprises</td>
<td>590</td>
<td>305</td>
<td>222</td>
<td>29.0</td>
</tr>
<tr>
<td>Municipally owned enterprises</td>
<td>849</td>
<td>661</td>
<td>679</td>
<td>1.7</td>
</tr>
<tr>
<td>Public corporations</td>
<td>1,268</td>
<td>963</td>
<td>929</td>
<td>2.3</td>
</tr>
<tr>
<td>Other public businesses and organizations</td>
<td>5,056</td>
<td>11,802</td>
<td>9,508</td>
<td>23.5</td>
</tr>
<tr>
<td>Private Sector</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Individual enterprises</td>
<td>4,264</td>
<td>2,930</td>
<td>5,223</td>
<td>12.9</td>
</tr>
<tr>
<td>Limited liability companies</td>
<td></td>
<td>10,604</td>
<td>14,208</td>
<td>35.1</td>
</tr>
<tr>
<td>Limited partnerships</td>
<td>13,490</td>
<td>8,084</td>
<td>6,158</td>
<td>15.2</td>
</tr>
<tr>
<td>Farms</td>
<td>4676</td>
<td>2211</td>
<td>1789</td>
<td>4.4</td>
</tr>
<tr>
<td>Social and religious organizations</td>
<td>432</td>
<td>1326</td>
<td>1738</td>
<td>4.3</td>
</tr>
</tbody>
</table>

*Source: "Main Socioeconomic Indicators of Primorski Krai," 2000.*

Some regional administrations employ protectionist policies to insulate "local champions" from competition—not only competition from within an oblast but from firms domiciled in "foreign" oblasts. For example certain oblasts have devised local registry stamps—under the guise of "ensuring quality control"—that have to be purchased and placed on beverage containers for the beverages to be sold within the oblast. Regional air transport provides another example. Collusion between local airlines and airports gives rise to effectively exclusive landing rights for local carriers: runway repairs
are temporarily halted for local airlines to land, but for non-local airlines, the repairs are either stopped at inconvenient hours or not at all. Clearly, the cozy relationships between local firms and local administrations hamper inter-regional trade and investment flows, reducing the prospects for competitive pressure (also see below).

**Box 2: Competition in Russia’s Far East Fishing Industry—A Twist on Public-Private “Partnerships”**

The Russian Far East fishing industry continues to suffer from the organizational structures put in place during the Soviet regime, with the result that the dominant firms continue to exercise State functions even as they move to secure for themselves the most lucrative sectors of the market and the most bountiful fisheries in Russian territorial waters. The agency which previously administered Far East fisheries on behalf of Moscow has struggled to reorient itself along commercial lines; in fact, it has been outstripped in this regard by its former operational subsidiary, which is now the leading actor in the regional marketplace.

The former subsidiary employs 16,000 and continues to support and maintain a social service infrastructure to support its employees. Both the subsidiary and its former parent “company” continue to carry out public sector functions — they are both members of the Regional Fishing Committee, chaired by a Deputy Governor. The Committee is responsible for allocating fishing quotas. Both of these companies—the “Big Two”—have arrogated unto themselves the choicest fisheries in the Russian Far East, the quotas for which are issued by the Committee at no cost to those companies awarded quotas. The parent company has apparently suffered from an embarrassment of riches in recent years, so much so that it was willing to part with some of its quotas in the less desirable Sea of Japan fisheries (it sold some of these rights to, and helped to obtain fishing vessels for, a start-up crabbing, sea cucumber, and sea urchin operation, which employs 30 and caters to the Japanese marketplace), retaining its more valuable quotas for fisheries in and around the Kamchatka peninsula, where it is in direct competition with its former subsidiary.

New entrants have avoided direct competition with the “bigger fish”, and are content with the lower-yielding Sea of Japan fisheries (Sea of Japan annual quotas for crab are 300 tons; Kamchatka quotas allow for 4,000 ton annual harvests). They contend instead with poachers from Sakhalin and the Kuriles, and with the ham-handed tactics of the Coast Guard, customs, and the security services. Despite their marginal status in the eyes of the Big Two, small-scale rivals still feel the pinch of market dominance — a new start-up which purchased Sea of Japan quotas from one of the Big Two found its subsequent request for an annual crab quota scaled back from 70 tons to 25 tons by the Regional Fishing Committee. The Big Two look askance at small-scale operators, accusing them of tax evasion. The new entrants have, however, benefited from their cultivation of the Japanese marketplace, attracting Japanese partners and financiers to help grow their business.

But there are cases where government is playing an indirect, competition-reinforcing role in the market. More progressive and reform-oriented regional administrations, such as Novgorod’s, have promoted new entry, enterprise restructuring and a more flexible labor market through judicious economic and fiscal policies, bolstered by greater policy stability and transparency. Since the mid 1950s, the Novgorod region developed as a production center for radio-electronics, especially for the military sector (for many firms, military orders accounted for up to 70% of their production). The transition process led the region into a deep economic crisis, since most of its industry was unable to compete in a market-based environment because of the halting of military orders and outdated technologies. In 1992, the oblast administration reassessed the business environment and decided to launch a multi-pronged strategy. It established the Economic Council of Novgorod with the purpose of formulating economic policies to revitalize the regional economy focusing on three areas of economic policy: (1) development of small businesses, so as to promote growth and new jobs; (2) administration of more effective tax collection, so as to reduce the regional dependency from the federal budget; and (3) creation of a favorable investment conditions for out-of-oblast investors.

**Local Competition is Affected by Transition Distortions**

In the “new” economy, government has yet to catch up with the market; as a case in point, the software industry benefits from the lack of sector-specific regulation. “New” economy firms also appear to be able to be exempted from other legacies from the Soviet era, such as the absence of old
social assets that would interfere with production processes or create vested interests; as a result they appear to be able to respond quicker to market competition. For example, to be able to survive changing economic conditions a medium size software development firm (350 employees) decided in 1997 to divide the company into 20 separate companies. The main problems stemmed from management’s inability to cope with rapid market changes. A very successful company was created by the split and has been able to increase its number of employees from fewer than 20 to 100 in less than 3 years. Sales have risen by 250% from 1999 to 2000. The enterprise also uses a myriad of innovative channels of sales: direct sales, sales through value-added resellers (that also provide technical support), and distribution through dealers (including e-dealers). It applies a standard price list to their 80 dealers, but also makes use of incentive schemes through targeted bonuses for dealers linked to sales performance.

Lingering social obligations burden enterprises—especially those in the “old” economy—and serve to undermine the free play of competitive forces. Many general directors indicated that their enterprises are still responsible for providing social services—such as housing, hospitals, schools and training centers—for both their current and former employees. This situation, a hangover Soviet corporate mentality, creates a web of deep ties between firms and employees that unduly complicates the restructuring process, where the ties remain even after the formal employer-employee relationship is terminated.

“Transition-driven” distortions appear to be limited in the “new” economy. “New” economy enterprises generally are subject to harder budget constraints than are their “old” economy counterparts: they appear to enjoy fewer subsidies—whether from government-sponsored programs or banks, and generally pay for their inputs, especially infrastructure services, in cash and on time—and their products/services are rarely subject to price controls, whether direct or indirect.

Indicative of this trend, “new” economy firms report that belonging to business associations—which in many other sectors of the Russian economy implies competitive advantage, preferential access to credit and infrastructure services and access to government sanctioned or provided protection—does not bring about much benefits. Interestingly, software companies are mostly affiliated with business associations at the international level to help catch up with best practices in the area of testing and certification of new software products.

Unanticipated Distortions Have Arisen from New Reforms

Unanticipated distortions are being engendered through industrial policy—particularly policy to foster SME development—which is artificially constraining firm growth and exploitation of economies of scale. Russia’s policy framework for directly encouraging entry is focused on SME support. Federal legislation fostering SME development dates back to 1993, when a Support Fund for Entrepreneurs was created that provided for short-term credits. A two-year holiday on profit taxes also was established. Subsequently, regional and local support funds were created, and it is at these levels that the bulk of SME support is implemented. In 1995 the State Committee for the Support and Development of Small Businesses was created, and in 1998 the committee and its programs were transferred to the Ministry for Anti-Monopoly Policy and Support for Entrepreneurship (MAPSE). In 2000 the number of registered SMEs in Russia was 891,000 (mostly likely an undercount since the grey economy is populated by small firms). The total number of Russian workers employed in SMEs in 2000 was 6.5 million, about 10 percent of the country’s workforce. (By way of comparison, in the EU, SMEs employ 72 percent of the workforce, and in the United States, SMEs account for 52 percent of the workforce).

The SME program includes the allocation of financial support to SMEs, largely in the form of low-interest credits from Federal, regional and international sources, as well as technical assistance from the latter. New laws also have been enacted to foster the development of SMEs. A key measure defines eligibility limits on SME size (“small” enterprises have no more than 100 employees), allows SMEs to pay only a single tax on income, and to take advantage of other incentives, including
accelerated amortization. These SME incentives, however, create palpable inducements for businesses to remain at certain scales, lest they not enjoy tax concessions: even if market signals call for a firm to expand its existing production line to take advantage of economies of scale, the tax credits work to limit the firm's existing size and instead establish small subsidiaries. This distortion serves to put a brake on competitive market pressure and misallocate capital and human resources. Box 3 illustrates the problem typical in many of the studied firms.

Box 3: The Perverse Influence of SME Tax Incentives on Firm Growth

Established in the early 1950s, this large company producing construction materials has undergone several transformations since 1991. To be able to survive the worsened economic conditions and minimize the burden of taxation, the senior management decided to divide the original company into about 30 separate enterprises. These firms are de facto departments of the "mother" company, but are legally separate entities. The newly established firms and the mother company are in constant re-organization depending on the needs of the mother company and changes in tax incentives and credits available to small businesses. The "subsidiary" companies are kept "alive" until they are profitable and then are closed down. Workers, on the other hand, have been continuously moved from one subsidiary to another, displaying trust toward the management and a great level of mobility, since each time a subsidiary closes down, the employees are laid-off with simply the implicit understanding that they will be later re-hired in another subsidiary. This fictitious closing down and opening of the subsidiaries, and the continuous flows and reflows of employees between different jobs—largely on the basis of tax incentives and disincentives—leads to a significant curtailment on economies of scale and the competitive growth of businesses.

Impact of 1998 Crisis on Local Competition

The 1998 debt default, economic crisis and ruble devaluation have prompted significant enterprise restructuring and changes in competitive strategy—especially in the "old" economy sectors—that are likely to change the face of certain market structures. A clear picture emerges from the case studies that the import substitution effects from the devaluation of the ruble and the general hardening of budget constraints that was engendered by the 1998 crisis have led to substantially greater focus by enterprises to respond to market signals and competitors. Many firms studied—particularly those in the tradeables sectors, such as wood processing, textiles and food—have embarked on restructuring (and expansion) strategies to take advantage of the void created by now-expensive imports and new opportunities of hitherto "off limits" export markets and are targeting sales to increase market share and profits. Table 3 illustrates the changes in the timber sector in Leningrad Oblast.

Restructuring is manifested in significant diversification of product lines, in rationalizing production and consolidation through mergers and acquisitions—both vertical and horizontal—in reducing the share of barter and offsets as means to effecting commercial transactions, in diversifying sources of supply, in seeking out and responding to institutional investors (both foreign and domestic), and in ensuring an appropriate skills mix in staffing the workforce; see Box 4.

Table 3: Changes in Production Volume in Leningrad Oblast's Timber Sector

<table>
<thead>
<tr>
<th>Product</th>
<th>Unit</th>
<th>1998</th>
<th>1999</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wood Cutting</td>
<td>mln cubic m</td>
<td>5.4</td>
<td>5.9</td>
</tr>
<tr>
<td>Lumber</td>
<td>mln cubic m</td>
<td>0.31</td>
<td>0.33</td>
</tr>
<tr>
<td>Plywood</td>
<td>th cubic m</td>
<td>7.8</td>
<td>11.1</td>
</tr>
<tr>
<td>Cellulose</td>
<td>th tons</td>
<td>245.0</td>
<td>328.3</td>
</tr>
<tr>
<td>Paper</td>
<td>th tons</td>
<td>235.1</td>
<td>267.9</td>
</tr>
<tr>
<td>Cardboard</td>
<td>th tons</td>
<td>111.3</td>
<td>191.1</td>
</tr>
</tbody>
</table>

Box 4: The Competitive Fallout of the Crisis: Diversification, Integration, and Conglomeration

Russian enterprises—particularly, but not exclusively, in trade-sensitive sectors—have responded to the exchange rate changes and hardened budget constraints that ensued from the ruble’s devaluation, debt default and crisis in 1998. While the restructuring has taken a variety of forms, the trend in diversification, integration and conglomeration appears most pronounced, as illustrated in the following business cases:

Diversification. This engineering and construction firm was established in 1995. Organized as a limited-liability partnership, the company is owned by 10 individuals. The company currently employs 150— it started out with 30 employees, had 150 after one year in business and saw this number increase to 300 prior to the August 1998 financial sector collapse. In 1999 it began to diversify its activities to include wood processing and development of laser technologies, the latter activity in collaboration with a railway operator and a major automobile firm. In 2000, although more than 80% of corporate revenues came from the company’s core engineering and construction lines, wood processing accounted for 15%—largely on the strength of exports, which account for 90% of this business; the laser technology development activities brought in 2% of revenues. The company is actively trying to reduce the share of public sector organizations as a proportion of its client base so as to increase the proportion of cash in its transactions; 50% of the company’s transactions are accounted for by barter/offset schemes with public sector customers.

Consolidation. Aiming to rationalize their warehouse and stocking systems, as well as to offer lower prices, this city’s five largest supermarkets and groceries wholesalers are merging into one commercial network. The five firms’ combined revenues totaled $45 million in revenues in 2000. The operations at the entity created by the merger will be coordinated by a newly created management company. The management firm will be responsible for business development, advertising and price policy. The core store, which gets about 5 percent of its sales through supplying the others at present, will continue in the role of wholesale supplier in the new relationship, but will take on added importance as it will provide increased central storage space for stock.

Conglomeration. This caterer/foodstuff company was established in 1994 by a trader from the Russian Far East together with a colleague. The business started out as a cigarette and confection sales agent focused on developing a nationwide distribution network. The company then began to import consumables for sale in Russia, and also established a branch in Germany. The August 1998 crisis drove the import business unprofitable and led the company to a conglomeration strategy. It purchased in 1999 a fish processing plant on one of the Kurile islands to serve not only the domestic market, but also export markets in Japan, Korea, and Taiwan. Today, beyond its cigarette distribution network, the company also owns a controlling interest in a number of affiliates—restaurants, supermarkets, refrigerator facilities, and fish processing plants. The company started out with five employees, increasing to 25-30 on the strength of its cigarette trading activities. As it expanded its holdings, it increased the number of employees, where today it employs upwards of 800 workers.

Integration. This producer of flexible surgical equipment was established in 1988 as a five-person cooperative, and has benefited from its partnership with a local technical-medical institute in developing its business. In the mid-1990s the cooperative was transformed into a joint venture with Finnish and US participation, and was later reorganized into the present closed-type joint stock company owned by two of the original five founders. The two owners serve, respectively, as the general and technical directors. The company currently employs 80. In the aftermath of the 1998 crisis the firm is beginning to integrate horizontally and vertically. The horizontal integration will involve the creation of subsidiaries/separate legal entities with equal rights to conduct business under the corporate name. The company has vertical relationships with six key suppliers of components for its equipment: the suppliers manufacture equipment subsequently sold under the their customer’s corporate brand name. By this means, the company hopes to limit the extent to which their suppliers become its competitors.

While the post-crisis hardened budget constraints—particularly on the infrastructure monopoly sectors—have done much to reduce barter and non-payments, problems with arrears have not been satisfactorily dealt with in an enduring manner. All studied companies experienced significant problems with non-payments, particularly following the financial crisis. To take but one example, a software company in Moscow reported a reduction in revenues by 8 times as a consequence of non-payments by companies that disappeared after the crisis. The senior management of the company took several actions as a consequence of the problems. The measures ranged from tighter monitoring of clients in arrears, significant changes in the composition of customers, moving away from the financial sector towards private companies in the real economy, and where possible the introduction of payment
in advance. The greatest problems persist with state-owned enterprises belonging to infrastructure sectors, which benefit from extended credit terms of nearly a year.

**Rising Concentration**

At the national level the degree of concentration of industrial output in Russia suggests an absence of a structural competitive problem. The average 4-firm concentration ratio (the sum of the market shares of the top four producers) is about 60%. For many industries, Russia and more industrialized countries (such as the U.S.) have similar 4-firm concentration ratios, and the largest Russian manufacturing enterprises (measured by number of employees) are not unusually large compared to firms in more industrialized countries. (Indeed, as we have noted, what is noteworthy is the lack of small firms in Russia).

However, this aggregate-level analysis masks important underlying attributes of Russia's industrial landscape. Large Russian enterprises tend to be configured as single integrated multi-plant establishments, often located in or near a single city. In contrast, in industrialized economies a given enterprise usually has multiple establishments and they are located across domestic regions and often abroad. On an establishment basis, the largest Russian enterprises are significantly larger than their counterparts in other countries. Sole reliance on conventional measures of national market share and concentration thus likely understate the true extent of horizontal dominance in many Russian markets. Data on 328 firms in a 1997 World Bank-Russian Academy of Science (WB-RAS) survey reveal that the average market share at the oblast level is 43%. Recent data on concentration indicate that at the oblast level, the average 4-firm concentration ratio is above 95%.

Many of the dominant enterprises in Russia are also highly vertically integrated (or have exclusive buyer-seller relationships). Excessive levels of vertical integration superimposed on (horizontally) concentrated product markets can foreclose the entry of rival firms. The high degree of observed vertical integration largely reflects inertia of the uncertainties and chronic shortages of the old Soviet supply system. But vertical integration is also increasing, occurring usually through mergers and acquisitions rather than through *de novo* expansion.

From our case studies, firms face few effective competitors in their markets. Concentration in market shares appears to be more frequently due to few firms rather than many firms of very unequal size. Most of the studied enterprises faced only a very limited number of effective competitors in their main product lines. While it is difficult to generalize from our qualitative case study information, in almost every sector we analyzed—whether construction, textiles, machinery, lumber, software, fishing, food processing, electronics and so on—businesses indicated they faced a maximum of 3-6 competitors in their oblast/regional market. Of course when the geographic scope of the market is broadened to cover multiple oblasts or whole territories of Russia, e.g., Siberia, the businesses indicated there could be effectively more competitors. But at this juncture, the existing sizeable transport costs across regions (as a percentage of the product's costs)—coupled with the barriers firms face in selling to other oblasts (see below)—act to limit the spatial dimensions of effective competition in Russia. Thus for many of the firms we studied, competition is for the most part mediated locally.

In light of the above, many of the firms indicated they had relatively sizeable market shares (at the oblast level), indicating a moderate degree of horizontal dominance, often brought about through horizontal integration, i.e., horizontal mergers. Of course the information on market shares we gathered showed a sizeable variance across sectors (as would be expected given generic sectoral differences in technology and industrial structure), with market shares ranging on the order of 20 percent to on the order of 60 percent. Consistent with the national picture, we also observed in our particular case studies an appreciable degree of vertical integration—especially in the "old" economy sectors—although it is pronounced in almost all the sectors we studied, including electronics, textiles, machine building, and construction. To take but one example in construction, some construction firms made bricks and other construction materials and were then building and subsequently selling
apartment buildings (to regional government). In many the sectors we studied, if there was not vertical integration, there were exclusive buyer-seller relationships through contracts.

Our case studies suggest that firms' ability to exercise market power is enhanced with concentration. One manifestation of this is that many of the firms we studied had plants that appeared to be above "minimum efficient scale" (i.e., the production level where unit costs are lowest). Indeed, during site visits our attention was often drawn to facilities that a general manager would proudly proclaim as being "the biggest in Europe". The fact of the matter is that such excess productive capacity serves as a credible threat to deter potential rivals from entering the market.

The case studies also suggested that increased profitability is associated with geographic dispersion, suggesting that market power comes from market segmentation. Not surprisingly, we also observed that where there is an increase in the number of firms entering into concentrated markets, competitive pressures were becoming more pronounced.

In virtually all sectors examined, enterprises indicated that in the post-crisis period there are significantly increased pressures by competitors in the local market—both foreign and domestic. Within the "old" economy, the stepped up competition is being felt greatest in trade sensitive sectors—particularly textiles, food, and wood processing—as firms in these sectors vie for domestic market share opportunities created by the fall off in expensive imports due to the ruble devaluation; on the flip side, they are also competing vigorously for newly found export market opportunities. In the "new" economy software sector, competition within the Russian market is due to the presence of global players available to the local customers. Still, local software companies are being overwhelmed by orders and are struggling to meet demand. Yet the absence of qualified strategists and project managers is a pressing problem facing these companies and is identified as one of the main obstacles to growth by many "new" economy firms (see below on labor market constraints). Senior software managers said that demand from Russian business giants for tailor-made corporate software has never been as intense. Most of the studied Russian software companies say they did not anticipate the boom in corporate domestic demand. Russia's big conglomerates, many of which are benefiting from high oil and gas prices, have recently realized their need to invest in information technology (IT) in order to remain competitive and to make better use of their assets. Russian business leaders want sophisticated accounting systems, marketing programs, internal messaging systems and data management software. Government agencies are also eager to improve IT systems.

Competition for export markets by Russian firms is being hindered by excessive bureaucratic customs requirements. This is particularly true in the "new" economy sectors. A software company based in St. Petersburg noted that the custom law makes delivering software to another country very hard. The procedures require completing 60 pages of documents, with permission needed for each single delivery. The total cost of delivery for one small box can be as high as US$70, representing a very substantial constraint to software export. Software companies are often left to convert to a service operation of offshore programming. Growth in offshore programming can partially compensate for the low demand by internal customers for project services (see Box 5). But to become a significant player in offshore programming business, enterprises report that it is crucial to circumvent the language barrier, to establish a track record with prestigious customers and to obtain the necessary certifications.

Barriers to Business Transactions in the "Old" and "New" Economy

Administrative Barriers to Entry and Expansion

Much has been written about the fact that Russia's business environment is hampered through administrative barriers that not only make it costly for new start ups to be established, but also for
incumbent firms to restructure and expand. Such impediments make changes in Russia’s corporate structure a slow and painful process; they also distract management from tending to the normal demands of running a business and absorb undue time and attention. Almost all of the firms we studied in all sectors and in all regions indicated a number of legal and practical constraints that make the registration and licensing procedure, including locational/construction approvals, one of the key administrative barriers to business development in Russia’s local markets. They pointed to the following problems: (i) economic activities are groundlessly segmented so as to require separate registration and licensing procedures; for example, the registering of new investments generally requires that entrepreneurs go through (a) company registration, (b) tax registration, (c) social fund registration and (d) statistical registration; (ii) separate licenses are issued for identical operations carried out at different production premises; (iii) applicants are confronted with additional requirements not stipulated in regulatory documents (e.g. requirements to submit additional certificates, copies of contracts or financial statements for the past several years, etc.); (iv) applicants are requested to pay additional charges for expert appraisal of their companies and their companies’ conformity to registration and license requirements and stipulations. According to Economic Development and Trade Minister Gref, artificially erected bureaucratic barriers cost the Russian economy 167 billion rubles annually.

Box 5: Russia as an Offshore Software Programming Haven

Venture and private equity capital in the Russian IT market is still rather limited, amounting to US$150 million and US$200 million in 1999 and 2000, respectively. Foreign companies are interested in setting up offshore programming centers in Russia. The Russian offshore programming market totals around US$80 million and is projected to reach US$2 billion in 2004. Investment in Chernogolovka (Moscow’s oblast) totalled around US$3 million, with orders as high as US$8 million. In Novosibirsk, investments were around US$20 million, with orders totalling US$12 million. Other offshore programming centres are being formed at academic institutions. The Fort Ross Information Technology Services was established in St. Petersburg in 1999 to introduce Russian software products and services to the world and to improve the quality of services provided by joining efforts of the leading Russian software developing companies. This consortium coordinates the activities of its members – including the largest IT companies in St. Petersburg with more than 1,500 highly qualified professional software engineers - and actively promotes the Russian IT community as a good potential for outsourcing. Among Fort Ross customers are companies such as Xerox, IBM, Novell and many others. Fort Ross is also affiliated with leading universities.

The Federal law “On Licensing of Certain Types of Activities,” which was adopted in 1998, streamlined and simplified licensing procedures. It established that standard rules for licensing specific types of businesses Russia-wide must be approved by Federal Government resolutions. Before the law was put in place, licensing rules for specific types of business had been established by different regulations with varying legal force (laws, decrees, resolutions, or governors’ orders). The absence of common legal norms led to exceedingly tough requirements to license applicants, as well as to unreasonably high license fees.

Our case studies suggest that a number of regional regulations and practices by some licensing bodies were not fully in line with the 1998 law on licensing, and in fact were in violation of Russian anti-monopoly laws. For example, we learned that among independent experts hired by a local licensing chamber to review applications, there were commercial organizations that were participants in the same markets as the applicants and that they had obtained access to their competitors’ financial and production information. To take another example, in St. Petersburg, when considering a claim by the St. Petersburg Association of Alcohol Companies, the regional branch of MAPSE established that the St. Petersburg Department of the Ministry for Taxes and Duties had issued eight different licenses for purchasing, storing and supplying alcohol beverages and demanded that applicants pay a duty in an amount of 500 times the official minimum wages for each of the eight types of beverages even though the existing law required only a single license for this type of business. Even in the “new” economy sectors such as software, the bureaucratic procedures for licensing can take around 4-6 months. We know of a multinational that did not need to obtain licenses, since it operates with local partners, but it reported the need for a general certification for each family of products on average 5-7 times a year.
Fortunately, in the summer of 2001, the parliament passed new legislation to further facilitate business licensing and registration procedures (see below).

Of course uncovering violations of registration and license issuance regulations that negatively impact the economic and investment environment in Russia is not easy. Neither applicants, nor existing registerees or licensees, are particularly desirous to openly voice concerns, less still file official complaints against licensing/registration bodies for fear of possible discrimination and recriminations. But while these administrative barriers surely exist, our case studies also reveal that most firms in Russia, including new entrants, have come to the point of treating these barriers as just another “routine cost of doing business”. Indeed, ironically the market for “registry-licensing agents” to deal with these barriers has been a growth industry in Russia. In many of the locales we visited we learned there is a stable of law and related service firms that, for a fixed fee, will register and facilitate the licensing procedures for new (or existing) businesses, thus saving an individual entrepreneur the time and hassle costs of going through the procedures himself (this service is not unlike firms in Washington, DC that assist residents renew registration for their cars).

**Inspections as Barriers to Day-to-Day Business Transactions**

While the problems posed by administrative requirements for business start-ups and expansion can be sizeable—though not unduly serious—excessive inspection intervention in business activities by various governmental bodies is more problematic. Indeed the political economy use of inspections in business activities by various governmental bodies—especially (but not exclusively) federal agency branch offices in the regions—are quite pernicious. These appear to be in the class of real economic barriers that obstruct entry into the market and hamper enterprise development. In general, we found across regions and sectors that in carrying out inspections, each relevant governmental inspection/supervision agency follows instructions and regulations of its own, with little agreement or coordination with other bodies. In many cases, the authorizing regulations and departmental instructions provide the agencies with unduly broad authority that in fact appears to exceed the agencies’ personnel potential and organizational structure. As a result, inspection functions are carried out, but without producing the desired positive impact on improving the quality of goods or services, the security of business operations, etc. On the other hand, many of the firms we studied indicated they are forced to intentionally break the rules established by inspection agencies because full compliance with such rules is impossible. The businesses with whom we met report that on average they are subject to inspectors several times a week, although of course it varies among sectors: “old” economy firms such as machinery and construction businesses seem to have a higher incidence of inspections than “new” economy firms, such as software producers. We did learn of several cases where a business may be subject to as many as five inspections a day. Many of these visits are nothing more than occasions for extorting bribes.

While the complete list of inspections/supervision agencies is voluminous, an indicative list would include: the tax agency; the transport inspection agency; certification bodies and test laboratories; licensing bodies; epidemiology inspection; veterinary inspection; the environment and natural resources protection service; urban technical inspection; inspection for power production, supply, and use; fire inspection; labor protection; inspection for trade, quality of goods and consumer rights protection; inspection on state monopoly for alcohol production; inspection for procurement and quality of agricultural products; inspection for telecommunications; inspection for architecture and construction, among others. A large proportion of inspection functions are performed by federal units through their territorial structures that are independent of regional administrations. In Leningrad oblast we learned that a government review found that one of the main factors behind the excessive number of inspections and the duplication of agencies’ functions is that local self-government bodies adopt regulatory documents contradicting federal laws. The review found that these problems are especially intensive in the sectors most heavily populated by SMEs, where such regulations are adopted even by district administrations.
The most frequently-cited inspections where it is common for inspectors to find discrepancies are taxes, fire (Ministry of Internal Affairs) and the sanitary and epidemiological inspection (Ministry of Health). The latter inspection, according to one Yekaterinburg-based software producer even has been required for its training activities room. Failure to meet sanitary and epidemiological inspection conditions can involve high penalties in the order of US$3,000.

Ironically, certain public associations, seemingly established to protect consumers' rights, also appear to contribute to the increase in the number of inspections. In Leningrad oblast, alongside organizations like the St. Petersburg and Leningrad Oblast Consumer Society, which does considerable work consulting consumers or protecting their interests in court, there have emerged entities whose main function appears to be to extort money from businesses under the guise of “protecting the public interest.” Equally important, in many cases inspections are based on allegations raised by rivals. In practice tax inspection is a powerful tool that can block the operation of companies, and penalize companies that do not enjoy good relationships with local officials (see Box 6).

Box 6: Rivals' Use of Inspections as an Anti-Competitive Weapon

A Moscow-based company, established initially as a hardware distributor, entered the software business at the beginning of 2000 as a developer of web applications for B2B and B2C e-commerce. Over the first 9 months of 2000 the company received 3 separate visits from local tax inspectors. Each time, as a result of the presence of external officials, operations were slowed for a week. Each time, no major fault was found, only minor faults requiring the payment of a small fine. The company believes that the inspections may have been triggered by rival companies' pressure on tax officials, requesting inspection of their competitors' companies. Another company based in Yekaterinburg -- enjoying a close relation with the local tax officials and less frequent inspections (at most once a year) -- confirmed that firms with good government connections can repeatedly request officials' inspections of rivals. Inspections in turn may severely delay production processes, and in the worst cases may oblige the inspected companies to close operations.

Political Economy Barriers to Entry

Our case studies suggest that the competitive success of many (though not all) of the firms we studied was significantly determined by privileged relationships they enjoy with governmental authorities—especially local agencies, less so federal offices—rather than their ability to serve customers effectively. This was particularly the case with firms selling to government agencies where the majority of orders were directly concluded with connected firms, with little or limited use of open, competitive tenders. These findings were not unique to specific “old” or “new” economy sectors. We heard bitter complaints of favoritism in the award of state orders by a large textile company in Novosibirsk and construction firms in Krasnodarskii. One relatively successful software producer enjoying a 30% market share in Yekaterinburg and a 15% market share in the Sverdlovsk oblast also cited evidence of government favoritism. At the federal level, the company had evidence of specific ministries recommending, via internal letters, to their commercial companies and to enterprises cooperating with these companies, the use of specific software brands of Moscow-based rivals.

Political economy barriers to entry also arise through discriminatory tax concessions granted to firms through regional administrations. In most cases, tax concessions may be granted on the criterion of the “social importance” of a given type of economic activity. But this criterion is applied rather loosely. For example, in one jurisdiction, preferential profit tax rates were established for specialized bakery and dairy retailers. Public catering units providing services to low-income citizens are also exempt from the part of the profit tax due to the municipal budget.

At the same time, most regions visited lack transparency in granting preferential loans or guarantees. For example, in August 2000, the St. Petersburg administration's gave a loan to the state enterprise Passazhiravtotrans for purchasing motor fuel. Apart from so-called "social" passenger services, Passazhiravtotrans provides commercial services and competes with private passenger
carriers in this market segment. Clearly giving a preferential loan to one of the participants in a market gives it unjustified advantage over the other market participants. At the same time, the conditions under which a locality may relieve an entity of loan repayment obligations are subject to great discretion. We learned of cases where debt write offs were given to incumbent firms which allowed them to continue operations that otherwise would have been ceased. Such an unlevel playing field creates barriers to entry by new businesses.

Lack of Competition in Warehousing and Distribution Networks as a Barrier to Entry

Without a vibrant market for distribution, many firms we studied either had to distribute their products themselves (i.e., downstream vertical integration) which can be very expensive, or forego enlarged geographic distribution of their products. While private entry has taken place in retail and commercial activities, distribution facilities are either dominated by state controlled entities or monopolies. Warehousing and distribution activities are also rife with corruption. In addition outside the major cities, there are either very poor or non-existent warehousing facilities. The situation is particularly acute for refrigeration facilities, placing severe handicaps on transshipment of perishable products across regions. The physical condition of inter-city roads is significantly poor, making long-haul trucking an extremely expensive and difficult mode of transportation (and railroad freight rates have traditionally been high in order to subsidize passenger traffic (see below)). These distribution problems are as acute in "old" economy sectors as in "new" economy sectors. To take an example of the latter, a software company we studied noted that distribution of software within Russia is very problematic because of bureaucratic procedures requiring special holographic stamps, in the absence of which the distribution of software is illegal. Logistics problems aggravate the problems of distributing software, due to the very poor quality of mail services such as express mail or couriers. The total delivered cost of transactions is, as a consequence, very high.

Local Barriers to Inter-Regional Entry and Expansion

Significant political economic power is wielded by Russia’s regional authorities. This power manifests itself, in part, by preventing entry in order to protect the market shares of local champions. The result is that such entry barriers define administrative—as opposed to economic—geographic market boundaries, and foster the regional segmentation of the Russian economy, diminishing the establishment of a unified economic space, vigorous inter-regional competition and exploiting natural economies of scale. For industrial sector goods, it has been estimated that inter-regional trade within Russia has declined from 22 percent of GDP in 1990 to 16 percent in 1994 and to approximately 12-14 percent in 2000.2

There are a variety of practices local authorities exercise to limit the inter-regional movement of goods and services. Tariffs are charged on the import or export of certain agricultural products. There also are regional duties being collected on the importation of vodka and other alcoholic beverages. Businesses using migrant workers are often charged registration fees by regional governments, which add to the costs of production and inhibits labor mobility (see also below).

Virtually all companies we studied mentioned these barriers—in varying degrees of importance. While it is difficult to generalize, "old" economy firms seem to have a better ability in over-coming inter-regional barriers to entry, in part because they have stronger political networks coming out of the earlier planning regime. “New” economy businesses seem harder hit, particularly those with foreign involvement. The experience of a Moscow-based construction company is typical: the company said that it had explored alternative plans to expansion outside of Moscow oblast but its attempts have been very difficult—due to not only visible barriers to entry (such as differential registration requirements set up by different oblasts) but to "invisible" and more insidious barriers that prevent "foreign" firms from gaining access to relevant documents, appointments, and access to infrastructure services.
Entry Barriers Posed by Infrastructure Service Providers

Without question one of the most critical bottlenecks constraining entry in Russia’s local markets in all of the regions we examined is the market power exercised by infrastructure service providers and the regulatory regime governing their service offerings. In the key infrastructure services—electricity, district heating, natural gas, railways and telecommunications—state-dominated monopolies still play a major role. In purchasing such infrastructure services, manufacturing firms, particularly new, smaller ones, confront little—if any—price competition or few opportunities to choose among suppliers. Indeed many firms we studied indicated that even getting service hook-ups for electricity or gas supplies took an enormous amount of time (roughly 3-6 months) and often required side payments to the utilities and the regulators. Some have resorted to stealing service from neighboring firms or renting space within existing firms’ warehouses just to be able to get utility service. At the same time, the quality of service is poor. We heard first-hand voluminous complaints about the quality of electricity service in Vladivostok—a well known problem market. In contrast, service from Lenergo, the electricity supplier in Leningrad oblast and St. Petersburg was praised for having improved its service, although it had had a rocky time in 1998-99. The railways were singled out many times for exercising monopoly power—less in terms of charging high prices (which are regulated by federal authorities and indeed are high to subsidize passenger rates) and more in terms of controlling the scheduling of shipments that suited the carrier’s interests rather than the shipper’s. Many firms indicated that mismatches in shipment scheduling engendered significant costs for them, and that they had little recourse to remedial actions.

For “new” economy businesses, the quality and availability of basic and value added telecom services is key. In most of the regions we examined, serious problems arise due to an old telecom network that leads to a very poor quality in the provision of services and the lack of choice in providers that artificilly keep prices very high. Both contribute to high entry costs. Software companies represent intensive users of enhanced telecom services particularly the Internet. Of the enterprises that we studied, telecom costs represent around 10% of total operating costs, despite discounts of about 20% off the official price. In the cases where they are able to, they prefer to get direct connection through foreign countries, because of the poor quality of lines in Russia. All of the studied software enterprises in Moscow use dedicated lines to access Internet services. Many of them claimed that they would stop working in the absence of Internet services. When asked which oblast was the most attractive in terms of telecom services, one software firm said that this was Moscow because of its state-oriented clients in Ministries that were able to facilitate telecom service problems. A software company in St. Petersburg engaged in Internet projects complained that it could effectively use the Internet only for ordering and not for selling. Such problems are aggravated by the lack of legislation on e-commerce (see Box 7).

Lack of Financial Capital as a Barrier to Entry

In almost any country it is difficult to persuade banks or other financial institutions to back a start-up businesses; in transition economies, where capital market imperfections are pronounced and institutions that intermediate savings into investment capital are typically nascent, the problem is particularly acute. Like many other CIS countries, in Russia our case studies indicate that bank loans for new businesses are short-term and expensive, typically for 6 months term at rates from 40% to 45% per annum. As a result, most SMEs we studied started from personal savings. In fact very few of the firms we studied—regardless of size—have either applied for or received bank credits. (A more complete discussion of the banking sector issues emanating from the case studies is contained in the chapter on the financial sector.)

Land and Real Estate Barriers to Entry

Our case studies showed that new startups are hindered by restricted access to commercial real estate due to monopoly ownership and control over urban land by municipal administrations. In
theory, enterprises have the right to privatize associated land plots; in practice, procedures are unclear. A very small percentage of the land under privatized enterprises has been privatized. Firms have not been able to realize the value of the land via mortgage, lease, or sale, nor have they been able to restructure effectively by modifying structures since control rights over land flow only from the ownership. The failure to assign clear rights over unoccupied and undeveloped urban land is another restriction. Prior to the recent passage in the fall of 2001 of the Land Code, the Government has pursued these objectives through presidential decrees. Implementation of these decrees, however, particularly at the sub-federal level has been weak; and the current land tax system contains disincentives on the part of regional governments to sell land under privatized non-land real estate. More progress has been made for establishing the legal framework to ensure leasing and selling of commercial real estate belonging to the federal government takes place under competitive conditions; but such provisions are not mandatory for regional and regional governments. Overall, it is clear that facilitating private access to real estate is a policy priority to enable new entry. To this end, rapid implementation of the new Land Code at the local level is needed and the real estate tax system needs to be assessed. Now that the legal constraints on private ownership have been removed, local governments need to realize that the commercial, fiscal and economic benefits of divestiture far outweigh those from continued government ownership.

### Box 7: Development of E-Commerce in Russia

E-commerce has become increasingly important in the business-to-business (B2B) and in the business-to-consumer (B2C) sectors in Russia. The sales volume of Runet (the Russian Internet sector) is estimated at US$ 90 million. Another US$ 7 million is earned through Net-advertising. The Communications Ministry is establishing a comprehensive program for developing E-commerce in Russia. The program calls for setting up pilot E-commerce zones in 10 regions, as well as developing and launching E-commerce projects for international trade. If other countries' experiences are any guide, developing E-commerce will be economically much more viable in Russia when more than 15% of the population (21.6 million persons) is on-line. Russia has currently only 2.5 million Internet users. One constraint on more rapid development is the lack of a unified payment system, although this problem is likely to be solved over the next few years. The legal framework also needs to be developed. The Russian Communications Ministry has submitted proposals to the government regarding several IT-related draft laws, including: On Electronic Digital Signature; On Changes and Amendments to the Federal Law On the Participation in International Information Exchange; On E-commerce; and On the Registration of Domain names. (The Law “On Electronic Signature” was approved by the State Duma in December 2001 and signed by President Putin in January 2002.) Work on the pilot zones is to be financed by regional budgets and interested organizations. The program calls for research into business processes, prospects for developing information technology, and standardization systems for E-commerce. Rapid implementation of the program is being held back by the poor development of some markets, unstable financial institutions, and breakdowns in commitments between E-commerce participants.

### Barriers to Essential Inputs as Blockading Entry

Access to essential inputs is very problematic in Russia's regions, especially in the "new" economy sectors. Many enterprises report problems with software suppliers. In most cases the suppliers enjoy near monopsony power and as a consequence can dictate their own terms and conditions. Additional problems are created by the specification of software that often does not work in Russian applications. Further problems arise since essential inputs under government control appear to be provided selectively, rather than across-the-board at market terms. According to a Yekaterinburg-based producer of map-related software, the main problem that the company faces is access to existing detailed maps. Rival state-owned enterprises that have inherited the maps produced during the Soviet era try to deter entry of private companies by denying access to such materials.

### Entry Impeded Due to Poor Access to Skilled Labor

One of the most severe constraints expanding firms face in the regions is their ability to find expert workers. Indeed almost all managers interviewed report that they currently face impediments to
increase their labor force—despite stronger demand for their products. A common complaint among general directors is the difficulty of attracting particular types of experts. This is due in part to the surge in recent demand for new skills but without the matching supply of requisite workers—for example skills in modern management techniques and in specialized areas such as computer programming; see Box 8. Although most firms acknowledge that a large part of the problem is that they are unable to offer competitive wages, the shortage also is the result of constraints reflected in limited regional mobility within the country and outdated training programs.

**Box 8: Lack of Skilled Workers — An IT Firm in Novosibirsk Oblast**

Established in 1991, this IT firm has expanded rapidly over the past 10 years, growing from 3 to about 300 employees. Its growth however has been constrained by the lack of available skilled labor in the software programming field and in modern management techniques. Especially since the crisis in August 1998, the firm has tried to increase its capacity and compete on the Russian market with foreign enterprises. Its recruitment efforts, through headhunters, its web site newspaper advertisements and its informal network, have all been hampered by the lack of the firm's internal marketing skills and an incomplete strategic vision. If possible, in the coming year, this firm would like to increase its management staff by 10 percent, and its overall personnel by approximately 30 percent.

The lack of skilled labor is increasing the economic gaps between Russian regions. Regions with well-established, state-of-the-art universities, for example, Novosibirsk, appear to be restructuring at a somewhat faster pace and attracting investment. Relatively few managers indicated that in order to overcome the shortage of skilled labor would their firms—at this juncture—hire unskilled labor and provide in-house training, although in the case of senior positions, training would be provided to new employees. The limited availability of skilled labor is also exacerbated by workers' unwillingness to move, especially outside urban centers, in part because of housing endowments they enjoy in their current locality, local residency requirements that act as constraints on new worker entrants (for example in the city of Moscow) or poor transport links. Despite substantial improvements since the start of the transition, worker mobility across Russia's regions is still quite limited. This creates unnecessary bottlenecks in the labor market, retards enterprise restructuring, and increases the wage and economic disparities across regions.

Some software companies are now encouraging some of their most talented programmers to study business so they can employ them later as strategists. But under Russian labor laws, they fear that graduates will not come back to work for their company and would rather take up better-paying jobs in the West. Moreover, many programmers do not want to go into further training because they cannot afford to live without an income for a year or two. To fill the gap between demand and supply, some Russian software companies import expensive IT strategists from western firms. But those are not easy to find either and are very expensive, costing at least US$2,000 a day. Several software companies were considering creating a school to train programmers to become strategists. But the idea is still at the conceptual stage and the missing link between Russia's businessmen and programmers is costing the country's booming IT industry millions of dollars in lost revenues.

**Lack of Enforcement of Intellectual Property Rights as a Barrier to Entry**

An important barrier to entry and expansion that stands out from the majority of case studies in the “new” economy software sector is the uneven playing field determined by lack of enforcement of intellectual property rights that lead to piracy. Pirates can sell at only a fraction of the official price—some managers noted that prices can be as low as 1% of the official price for some software products—and still making a profit because they do not incur the high development costs (see Box 9). In turn, pirates steal business sales, raising economic and technological barriers, constraining software producers to keep a low scale of production. Economies of scale—especially in packaged software—are very high, because of the high development fixed costs and marginal imitation costs (for pirates). Hence, many managers find that because of the small size of Russian software companies, productivity is much lower than it would be if they could enjoy the benefits of economies of scale. They believe
that by recapturing the market shares stolen by the pirates would lead to enhanced productivity. For example, a software company based in St. Petersburg noted that piracy led to a significant decrease in the volume of sales, estimated to be 4 times lower than what would be the case in the absence of piracy. It also complained that Russian piracy is institutionalized in shops and not fought effectively by the authorities. Another consequence of piracy is that companies are left with limited resources to invest in R&D and develop competitive products. This leads also to lower productivity since many companies supply less sophisticated, and consequently cheaper products (with the exception of global operators who deliver very similar products around the world).

**Box 9: Software Piracy in Russia as a Barrier to Entry in the “New” Economy**

The Business Software Alliance, a copyright protection agency for software products reports that pirated products accounted for about 90% of all software programs sold in Russia in 1999 and 2000. To understand the severity of the problem the level of intellectual piracy in Western countries averages 34%. The overall loss of software vendors was estimated at US$165 million in 1999. The Russian Patents and Trade Marks Agency reports up to US$200 million in unpaid taxes in the field of intellectual property, the problems being more dramatic in the case of software and audio recordings, and less severe for book publishing. Intellectual property rights issues have recently achieved prominence in Russia, in its attempt to achieve membership in the WTO. Indeed, Russia's struggle for membership in the WTO has become a test of how serious the government is about cracking down on piracy. The basic legal framework for prosecution of piracy is already in place with both the Criminal and Administrative Codes containing relevant articles. Most software enterprises studied agree that Russia's civil courts generally deliver fair legal decisions and the shortcoming is the lack of enforcement. In 1999, the latest year for which there are statistics, only 29% of all criminal cases of piracy resulted in convictions, and penalties were generally minimal. Maximum current fines, 50,000 times the minimum monthly wage (approximately US$185,000 at current exchange rates) do not act as a deterrent. Some reactions from the key players in the market have followed: Microsoft stated that it would introduce a new registration procedure for the users of its new versions of software programs in 2001. Legislation recently passed by the Parliament will help bring Russian law into line with international conventions on intellectual property.

**Conclusions and Policy Implications**

Our case studies indicate business competition in Russia's regions has intensified significantly in the wake of the 1998 crisis. But the incidence of such competition varies considerably across regions and across sectors—across product sectors and across “old” and “new” economy sectors. In large part this is not surprising in an economy undergoing major transition and as heterogeneous and large as Russia's. More important, it is not clear the extent to which new competitive pressures are enduring. Indeed, our case studies reveal several fundamental constraints on competitive market forces. Many of these constraints are long-lived and will require major policy changes, which will likely pit vested interests against one another. Moreover, concerted and coordinated actions at both the federal and the regional levels are required to ensure the successful implementation of such policies.

Given Russia's inherited industrial structure and in particular the continuing relative scarcity of private start-ups, the policies required should be two-fold. On the one hand, policy actions should include pro-active, transparent and even-handed competitive restructuring of incumbent firms, which provides for both the horizontal and vertical divestiture of integrated firms operating beyond the point of scale economies and the exit of insolvent and value-subtracting firms bottling up assets that otherwise can be deployed to higher values in use. But more importantly the policy framework should also create a clear rules-based enabling environment encompassing a level “playing field” for fostering new business entrants. Indeed, the main emphasis of policy should be to facilitate entry on equal terms for all market participants, ranging from removing economic entry barriers to helping liberalize trade and attracting foreign direct investment.

Make Structurally Dominant Markets Contestable for New Entrants. Our case studies suggest that the emphasis in Russia's competition policy should be on dealing with horizontal and vertical structural market imperfections among incumbent industrial firms to create economic space
for new entrants. Priority attention and resources—both human and political—should be directed toward those markets where there is already significant concentration and structural dominance; other markets can be dealt with subsequently. Moreover, resources should be directed at preventing further horizontal and vertical consolidation through mergers and acquisitions in markets where concentration and structural dominance are already excessive. In this regard, more explicit and well-defined merger guidelines should be developed that establish general policy parameters for distinguishing between pro-competitive and anti-competitive mergers based on similar guidelines used in industrial countries, such as the EU and the US. Public announcement of the guidelines is critical to maximize transparency, credibility and predictability of the merger/acquisition policy regime so as to not hinder a “market for corporate control” and the rechanneling of assets to higher values in use. Merger applicants should know ex ante they have to meet the burden of proof that a merger will enhance efficiency and not result in a significant loss of competition. But a balance must be struck between, on the one hand, prohibiting excessive enterprise integration that engenders the exercise of market power, and on the other, fostering sufficient integration that permits the realization of technical economies of scale and scope.

**Remove Regional Government Barriers to Inter-Regional Trade and Investment.** The use of licenses, taxes, loans, debt forgiveness or other instruments to favor some local enterprises over others should be penalized; the existing anti-monopoly law contains provisions disciplining anti-competitive acts by State executive bodies. Entry and expansion is critical for effective competition, not just from local enterprises but importantly from enterprises located outside an oblast. To facilitate trade and investment within the country, all requirements that unduly obstruct economic activity, such as bans on the import or export of goods and services across localities and oblasts, unequal price controls or taxes for local versus non-locally produced goods, or the granting of other unequal privileges to some enterprises and not others should be removed based on enforcement of the provisions related to state executive bodies. In this context the regional branches of MAPSE should play a stronger role (Box 10). Consideration should be given for a new policy of making federal transfers to the regions conditional on progress in removing barriers to inter-regional trade and investment. This could help counteract the captured relationships between local government agencies and incumbent businesses.

**Box 10: The Role of MAPSE**

The Ministry for Antimonopoly Policy and Support for Entrepreneurship (MAPSE), established in 1998, succeeding the State Antimonopoly Committee founded in 1990, has a nominally strong presence at the local level, through its 70 regional offices. MAPSE enforces rules on abuse of dominance, price agreements, concentration by enterprises, and unfair competition, defined according to similar criteria as in most established market economies. The scope of the law applies also to state executive bodies at the federal, regional and local levels, with executive bodies and their officials bearing civil and criminal liability in the event of violations. These provisions are intended to prevent administrative bodies from introducing barriers to competition, for instance by impeding the mobility of goods and services or by establishing favorable conditions for selected enterprises. Based on annual reports of MAPSE, cases coming from abuse of dominance accounted for about 30% of the total application considered during 1998 and 1999 and about 10% of the decisions. Anticompetitive acts by state executive bodies accounted for about 25% of the total applications and more than 15% of decisions. Mergers and acquisitions cases dominate both in terms of applications and decisions that account respectively for about 40% and 60% of the total. MAPSE also has a competition advocacy function, which is not only limited to give opinions on new regulations when asked, but also include the right both to order changes or withdrawal of existing rules that impede competition, as well as to recommend the introduction of new rules where necessary to promote competition.

**Intensify Enforcement Against Anti-Competitive Conduct by Incumbent Firms.** In addition to barriers erected through government actions and rules, the entry and expansion of efficient enterprises is also made more difficult or entirely deterred by existing firms. Many of the complaints on abuse of dominance pertain to essential service inputs from infrastructure providers, in particular electricity, gas, oil, communications, railway and air transport, and airports. The regulatory reforms in the infrastructure sectors will help in resolving some of the underlying issues. In principle, it is easiest for enterprises that have significant structural dominance over one or more markets to adopt entry-
deterring practices, including mergers and acquisitions that reduce the number of sellers in a market, so the control of concentration is an important area for MAPSE vigilance. It is critical for MAPSE to elaborate clearer rules on mandated restructuring to overcome excessive market power where existing market structures are not the result of competitive market outcomes. In the light of the broad connection between enterprises and the informal nature of some of the interdependence/ownership relationships among them, new methods of investigation focused on the least competitive sectors, documented by more detailed background studies, will help increase the effectiveness of cases designed to reduce concentration and abuse of dominance.

**Promotional Policies for SMEs.** SME support is clearly critical for engendering new entry and competition in Russia's regional markets. But as the case studies show, the current tax concession regime for SMEs is creating widespread distortions by fostering firms to remain at relatively small levels in order to enjoy the tax benefits. Where existing firms are below minimum efficient scale, integration should not be prevented but rather encouraged. Consideration might be given to provide the SME tax credits along a sliding and less graduated scale. The system of targeted SME support through subsidized lines of credit may, in the end, be counterproductive. Such a regime undermines market-based reforms of the banking sector and the strengthening of the commercial intermediation role of banks (see also the chapter on the financial system). Worse, particularly in the context of a weak property rights in Russia, the credit lines breed corruption. Non-governmental support programs (sponsored by commercial banks or international donors) that can be helpful include (i) providing equity participation in venture capital and investment funds; (ii) funding of local banks providing commercial based credit to SMEs; and (iii) co-financing with local banks of SME projects.

**Enforce Newly Liberalized Ownership and Access to Land and Real Estate.** In late 2001 the new Russian Land Code was signed by the President. This landmark statute establishes rules for the free transfer, ownership and user rights of non-agricultural land. However, ensuring implementation of the new Land Code at the local level will require enforcing actions on the part of regional administrations. The federal government has created a state system for registering real estate rights and transactions, as well as creating a base of standards for a system by which to ensure rights of ownership of real estate, including the institution of title guarantees and insurance; regional governments have not fully instituted the system at the local level. An assessment of the land tax system should be completed with a view to removing disincentives on the part of regional governments to sell land under privatized non-land real estate.

**De-Bureaucratize and Strengthen Enforcement of Rules-Based Procedures to Reduce Discretion.** The federal government and parliament have been establishing legislative changes in this area that can help address some of the problems. In particular, in August 2001 several laws have been enacted, which will become effective in 2002. One new law provides for the establishment of a special body to register legal entities and moves to a "one window" registration process. The law introduces a unified state register of companies to include information on all companies, regardless of where they are registered and what business they are in. The law also lists the documents required for registration and simplifies the procedures for submitting documents, as it allows these to be either handed in or sent by post. Registration bodies will not be allowed to ask for any other documents other than those established in the law. Another law replaces the 1998 Law on Licensing. It reduces the number of economic activities subject to licensing from more than 500 to about 100 at the federal level. It aims to instill a uniform state policy in licensing and to introduce a simplified procedure for issuing licenses, together with a list of criteria for licensing activity with uniform legal standards. Another law conditions the power of officials to subject companies to inspections and other investigations. It formulates new principles for the protection of entrepreneurs' rights in this area. Among these principles is the provision of a single economic space in Russia and that state control (supervision) be carried out only by officials or authorized personnel of state bodies and state institutions, authorized to implement such supervision by Russian legislation.

Of course the key to success of such legislative initiatives is the extent to which once they come into force, they are implemented and their provisions are actively enforced. Appropriate
incentives and disincentives thus need to be created through implementing regulations in order to ensure satisfactory results. This is particularly challenging at the regional level, where there is a long history of discretionary actions by local officials.

In addition to these legislative changes, fundamental reforms in the civil service, such that salaries are appropriately increased and performance-based reward structures are introduced, will be necessary. In addition, reforms are needed to prohibit the use of fine-generated resources to fund inspection bodies or preventing tax inspectorates from using the revenues from fines to meet their tax revenue quotas.

**Establish Independent Monitoring Systems as a Check on Reform Implementation.** International experience from other countries suggests that the development of an integrated de-bureaucratization program is most effective when there is independent public monitoring of the program’s implementation with strong support at the highest political levels. Monitoring of reforms should be entrusted to a specialized unit to oversee the success of the de-bureaucratization effort, based on widely-publicized and anonymous feedback channels for enterprises to report violations at the local level. As an example, monitoring mechanisms in the area of business inspections could thus include: (i) quarterly public reporting by inspection/supervisory agencies about their inspection activities; (ii) introduction of inspection logs at enterprises and organizations; and (iii) establishment of coordinating boards to organize inspection activities (these boards would be responsible for monitoring and summing up the results of all inspections, as well as for maintaining a database of such inspections). St. Petersburg has launched several initiatives in monitoring; see Box 11. Centralized enforcement could be strengthened with direct federal support through the withdrawal of federal transfer benefits from any region that fails to comply.

**Box 11: Monitoring Initiatives in St. Petersburg**

In recent years St. Petersburg has witnessed the emergence of a number of business self-regulation organizations, including non-commercial organizations, the aim of which is to monitor relations between enterprises and consumers. For example, the non-commercial organization St. Petersburg Bureau of Irreproachable Business, set up in 1997 on an initiative by the St. Petersburg and Leningrad Oblast Consumer Society, among other things, maintains a database of consumers’ complaints to various organizations, where complaints are classified by consumer market sectors, and models of items/services. Indeed, St. Petersburg has begun to annually monitor local markets and the business environment in the City. This monitoring, funded by the St. Petersburg Administration, is conducted by the independent non-commercial organization Center for Market Environment Research in collaboration with the regional branch of MAPSE. The sample of the markets subject to monitoring varies with the regional economic-policy priorities or with the emergence in certain markets of problems requiring analysis or, in some cases, state intervention. In the three years since the program began, the Center for Market Environment Research has obtained and analyzed the markets covering: infrastructure services provided by the “natural” monopolies; meat and meat products; dairy products; flour; margarine products; medical products; storage and wholesale of fruit and vegetables; wholesale supply of alcohol products; “commercial” fixed-route passenger transport; retail trading in car fuel (petrol and gas); storage and wholesale of petroleum products; forestry and timber products; newsprint paper; construction materials (bricks, sand, and telephone cables); marine port services; waste removal and disposal; housing-and-utility services; non-residential stock leasing; banking services; insurance services; leasing services; auditing and consulting services; paid education services; ritual (undertaker’s) services; and street advertisement carriers.

Another important lesson from international experience is that transparent and participatory regulatory impact assessments (RIAs) should be institutionalized for new regulations. RIAs would subject any new regulatory proposals to cost-benefit scrutiny before the regulations were issued. Input from business should be sought for an appropriate consideration of all possible costs of any new regulatory requirements; see Box 12.

**Compete for Reform Progress.** The documentation of reform progress at the local level could help create bottom-up pressure for more effective implementation. By creating comparable information across regions on policy-based barriers to entry and expansion, such as the average
number of days and cost required to acquire a specific license, register a new business, or hook up for utility service, it becomes apparent to domestic (and foreign) investors which regions are creating a more favorable investment climate. Such "benchmarks of deregulation", if appropriately disseminated, should create a basis both for local enterprises to advocate for more rapid reforms in areas where their regional governments are resisting change, and for regional governments to further deregulate in order to attract more investment and hence greater employment and growth. In order to jump-start this type of virtuous competition among regions in regulatory reform, government at both federal and local levels could play an important role in proposing appropriate metrics to assess progress in regulatory reform together with a simple survey methodology (see Box 13).

**Box 12: Regulatory Impact Assessments**

The United States has had since 1980 the most stringent system to control process regulation, with legal authority granted to the Office of Management and Budget (OMB) in the Office of the President to review and approve all paperwork requirements imposed on enterprises. OMB is the sole review body with unilateral legal authority to overturn the decision of any entity issuing administrative requirements. Under the program, OMB reviews more than 3000 requirements a year, at least once every 3 years, against several simple criteria, including whether a regulation continues to be useful; it imposes the least burden necessary; or does not duplicate information otherwise available. A public consultation process elicits suggestions to reduce burdens. A central database records time for each requirement and total burden. Mexico also launched a similar program at end-1995 through a Presidential Decree. Central oversight is by a co-ordination unit under the Ministry of Trade and Industry (now Economy) with a high-level Economic Deregulation Council of government, business and non-government representatives overseeing progress. A complete inventory of remaining regulations is available on the Internet to ensure easy access by businesses.

**Box 13: Benchmarking Reforms**

In response to the conclusions of the European Council held in Lisbon in March 2000, the European Commission has launched a benchmarking exercise on policy towards enterprises ("Benchmarking Scoreboard"), including indicators on regulatory constraints in starting new enterprises, including average time and costs involved in setting up a company. The intention is to provide an assessment of relative effort, performance and progress in member states and the Community as a whole vis-à-vis a number of other countries, in order for member states to take actions based on learning from shared experiences and good practices. In Mexico, spurred by the ongoing federal regulatory reform initiative, the leading national business organization, through its own private think tank, has since 1998 produced an annual benchmarking study comparing the quality of regulatory reform initiatives across the 32 regions of the country. The yearly study includes an assessment by region both of changes in the regulatory framework based on number of changes in rules and the results of an enterprise survey of 950 recently-started enterprises. The survey covers two areas: an assessment of the implementation of regulations in practice (costs, required documentation, level of discretionality) and the number of days that were required to start the enterprise.

**Support “Natural Allies” of Competition at the Local Level.** In order to overcome the weight of entrenched incumbent enterprises seeking to block new entry and protect their markets from competition, MAPSE and regional administrations need to build coalitions of support among household consumers and those enterprises that in the short-term stand the most to gain from enhanced competition -- such as new local investors, SMEs, exporters, foreign entrants, and all important groups of enterprises that are intensive users of critical upstream inputs. Such promotional activities should bring to the attention of MAPSE and the regional bodies the most crucial problems faced by the business community in fostering competition. The extent to which existing and new anti-competitive practices by state executive bodies as well as anti-competitive practices by incumbent enterprises restrict entry and expansion is generally difficult for local MAPSE offices to ascertain without the assistance of affected enterprises. The development of a more effective dialogue between concerned enterprises within the local business community (and possibly some representatives from neighboring oblasts) and the regional MAPSE offices would help ensure that a greater proportion of MAPSE initiatives are driven by appropriate competition-related complaints. In addition to cases brought forward by individual and groups of enterprises, information gained at such meetings also should facilitate MAPSE offices to open investigations on their own initiative.
Enhance Public Education Efforts to Foster a "Culture of Competition." As part of their competition advocacy mandate, regional MAPSE offices should undertake more regular education activities aimed at ensuring that the consumers at large, as well as all enterprises, especially start-ups, are aware of the importance of the competitive process in practice, and the objectives and content of the competition law. Such efforts should include region-specific examples of the impact of anti-competitive actions by both government entities and enterprises, and of the process that leads to the curtailment of such actions. MAPSE offices should play an active role in mobilizing and teaching these constituencies how they can help support sustained and enhanced competition, through their purchase decisions in markets, by sharing information on observed anti-competitive acts by enterprises and state executive bodies, through written letters of support to government decision-makers for pro-competition policies, and through all other available forms of joint political pressure.

Improve the Functioning of Distribution and Warehousing Infrastructure Across Oblasts. In order to facilitate entry, it is essential to improve access to distribution infrastructure services. This would include facilitating access to distribution channels, warehouses and transport networks, and the telecommunication network. In particular, increased availability and affordability of data and information services, and the development of e-commerce can significantly lower transactions costs across oblasts and facilitate downstream entry. (The policy priorities needed in order to achieve such aim are described in more details in the chapter describing the regulatory regime.)

Liberalize International Trade and Foreign Investment. To facilitate entry through trade and investment from other countries, further liberalization should be enshrined in the context of an early accession by Russia to the WTO. The competitive benefits from a more predictable and transparent open trade regime that would come with WTO accession would accrue not only to enterprises in other countries, but also to Russian enterprises, exporters through enhanced access to foreign markets, downstream users of imported inputs, and all firms that directly and indirectly would benefit from increased foreign and local investment. Furthermore, additional reforms to the customs code are required beyond the simplified tariff regime that took effect in 2001. In particular, the discretion that customs officials still have, which creates opportunities for corruption, for instance in the classification of goods, needs to be curtailed. Further relaxing of foreign currency surrender rules, and equalizing the rights of non-residents and residents such as granting non-discriminatory national treatment to foreign investors for both right of establishment and post-establishment operations across industries would help create an internationally more level and more competitive playing field.

Improve Intellectual Property Rights Protection. Protection of intellectual property rights is required to address R&D market failures and uncompensated benefits and costs generated by the interaction between innovation and skills. Importantly, it should stimulate entry and expansion by producers of software by recapturing market shares stolen by pirates. Russia is making large steps towards protecting companies’ intellectual property rights in strengthening its legal framework preparing itself for WTO membership. Its passage would bring Russian legislation into line with international conventions on intellectual property including the WTO TRIPs agreement. The key shortcomings derive from inadequate enforcement and should be addressed both by deterring initial and repeat offenders through the imposition of civil and criminal penalties for intellectual property rights abuses, as well as by improving policing tools. Among the most effective tools to combat piracy at the international level are “civil search” warrants granted for the purpose of investigating allegations of software piracy to obtain evidence of the unlicensed use and copying of the products. In 2000 and 2001 raids were made against a number of companies in Moscow, Samara and Novgorod, resulting in the filing of criminal charges in three cases. Another six cases are still under investigation, and in one case the Meschansky district court in Moscow gave a one-year suspended sentence to a distributor of pirated copies of software.

Address Skills Shortages Through Changes in Educational and Training Programs. Our case studies provided strong evidence of the severe skills shortages for business management and strategy capabilities. Changes in educational and training programs that can help addressing such shortages include the establishment of accreditation and apprenticeship programs, providing a mix of
work-based training and off-the-job vocational training. Helping support stronger links between academic institutions and prospective employers (particularly in the case of IT industries) would represent good first steps in order to establish clear vocational paths from secondary schools for new entrants into labor force. Financing of training is complicated by the existence of incentive issues. As noted by many studied companies, the possibility of workers leaving the company discourages enterprises from providing training. On the other hand, labor and capital market imperfections discourage workers from acquiring training. An approach suitable for transition economies could be through the provision to workers of training vouchers financed out of general government revenues. This policy aims to compensate firms more fully for providing training by giving them an explicit subsidy for this purpose and workers for acquiring skills since they permit higher take home pay to be negotiated over the training period.
Bibliography


Endnotes


III. The Regulatory Regime in Russia: The Telecom and Internet Sector in the Regions

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Introduction

The operations and structure of the key network infrastructure services sector in Russia—comprising the energy utilities, rail freight operators, and telecommunication providers, among others—condition the development of the country’s “real” sector. Indeed, there is accumulating evidence that one of the principal burdens on efficient enterprise entry, expansion and innovation in Russia is the extent to which infrastructure service providers pose bottlenecks to broader commercial activity. In principle, one of the tasks of the economic regulatory regime governing infrastructure firms is to minimize such bottlenecks. Of course, as in all economies worldwide, while such “utility” regulation should enable government to provide important economic and social protections to the users of the services—both the population at large as well as businesses—they invariably also impose costs. In Russia these costs arise not only from inappropriate rules (e.g., prices not in line with market valuation), but also inappropriate application of utility-related rules (e.g., some enterprises have been entitled to special privileges—in terms of both differential access and pricing).

The current regulations and their enforcement vis-à-vis certain infrastructure services in Russia are only starting to reflect recent international trends—towards increasingly pro-competition rules, towards unbundling of service offerings and more open entry and exit. Indeed it is increasingly understood by policy makers—both inside and outside of Russia—that to create the appropriate incentives for growth and innovation both by business users and service providers it is clear that a priority is to introduce competitive forces where “natural” monopoly conditions no longer exist, with appropriate regulation restricted to those areas where competition alone is not likely to generate desirable outcomes.

The benefits for Russia of fostering liberalization of the infrastructure sectors, accompanied by transparent and clear “rules of the game” are twofold. First, these sectors are important sources of employment and innovation in their own right. Moreover, more efficient provision of infrastructure services, in turn, will allow the development of the downstream real sector, as the latter depends crucially on more efficient infrastructure. Finally, transparent regulation will help to reduce incentives and opportunities for corruption and preferential privileges for certain operators both upstream and downstream.

Much has been written about the regulatory problems—both political and economic—and about the debate concerning reform initiatives in the “traditional” infrastructure sectors in Russia. The focus of this chapter is on the telecommunications sector, especially enhanced telecom services, such as Internet services, for a number of reasons.

The role of telecommunications as a facilitator for local, inter-regional and international trade is crucial to reduce transaction costs and to allow exchanges that otherwise would not take place. Internet development could potentially offer Russia an electronic solution to the transportation and communication problems posed by its large size and geography. As such, the Internet could be a promising source of future growth. Moreover, Internet technology is an invaluable business resource.

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and is bound to grow in countries such as Russia, where it is used by the expanding manufacturing sector. In spite of the adverse regulatory environment, the telecom sector has already been growing at exponential rates. It thus represents an ideal sector in which to explore the benefits of regulatory reform in terms of key performance indicators across different market structures across different oblast, some of which are characterized by very few players and others in which competition is flourishing and involve small start-ups versus larger (in some cases state-owned) operators.

This chapter evaluates the ways in which the regulatory regime for telecom services at the oblast level influences the development of Russia's business environment and firms' performance. The structure of the chapter is as follows. The next section provides an overview of the telecom sector, with particular reference to the Internet. Then we focus on the regulatory framework, assessing the nature and extent of barriers to entry and expansion of telecom operators, including Internet Service Providers (ISPs); see Box 1. The closing section concludes with an overview of the reform efforts already underway and the remaining challenges.

**Network and Structure of the Telecom and Internet Sector in Russia**

The Russian telecommunication industry structure is, at present, characterized by market and competitive fragmentation, largely due to the lack of a transparent and clear sector strategy. Although consolidation plans are soon to be underway, the traditional fixed-line market is currently organized into 89 regions, each of which has an incumbent operator known as Electrosvyaz of Svyazinform. All of these operators provide local, long-distance and international voice services, and many also offer data transmission, mobile and Internet services.

The telecom holding company Svyazinvest controls the majority of these operators. It was formed in 1995, as a first step towards telecoms privatization. However, the method of privatization has resulted in a complex and diffuse sector-wide ownership structure. Svyazinvest owns a controlling stake in both Rostelecom (51%) and 82 of the elektrosvyaz. Controlling stakes vary between 50.67% and 60.35%, and the holding company has large stakes in four elektrosvyaz that it does not control. Also, a stake in Svyazinvest is impressive on paper, but exposes the investor to liabilities across a range of regions with varying economic prospects and varying degrees of control. Other significant shareholders include the state, regional authorities, foreign telecom companies and international investors.

Only three regional operators (MGTS, which serves the city of Moscow, PTS, which serves the city of St. Petersburg and Moscow Elektronsvyaz, which serves Moscow region apart Moscow itself) have more than 1 million access lines, accounting for approximately 27% of total access lines in Russia. Competition to the traditional incumbents is starting in many regions, particularly in Moscow and St. Petersburg. Alternative providers offer competitive exchange carrier (CLEC) voice as well data services to business customers. Holdings such as Golden Telecom, Sistema Telecom (Moscow) and Telecomminvest (St. Petersburg) are very powerful when they have formed alliances with the traditional telecom operators to get access to the Public Switched Telephone Network (PSNT).

The announced sector consolidation through the creation of seven new enlarged supra-regional telecom operators is proceeding ahead of schedule, with the merger terms already announced for all companies. In particular, the swap terms for all seven enlarged regionals have been approved by all shareholders except for those in the Central region, where the process is expected to be formally completed before the spring of 2002. (More details on the consolidation process currently underway and its likely impact on the sector are discussed below).

The Russian Internet sector is still in the early stage of development, with penetration just around 3% compared to an average of over 20% in Europe. Figure 1 shows how Russia compares
unfavorably to countries in Central and Eastern Europe. Only in 2000 has it moved ahead of Kyrgyzstan, Macedonia and Armenia.

**Figure 1: Internet Penetration Per Capita (1994, 2000) Across Transition Countries**

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**Box 1: The Typical Structure of Revenues of a Russian ISP**

65-90% of an average Russian ISP’s current revenues comes from dial-up access charges (with annual dial-up revenue per subscriber ranging from US$150 to $230). Dedicated access subscribers may generate from 8-20% of revenues. Web-related services are quite new and can account for 1-10% of revenues. After the 1998 financial crisis many ISPs which pegged tariffs to the dollar declined in revenue per user and customer numbers. In order to preserve their customer base most ISPs have significantly reduced their prices. As a result, Internet tariffs are expected to keep on declining and at the same time traffic volumes are expected to increase due to increased usage and new subscriber growth.

The Internet access business in Russia is highly fragmented. There are around 300 companies licensed to provide Internet access services. More than half of the ISPs are based in Moscow and St. Petersburg. However, only around 15 of them have more than 15,000 subscribers. Moving outside Moscow and St. Petersburg to Yekaterinburg (a city of 1.4 million inhabitants) the largest ISP has only 8,000 subscribers. Of these companies, 10 started providing services since 1998. Accordingly, it is not surprising that, when asking ISPs as to the number of effective competitors, most of them indicate only the first ten major players, and some only just one or two telecom operators. Competition is particularly fierce among telecom operators that provide integrated services (combining Internet, data and voice telephony).

Quality of service varies significantly throughout Russia depending mainly on the public network involved in the transmission process. Quality is significantly better when digital overlay
network operators provide transmission. Local loop digitalization in the regions is quite low at 35%. Such low digitalization harms the quality of the service, call completion rates and capacity to provide Internet and value added services. To improve the quality of the service, ISPs in regions with higher levels of telecommunications development have started to introduce ADSL (Asymmetric Digital Subscriber Line) technology. ADSL is a type of technology that allows for an increase in transmission speed in a copper cable (at a speed comparable to that of fibre-optic lines) by a division of capacity into a channel with a higher speed to the subscriber, and a channel with significantly lower speed in the other direction. The problem is that if the quality of the copper network is not good, ADSL quality will be bad too. Given the poor status of the public network in Russia, new lines must be acquired for deploying ADSL. Box 2 illustrates the variation of the quality of connection across the different oblasts.

**Box 2: Quality of the Internet Services Across Oblasts**

The majority of ISPs see the development of the Internet mostly constrained by problems in getting local access to the public network, the bad quality of the lines and the low penetration of personal computers. Problems of access to the network are more serious in less developed oblasts, where the local subsidiaries of Svyazinvest are facing financial problems and are not able to upgrade the network, whereas major cities (particularly Moscow) experience problems of congestion, due also to the fact that many local ISPs prefer to link to the Moscow exchange rather than their local one. Telecom operators with a presence in most of the Russian oblasts confirm that in some areas it is impossible to get access to the network and the only viable solution is to create joint ventures with the local operators. From their experience outside Moscow and St. Petersburg problems are less severe in Krasnodarskii, Nizhny Novgorod and Samara and particularly severe in Volgograd and Voronezh.

Figure 2 shows evidence of the poor development of the network, both in terms of fixed line and personal computer penetration. Fixed-line penetration in Russia was 22% in 2000, compared to 37% for Slovenia, Czech Republic and Hungary, and over 60% for the more advanced OECD countries. Russia is also lagging behind Belarus and Macedonia. Personal computer penetration was just over 4%, compared with 25% in Slovenia and almost 60% in the US.

Box 3 shows the few players that provide access to international Internet provisions. Rostelecom is the key player, as it provides the major national backbone transmission service, though Transtelecom is also developing its own national backbone.

**Regulatory Framework**

The telecom industry in Russia is mainly governed by Federal Law n. 15-FZ “On Communication” of February 16, 1995, which is currently in the process of being amended. There is a series of subordinate legislation on licensing, tariffing, network security and other issues, as well as a series of regulations adopted by federal and regional authorities. The details of application are generally worked out on a case-by-case basis, which gives rise to general complaints of lack of transparency and predictability in the regulatory environment.

The industry is generally overseen by the Ministry of Communications (MoC). However, the Ministry of Antimonopoly Policy and Support for Entrepreneurship (MAPSE) and the regional administrations also exert some power, such as the setting of tariffs. In September 2001 President Putin signed a decree setting in motion the creation of a new Unified Tariff Body (UTB) with sectoral jurisdiction over regulation of effectively all infrastructure prices in Russia, including telecommunications. The UTB would be based on the existing Federal Energy Commission (FEC), and in the case of telecom rate-setting, absorb the authority currently vested in MAPSE. (The expected impact of such changes is discussed in more detail below.) Regulation of the use of radio frequencies is within the jurisdiction of the government, with a special commission “Committee on Radio Frequencies” responsible for frequencies allocation. Our analysis examines in detail problems
deriving from terms of licensing and interconnection, as the majority of ISPs have reported both of them as key problematic areas.

**Figure 2: Telecom and PC Penetration Per Capita (2000) Across Transition Countries**

![Graph showing telecom and PC penetration per capita across transition countries.](image)


**Box 3: Backbone Transmission Services**

International Internet connections are provided by Rostelecom, Relcom, Sonera or through resellers. Rostelecom itself provides almost no end-use access to the Internet but rather is positioning itself as a carrier of ISP traffic, being the only operator with a nation-wide broadband backbone capacity and high quality international connectivity. Rostelecom provides a network for over 70 ISPs, with 41 hubs in 35 Russian cities, with the biggest hubs being in Moscow, St. Petersburg, Novosibirsk, Khabarovsk, Rostov-on-Don and Samara. At the end of 1999 Rostelecom had 192,800 km of trunk lines, of which only 16.7% were digital. Data transmission is based on a number of networks including Global One, Rosnet, Rospak, Infotel, MMTEL, Business Net and Sovam Teleport.

**Licensing.** The Licensing Law establishes that each type of licensed activity be covered by a separate license. Licenses issued by the federal authorities are valid within the Russian Federation, whereas regional licenses (issued by regional authorities) only apply within specific regions. Licenses are issued for a period of at least 3 years and up to 10 years. The Department for Communication Activities Supervision has the right to monitor communication activities, suspend, renew and revoke licenses. Box 4 reports the most relevant drawback and distortions created by the Russian licensing system.

The key regulatory issue emanating from the telecom operators we studied is the lack of transparency in licensing procedures, aggravated by the lack of formalized and specific appeal procedures. Most ISPs need two basic licenses (one telematic—email and hosting—and one for data transmission). Several other licenses are required by ISPs that provide a range of services (including...
channel leasing, equipment certification, and software for mail). Certification of telecommunication equipment is required by Art. 1 of the Communication Law. The procedure entails a telecoms equipment manufacturer to send an application to the Certification Department of the Ministry of Communications for preliminary technical analysis. The equipment is then tested for quality assurance by one of designated certification laboratories. This involves testing in the field and at the enterprise's site. Equipment certification procedures are often cited as unduly burdensome. IP telephony has been legalized as a telematic service and consequently it has been subject to less complex regulation than if it had been designated as telephony service.

**Box 4: Cream-Skimming and Licensing**

The current licensing regime enables new competitors to concentrate on providing services to the cream of the market. They provide services that are lucrative because there have been no restrictions and negligible fees imposed on them when receiving licenses. As a result, competition has not developed outside of the most profitable regions, including Moscow, St. Petersburg and Krasnodarskii. Additionally, 7,500 licenses have been issued for specific services in narrowly defined geographic markets. This contributes to further distortions. Finally, licensing decisions have not followed uniform industry development plans. Even within the number of active licenses, the intensity of competition is limited to certain customer segments—particularly for business users—and regions (Greater Moscow and the NorthWest).

Every year during the lifetime of the license, each license is subject to confirmation. Problems of red tape and formal complications abound. Formal technical requirements are very unclear and, in some cases, inconsistent between each other (see Box 5).

**Box 5: Certification of Equipment and Technical Requirements**

A small ISP operating in St. Petersburg has complained of the serious problems faced in the process of getting certification of equipment. The application is frequently sent back to the company saying that it does not fulfill all of the requirements, but not specifying which ones. When the company approached different officials, it received different answers, so that this process has been protracted for almost a year. A recent entrant in the Internet market in Moscow that received a license in 1997 complained that telematic and data transmission licenses contain requirements in terms of quality standards that are not further defined. It is not clear how to ensure quality for Internet users and thereby obtain compliance with the license conditions and thus receive confirmation.

ISPs report that it is often very hard to locate the appropriate documents for licensing and certification requirements and that one learns about interpretation of rules only during the inspection. One ISP had problems even with certification of air conditioning equipment. An example of the cost and time required for fulfilling such requirements is illustrated in Box 6.

**Box 6: The Cost of Abiding by Licensing and Certification Procedures**

According to a Yekaterinburg ISP, the local preparation of its papers took about 3 to 4 months, then another 3 months for the papers to be considered by the MoC. All license application papers had to be sent to Moscow to the federal Ministry. The cost was about US$10,000 in 1997, which is substantial since the fees are multiplied by the number of oblasts in which the company operates. The process of certification of equipment was considered particularly onerous in terms of time and associated costs, as the company had been forced to prepare itself most of the required documentation and pay a fee to the specialized entity for signing the documentation. Inspectors from the local surveillance body visited the company and tested the quality of equipment in detail. It is sometimes necessary to actually downgrade the parameters of existing equipment in order to be granted the required certification.

Required compliance with government surveillance systems imposes significant costs on ISPs. A federal law of August 12, 1995 “On Operational-Investigative Activities” initiated a surveillance system known as SORM (System for Operational-Investigative Activities) which is operated partly by the Federal Security Service (FSB), the government agency responsible for surveillance. The
regulation requires all ISPs, automatic telephone exchanges and also mobile telephone and paging companies to install special transmission monitoring devices so that government can monitor electronic traffic, including e-mails. It requires all providers to finance the cost of additional equipment needed to make their systems compliant. A warrant is required to monitor individual e-mail correspondence. SORM-2, a technical regulation issued jointly in July 2000 by the FSB and Gossvyaznadzor, requires ISPs to provide the technical upgrades (including criminal investigative functions and expertise) necessary to reroute all transmissions directly to the FSB in real time. Seven other state entities, including the Interior Ministry and the Tax Police, are also able to access transmissions. Reportedly, the intention of such regulation is to uncover terrorists, spies and other illegal activities, following the arrest of five suspected hackers, who were accused of stealing credit card numbers from Internet retailers for an amount of US$630,000. Nevertheless, it represents a very onerous requirement to Russian ISPs (see Box 7).

Box 7: Surveillance Requirements

Every ISP has to host a “black box” interceptor to tap Internet traffic. The ISP pays for the black box and a high-capacity line to the FSB state security service headquarters. Failure to put in the bugging devices means the loss of the ISP’s license. Apparently the FSB uses the fact that Echelon, a satellite traffic-tapping system, is also operated by the US and UK as justification for its stance. In the UK, however there must be a warrant issued by the Home Secretary according to online security laws (Regulation of the Investigatory Power Act). The harsh sanctions for refusing to implement SORM is illustrative not only of the operational problems that companies face when not implementing costly surveillance rules but also the discretionary powers of Gossvyaznadzor in interpreting other telecom-related regulations. SORM is reportedly a red flag to investors looking at Russian telecoms and the Internet. This requirement has caused concern among human-rights activists because e-mail, e-commerce transactions and other Internet traffic can be easily monitored without anyone ever knowing, regardless of whether a court warrant has been obtained.

The unpredictability of changes in licensing terms at the time of renewal is extremely high. This dramatically reduces ex-ante incentives to invest in view of the ex-post renegotiation of licensing conditions (see Box 8). Overall, such a regulatory environment creates an uneven playing field, which penalizes new entrants not only because they find more restrictions on their operations, but also because of more complicated procedures. Telecom operators with a presence in more than one oblast also find that in each oblast they experience idiosyncratic problems due to the absence of standardized licenses, clear guidelines and different interpretations of the same law.

Box 8: Uncertainty in Renegotiation Terms

Telecom operators that went through the process of renewing a license experience a dramatic change in the conditions attached to the license. Specifically, at the start, the Ministry of Communication attaches to the license very strict conditions for obliging the telecom operator to make investments in the network or reach certain targets. The trend is now going in the opposite direction; that is, licenses are becoming extremely restrictive in terms of services and at the same time much less demanding in terms of obligations.

Interconnection. Users and operators are given the right to interconnect their network and terminal equipment to the PSTN if they meet the “interconnection requirements” set out by the government, which are provided by the common carriers or stipulated in the license. Since the list of conditions under which access can be denied includes lack of technical capabilities, many carriers experience delays and difficulties. The very same problems are reported all over the visited oblasts and relate to the severe under-investment in the basic network.

There are provisions of non-discrimination among operators when issuing technical requirements for interconnection, but the criteria to assess discriminatory behavior are not defined, nor is the role for the regulator to detect and deal with discrimination. Lack of transparency and reasonableness with respect to fees prevail as well (see Box 9).
Box 9: Discriminatory International Interconnection Terms

ISPs are victims of discriminatory behavior in getting international connection. Not only are prices set in a discriminatory way, but price increases are not uniform and hit some enterprises in a severe way. The only way forward by these firms is to unite together and complain directly to the provider of the interconnection or build their own infrastructure (a very expensive alternative). Notably, the few ISPs that rely on their own infrastructure report problems of restrictive policies for telecom operators to establish their own equipment. On the other hand, the remaining operators complain with respect to barriers to entry created by ISPs owning their own infrastructure, by creating de facto monopoly access and refusing to resell access to other players. A local ISP that started operations 3 years ago in Moscow finds that although it is prepared to pay, it often faces difficulties in acquiring new lines, with the leading regional operator refusing to give lines to all but its own subsidiaries, on the grounds that they lack technical capabilities.

Problems appear to be particularly severe in less developed oblasts, very likely because of the quasi-monopolistic structure for interconnection providers. From the firms studied in Yekaterinburg, there is a striking difference between the interconnection-related problems across different operators, depending on their links with the local fixed line operator. An ISP that has ownership links to the main city operator enjoys a very privileged position, as it can negotiate very aggressive interconnection prices and does not have any interconnection problems. The situation varies substantially for other ISPs in the same city for which interconnection costs are very high, amounting to 60-70% of revenues. Currently there are well-connected telecom operators that receive special terms of access to the network, tilting even further the already very unequal playing field. Box 10 provides strong evidence of the different terms of faced by small versus large ISPs.

Box 10: Uneven Playing Field: Access to the Local Network

A small ISP in St. Petersburg experienced serious problems in having access to the local exchange. It spent an average of 3-4 months to get access to new lines after applying for them. Three months after they bought 100 lines, they were informed of a price of more than 5 times the original price. It tried to appeal without success: the main reason is that contracts are designed so that any terms of the contract (including prices) can be changed and the only obligation on the suppliers' side is to inform of any variations. The general manager tried to negotiate for a long-term contract (setting the prices for at least for a year, much shorter than that for larger ISPs, which have on average 3 year contracts); but he did not reach any agreement. The same company also had to give up access to digital lines as soon as the provider decided not to offer discounts and the unit price per line (US$130) was higher than their maximum revenue per line (US$100). They appealed this decision, as there were no other alternative suppliers of such services. But they have not received any answer after 6 months.

Most of the ISP companies studied do pass high interconnection charges onto the customers. Among the main complaints that they receive from business customers are the lack of lines for good quality access and the high price for dedicated channels. ISPs do not feel they have much control in improving the situation unless they invest in lines, which, as already noted, can be a very expensive alternative.

There appears to be reluctance by ISP operators to launch formal complaints regarding interconnection problems. To address those instances where the two parties cannot come to an agreement on their own, Russia established an Inter-agency Commission for Dispute Settlement in September 1999, under instructions from MoC and MAPSE. However, of the 17 cases that came forward in the first year, none related to Internet or mobile telephone providers, with almost all brought forward on technical grounds by traditional voice operators. Where interconnection problems are more severe, e.g. in less developed oblasts, problems of interconnection both at the federal and departmental MAPSE have not been raised by ISPs. The reluctance to launch formal complaints in an environment where switching providers is not an option might be explained by the desire to avoid subsequent problems with businesses that one is compelled to keep working with.
**Other Regulatory Distortions.** Interestingly, the same enterprises suffering from problems of access to the Internet network face similar problems in access to electric power—they are switched off from electricity provision without any explanation. This causes serious problems in terms of interruption of service, direct compensation that the company needs to pay to their customers, as well as reputational losses and consequent loss of clients.

In general, we found that regulatory distortions are biased against smaller companies. Given the fixed nature of regulatory costs, the burden of regulation falls most heavily on smaller start-ups. Costs can be substantial relative to revenues generated by a small enterprise. There is also the continuous uncertainty of new regulations (see Box 11).

**Box 11: Regulatory Costs Biased Against ISP Start-Ups**

According to a Yekaterinburg ISP that has 30-35 employees, administrative and utility-specific regulatory requirements are very rigid. Although a small company in terms of employees, they must employ a part-time specialist on labor safety, sanitary and hygienic standards. It takes significant expenditures of time. This company estimates that the total costs of meeting all requirements amounts to 7-10% of annual revenues.

The uneven playing field penalizing smaller ISPs is aggravated by the problems on the demand side. Such problems include less attractive customers that view the Internet as less essential for their work, as the largest customers are served by few privileged ISPs (see Box 12). However, very limited problems of non-payment are experienced, because of pre-paid tariffs—increasingly used after the 1998 financial crisis (especially in the case of riskier groups)—and due to the practice of dealing only through agencies that guarantee the payment of the associated enterprises.

**Box 12: Privileged Access to Customers**

The largest telecom players provide services to the corporate network of Russia's large firms, government entities, and infrastructure providers, whereas smaller players concentrate on individuals, but increasingly target SMEs. Some telecom operators identify the fact that for many users the Internet is still a curiosity rather than a necessary tool, although such attitudes are gradually changing. Privileged access arises from the fact that the main providers keep prices relatively high and adopt a competitive strategy aimed to ensure high quality in order to keep their most lucrative customers, rather than targeting the smaller customers.

The main determinants of the effective use of the Internet in Russia on the demand side are the cost and availability of services and purchasing power, as well as the availability of Russian language content. If the average Russian Internet user spends the same percentage of his/her income on the Internet as the average US user (adjusted by a deflator based on the relative Internet penetration), this would amount to just under US$ 9 per year per regular user. This does not seem to be a prohibitive amount for the average Russian. As a result, the main barriers to the use of Internet seem to be the lack of Internet penetration, and the difficulty of the conducting the transaction, rather than the lack of purchasing power.

We have already examined in detail the main drivers for the lack of Internet penetration, which depends mainly on the supply side and the lack of competition, which keeps prices artificially high. The difficulty of conducting a transaction via Internet depends on the low credit card penetration in Russia, which is aggravated by the little faith that Russians have in their banks (apart from Sberbank) after the crisis of 1998, when those Russian retailers who accepted credit cards were badly burned. One channel to pay for transactions over the Internet is through Sberbank, which could make transfers to Russian sites that accept such forms of payment (such as Cyberplat.ru, Webmoney.ru, Paycash.ru, Assist.ru and Internetbank.ru) and provide for transactions with participating Internet stores. Prepaid cards provide another alternative, but they are subject to a commission to the dealers and to VISA or some other financial intermediary.
A more general problem depends on the lack of market awareness. A survey on public awareness of the Internet, conducted by the Obshchestvennoye Mneniye (Public Opinion) Foundation was released in 2001. The survey involved interviews with a sample of 69,610 people in 115 Russian cities. The main findings were that 51.04 million Russians (55.9%), are barely aware of the existence of the Internet: 20.3% said that they had heard nothing about the Internet and 35.6% declared that they had heard 'something'. The survey suggested that 10.3 million Russians (11.3%), have access to the Internet at work, at home or through friends. It also suggested that the number of actual users is only 3.3 million people (3.6%); that Web use is dominated by the capital city, as Muscovites make up as much as one quarter of users, with the inhabitants of St. Petersburg coming next; and that interest in the Internet is, however, growing gradually in the major cities of the Urals, the Volga and the South Federal Districts.

The availability of quality telecommunications services both attracts new investment to a region and increases the return on investments made. For industries that are intensive user of Internet services or where Internet use is essential, improvements in the availability, price and quality of Internet services stimulates the entry of enterprises and results in a whole new range of products being offered. More broadly, the benefits of rapid growth in e-commerce is in inducing the number of intermediaries necessary for transactions, reducing costs and stimulating further activity. Carrying transactions over the Internet brings more transparency to the conduct of business, thereby also increasing efficiency; see Box 13.

Box 13: The Impact of Internet on the Real Economy

The impact of improvements in Internet services is most direct in two types of industries. First, there are those industries that directly generate all or a large part of their revenues from the Internet, such as Internet application providers (web design, web hosting, Internet consulting), Internet intermediaries (portals, online brokerages) and companies conducting online transactions (e-tailers and online entertainment). RFK (Russian Financial Communications), a company that offers Internet payment systems, has calculated that if all Russia's Internet users were to make their water, gas and electricity payments online, that would draw well over 380 million rubles or over US$ 13.5 million to the Internet each month. Second, there are those industries that do not generate revenues directly from the Internet but are intensive users of Internet services, such as software producers, financial institutions and media companies involved in publishing and broadcasting. Although Internet costs are not sizeable in terms of overall expenditures for intensive downstream business users, such as software companies, access to high-quality Internet services is essential for business innovation. The key benefits for software companies is the intra-company exchange of information between developers as well as the exchange of ideas with foreign developers. The Internet boosts efficiencies by making possible joint work for a group of part-time developers.

Box 14 illustrates how the Internet has already directly provided for the development of new lines of business and innovation in Russia, using as examples two small Moscow-based software companies. Without the Internet, these new lines of business would not exist. (More detailed case studies on the Russian software industry as an intensive user of enhanced telecom services are discussed in the previous chapter on competition.)

The Reform Agenda and Policy Recommendations

Regulatory Reforms Underway

A presidential decree 'On basic principles of structural reform in the sphere of natural monopolies' (28 April 1997, number 426) provides that the purpose of telecoms reform is to improve the quality of service to customers, to increase profitability, and to develop competition in the industry. Reforms were supposed to be implemented in two steps:
(i) During 1997 a mechanism for settlement between operators and for the regulation of tariffs for traffic (in order to secure equal access) was introduced. Cross-subsidization of certain spheres of the industry and groups of customers has also been reduced.

(ii) During 1998, the introduction of a dual-tariff system for business and non-business customers was supposed to be completed, though this program has not been fulfilled to date.

**Box 14: The Impact of the Internet on Software Enterprises**

This traditional IT hardware distribution and systems integration company was established in the late 1980s, and it formally established its e-commerce solutions department in January 2000. Not only are the department’s product ranges entirely related to the Internet (software allowing access to and search for databases, ordering and customization allowing for presentation of different prices for different customers with different delivery options, direct on-line queries, etc.), but its inputs and production processes are also fully dependent on the Internet. Without access to the latest software development tools and the latest design information from the Internet, it could not produce its outputs. The Internet also is essential to communicate with all their clients. Whereas Internet-related software systems accounted for 40% of revenues at end-1999, its share rose to 60% by end-September 2000. The company plans to increase its software developers from the current level of 8 persons to 50-60 persons over the next 18 months. Another fully Internet-dependent company—a multimedia web design company—was founded in 1997. Initially developing top-quality CD-ROMs with in-house developed software, the company has produced a large number of sophisticated corporate web sites and has acquired a telematics license to provide information and other Internet services on-line.

**Tariff Increases.** Delays by regional administrations in introducing more rational policies towards the telecoms sector stifle needed investments in network infrastructure, adversely affecting all operators, including ISPs. The fact that tariffs for local calls for residential customers are so low has starved regional operators of funds for investments, in turn exacerbating the problems surrounding access to the required network infrastructure. Starting from November 1999, MAPSE started to raise telecom tariffs by an average of 20%. The increases exceeded inflation and ruble depreciation, with tariffs starting to grow in real and dollar terms. However, tariff regulation continues to lack predictability, as there is no clear tariff formula and increases are authorized sporadically. Moreover, the process of tariff changes is open to political interference at the local level. A company must make the request to MAPSE and justify the increase. MAPSE reviews the requests and then confers with the relevant regional authority, which may oppose the hike.

In November 2000 a joint board of MAPSE and MoC announced plans to regulate private telecommunications firms and their tariffs. However, this should not necessarily immediately affect alternative operators, all of which have foreign investment. The tariff controls will only cover household calls, which form only a small part of competitive local exchange carriers’ revenues. Their control of the high-end corporate market is unlikely to be affected by the planned changes, which also include the hiking of local household tariffs by state-controlled regional operators by 20%. On the one hand this is positive news, as it will allow them to move towards a position where they cover their costs. At present, many operate at a loss, due to highly regulated local tariffs falling well below operating costs. The government had talked about imposing a social tax on alternative operators, the revenues from which would be used to subsidize loss-making regional operators. However, there has been little news about these plans in recent months.

Sviazinvest has recently proposed a gradual three-stage approach to tariff reforms. The first stage involves a 20-30% average increase from current rates. During the second stage, Sviazinvest proposes the introduction of a return on capital approach, expected to be in place in late 2002 or early 2003. The final stage entails the move to price-cap regulation. The success of the planned tariff reforms depends on government support and implementation by the regulator, expected to be the Unified Tariff Body. In 2001, MAPSE (then the regulator) only revised the tariffs once, approving a 15-20% increase in the first quarter of the year. In January 2002 there was approval for a 25% rate hike. However, that increase does not take into account the new methodology for cost calculation.
approved by the MoC and MAPSE. Once this is adopted (expected in July 2002), further tariff increases are likely to take place in the second half of 2002.

Tariff reforms are still a subject of intense political debate. Sviazinvest and the MoC are lobbying hard to liberalize tariffs and to reduce the power of the MAPSE, which is one of the main opponents of higher tariffs. It is still too early to assess the likely impact of the establishment of the Unified Tariff Body, but it raises several key issues that need to be resolved. One is the potential benefits and costs coming from the establishment of a single cross-sectoral regulator. Worldwide, sectoral agencies are considered to be more desirable because of the presence of strong economies of specialization and because they diversify the risk of institutional failure. Another key issue to be resolved is the definition of the (sub)sectors that can be considered as "natural monopolies" and should as such be subject to regulation at all. In telecommunications, technological progress has rapidly eroded monopolistic practices and "protected markets", even for fixed line local providers, so no segment of the sector can any longer be considered a natural monopoly (see below).

**Time-Based Billing.** The proposed introduction of time-based billing has raised a lot of opposition among low income subscribers and their political representatives. Moreover, the process of installing per-minute equipment to outdated analogue lines is costly and time consuming. In Sverdlovsk oblast, the Governor initially banned the change. Eventually, time-based billing equipment was introduced in the region at the end of February 2001.

**The Scope of “Natural” Monopoly Conditions in the Telecom Sector.** In practice, regulation of private telecom operators means including them on the government’s list of “natural monopolies” (see Box 15). The first to enter the list were six companies in Tatarstan—Tattelekom, Kazan City Telephone Network, Teleset, Intelsat, Sviazinvest (Naberezhniye Chelny) and Kama-Teto—probably not coincidentally often perceived as one of the more politically autonomous parts of Russia. Predictably, the move was not well-received and some observers expressed doubts about whether the move is in line with the federal law on competition. (In November 2000 there were only 200 registered “natural monopolies”, but MAPSE said that this could be increased to 3,000.)

**Box 15: “Natural” Monopolies under Russian Law**

According to Russia’s Law on Natural Monopolies, which came into force in 1995, a natural monopoly is a condition in the market for goods or services:

i) where the satisfaction of demand in that market is more effective in the absence of competition, due to the technical particularities of production, and

ii) where goods and services produced by monopolies cannot be replaced by the consumption of other goods, so that demand is not as susceptible to price changes as for other types of goods.

The Law on Natural Monopolies includes communications services in the list of natural monopolies subject to state control and regulation. There are three basic methods for such control and regulation:

1) Tariff regulation.

2) Protection of consumers (operators cannot refuse to enter into a contract with a consumer).

3) Control over transactions and investments (MAPSE must be consulted on the acquisition of any major assets with a value over 10% of the value of the acquiring company, and must be informed within 30 days of any acquisition of more than 10% of the voting shares of a natural monopoly).

Subsequently in early 2001, MAPSE announced that 60 telecom companies in the Sverdlovsk region would be included in the list, meaning that 10% of Russia’s 4,500 firms in the telecoms sector were to be classified as natural monopolies. The same month MAPSE said that it would look into the possibility of including into the list firms offering local, domestic long-distance and international telephony (including fixed-line, cellular and Internet firms). This raises the possibility that MAPSE intends to regulate domestic long-distance and international, as well as local tariffs.

A process of consolidation is currently underway in the sector, following the recommendations made by a study carried out by Arthur Andersen funded by a World Bank administered grant.
Overcoming fragmentation has very significant strategic payoffs as it would allow for the realization of the economies of scale and scope in this industry that relies so heavily on network efficiencies. Svyazinvest merged Rostelecom with Moscow Intercity and International Telephone (formally completed in October 2000), and in late 1999 it initiated consolidation of its largest elektrosvyaz in St. Petersburg, Novosibirsk, Yekaterinburg and Rostov On-Don, to bring its number of subsidiaries down from 86 to 77. The process of consolidation in the initial phases has not been smooth, with significant opposition from minority investors, managers, and regional governments. However, recently it is going ahead faster than expected, with the merger process approaching its final stages. Finalizing the merger terms is a crucial step, allowing investors to assess the contribution of individual operators to the new enlarged supra-regional. The remaining steps in the consolidation are largely formalities. The Federal Securities Commission needs to register the new share issues and MAPSE needs to approve the mergers (as it has already done for the enlarged Ural Telecom). The enlarged regional companies are expected to be tradable in the next 10 months.

The expected impact of the consolidation is expected to be significant in terms of strengthening the new companies in terms of revenues, added liquidity through their ADR programs and greater transparency implied by consolidated IAS accounts. Such an impact is expected to be greater if accompanied by the introduction of a predictable and transparent tariff regime. Telecom tariffs are currently only 50% of their pre-crisis levels in US dollar terms. Further tariff increases are needed to finance much needed investment and to make the companies attractive to foreign strategic investors. In addition to tariff increases, other important drivers of revenue growth should be further development of Internet and data services, which currently represent a very small fraction of telecom operators' revenue but are rapidly expanding. In particular, Internet revenues are expected to grow substantially with the introduction of per-minute billing.

**Political Interference.** If the government wants to find investors for the fixed-line holding Svyazinvest and its seven pan-regional subsidiaries, it will have to convince them that there will be less political interference in the sector over the next few years. The political risk in the telecoms sector has heightened over the past year. The fairness and transparency of the regulatory procedures cannot be guaranteed. This was shown in September 2000, when the Telecoms Ministry sent letters to VimpelCom and MTS, requiring them to vacate 20 (of its 35) 900Mhz channels and 22 (of its 73) channels by November 1, 2000. When this news went public, the companies' shares crashed in value. In November 2000 both companies finally received letters from the Telecoms Ministry confirming their rights to their frequencies.

**International Agreements.** Russia is not yet a WTO member, but negotiations are in progress. The country's legal framework provides for co-operation with the EU, with the aim of gradual integration at the technical level. The law provides for most-favored nation treatment, but both the EU and Russia have made reservations on this regarding some telecoms services, including mobile and satellite services. The Agreement on Partnership and Co-operation between Russia and the EU restricts Russian market access to some EU member states in the fields of complementary services and infrastructure.

In 1997, the members of the Commonwealth of Independent States (CIS), i.e., the former Soviet Union minus the three Baltic States, signed an Agreement on Co-operation in the Development and Use of Mobile Cellular Telecommunications Services (the 'CIS Co-operation Agreement'). The parties agreed to ensure the free movement of mobile phones within the CIS, provide roaming for mutually approved standards, and take measures with the purpose of harmonizing national legislation on telecoms services. They also agreed to develop recommendations for the co-operation of cellular operators.
Policy Recommendations

Broad-based policy recommendations include the following:

(i) **Promoting Further Private Sector Involvement in Telecom Sectors**, with specific priority measures to stimulate competition. Options include unbundling Svyazinvest by separating and liberalizing international long distance and local calls; move forward the consolidating local telecom operators and allowing them to compete with each other; and licensing additional wireless local loop operators as alternative access providers.

(ii) **Establishing an Improved, Independent, Transparent and Publicly Accountable Regulatory Oversight Process and Institutions** (bringing Russia close to meet WTO and EU requirements). In this context, Russia should consider giving the regulatory power for interconnection to the same institution responsible for price regulation, ideally vesting both functions in a new sector-specific regulatory agency. With the creation of an independent sector regulatory agency, MAPSE would no longer be responsible for tariff-setting processes and supervision, leaving technical and pricing regulation to the specialized agency. On the other hand, MAPSE could play a more forceful role in the determination of the appropriate scope of the regulatory authority, of the appropriate market structure of the telecommunications markets, and focus on controlling anti-competitive conduct by dominant enterprises.

(iii) **Strengthening and Ensuring Appropriate Coordination for the Institutions Charged with Implementing and Enhancing Competition**, such as the MOC and MAPSE, especially the latter’s oblast branches that appear to lack authority in addressing cases of abuse of dominant position and discriminatory license or terms of access to the network. The local branches of MAPSE are aware of the key problems hindering the development of Internet, but lack authority in taking decisions that are mainly made in Moscow. This is particularly evident after centralization of the key functions (as a result of the transfer of regulatory authority from the regional government to the Moscow MAPSE itself in January 1999). Effectively, local branches of MAPSE exert merely supervisory roles and opinions (their view points have been asked only recently). Less cumbersome regulations seem facilitated by the openness of local regulatory institutions to the legitimate business needs of (small) ISPs. In Moscow Oblast, local associations and interest groups have intensively lobby for improved regulation, though their impact remains limited.

(iv) **Adopt Uniform Guidelines**: apart from more transparency in licensing procedures, the same interpretation and requirements in different oblasts should be ensured. Moreover, clear formalized appeal procedures need to be established.

(v) **Establish Clear Terms of Licensing Renewal**: From our case studies, ISPs seem to experience dramatic and unjustified changes in license terms. The unpredictability is a serious concern as it acts as a deterrent to investment in light of the ex-post renegotiation issues at stake.

(vi) **Ensure Non-Discriminatory Terms of Interconnection**: ISPs are exposed to discriminatory behavior in getting access to connection in terms of price, quality and even the opportunity to get access to the network itself. Currently the law leaves interconnection to be determined as a bilateral negotiation between operators, a procedure that is largely inappropriate in the presence of one party (the provider of access) who has a much stronger bargaining position (in most cases acting as a monopolist). Interconnection needs to be address in a clear way, to avoid conflict of interest. Public policy requires interoperability of networks. Consequently all public network operators should be obliged to interconnect their networks with one another. Those operators with the ability to abuse their market power should be subject to special rules (ex ante regulation) to ensure that they do not abuse their dominance. These include: a requirement to meet all reasonable demands for interconnection services from other network operators; transparent and cost based interconnection; unbundling of interconnection charges; and non-discrimination and publication of interconnection offers (terms and condition of contract and prices).
The resulting price needs to be economically efficient, guarantee fair recovery of costs for all operators and provide the right entry signals. Long run incremental cost methodologies meet these criteria and entails the calculation the total costs of provision of the additional capacity needed when one operator causes another to provide an essential component of service.

(vii) Ensure that E-Business Legislation has a Strong Bias Towards Promotion Rather than Control, including moving forward with the adoption of a sound electronic digital signature law extending the scope of the current law.

(viii) Promote a Russia-Wide Dialogue on Informatics and Communications Policy. The provision of Internet services and e-commerce potentially affects all citizens and would benefit from a consensus-based higher-profile national debate on telecommunications, information and media policy.
Bibliography


IV. Corporate Finance in Russia's Regions: Demand and Supply Constraints

Stijn Claessens* and Esen Ulgenerk**

Introduction

Many of the bottlenecks that businesses face in Russia to get started and grow are finance related. Examination of bank-enterprise relationships at the regional level reveals that finance is aggravating business development in several ways. On the supply side, the volume of financing is very limited as banks have small deposit and capital bases. A series of crises, most particularly the 1998 crisis, has eroded the confidence of the public in the fledgling banking sector, with only Sberbank and a few large banks enjoying any trust today. Short-term bank credit is scarce and highly priced, and requires liquid collateral of up to two times loan amounts. The limited contract enforcement environment discourages banks to lend, except to those enterprises in which they have shareholdings or another relationship. Most banks and other financial institutions—especially in the regions—do not have the expertise or skills to properly assess risks and structure financial products and services which meet the needs of the real sector. Furthermore, the banking sector is highly concentrated in urban centers, further limiting the access of many enterprises to finance.

The lack of long-term bank and other financing means corporate capital investment, outside of foreign investments, is mainly limited to internal earnings. Yet the capital market is very limited in size and mostly caters to the top Russian corporations that also have access to foreign sources of finance. Equipment leasing is only available to some extent. The lack of financing is, however, not just a problem for capital investment, but also extends to trade finance and makes it difficult for enterprises to maintain normal operations. The working capital shortage from the banking system is aggravated by the fact that few enterprises offer trade credit because of the lack of credit tracking and underdeveloped dispute settlement mechanisms.

The lack of adequate working capital and trade credit financing discourages the expansion of firms and the establishment of new firms. The existence of large arrears by many, often insolvent entities and the many informal business links among enterprises further encourage non-monetary forms of payments. This in turn increases the costs of operation to the productive sector as enterprises spend resources to screen their trade partners for credit-worthiness and to collect non-cash payments. The existence of barter, offsets and countertrade encourages further non-transparency and discourages the use of formal channels to finance viable enterprises.

This chapter primarily discusses the various constraints to finance on the supply side, using case study examples from various regions on how demand from potentially viable enterprises is often not met. The next section contains a general description of the Russian financial sector, highlighting that the formal financial system has little to offer to most firms, especially to de novo firms. The subsequent three sections analyze what other forms of financing are available for de novo firms and capital investments for existing firms. The case studies suggest that the most important source is internal financing. Next are local and other government forms. Some specific credit lines by international financial institutions are also being used. Trade finance is normally an important source of working capital financing for firms, but in the case of Russia it is tied up with arrears and other

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This chapter draws on background material written by Tatiana Nenova and on joint work by Stijn Claessens and Daniela Klingebiel.
non-market forms of financing. The chapter concludes with an overall assessment of the financing prospects for Russian firms and with suggestions for policy changes.

The Russian Financial System

The Russian financial system is small in absolute and relative terms and underdeveloped compared to countries with similar per capita incomes. At the start of 2001, the ratio of M2 to GDP in Russia was 16.6 percent of GDP, compared to an average of 50.6 percent for Central European countries and 76.3 percent for OECD countries. With only 12.0 percent of GDP, the ratio of private credit to GDP in Russia is substantially less than in Central European countries and OECD countries. The high currency to deposit ratio in Russia furthermore indicates that a large part of monetary transactions takes place outside the banking system and that public confidence in the banking system is very low. Underscoring the low public confidence in the financial system is the fact that a large amount of savings are held outside the financial system in hard currency. The small size of the Russian financial system can largely be attributed to a lack of trust of households and enterprises in the financial sector, a lack that arises from past experiences with hyperinflation, the government’s default on its domestic currency debt, and a weakly governed and fragile domestic banking system.

Table 1: The Size of the Russian Financial System Relative to Other Financial Systems

<table>
<thead>
<tr>
<th>Country</th>
<th>Liquid Liabilities</th>
<th>Private Credit</th>
<th>Deposits</th>
<th>Currency to Deposit Ratio</th>
<th>Change In CPI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russia (2000 est.)</td>
<td>16.6</td>
<td>12.0</td>
<td>16.21</td>
<td>40.6</td>
<td>20.2</td>
</tr>
<tr>
<td>All countries</td>
<td>59.9</td>
<td>60.94</td>
<td>52.57</td>
<td>8.11</td>
<td></td>
</tr>
<tr>
<td>Eastern Europe of which</td>
<td>50.55</td>
<td>27.08</td>
<td>48.89</td>
<td>11.53</td>
<td></td>
</tr>
<tr>
<td>Czech Republic</td>
<td>71.05</td>
<td>59.9</td>
<td>71.10</td>
<td>11.3</td>
<td>8.45</td>
</tr>
<tr>
<td>Hungary</td>
<td>42.3</td>
<td>22.5</td>
<td>34.91</td>
<td>23.4</td>
<td>18.07</td>
</tr>
<tr>
<td>Poland</td>
<td>35.44</td>
<td>15.58</td>
<td>30.81</td>
<td>18.7</td>
<td>15.91</td>
</tr>
<tr>
<td>Ukraine</td>
<td>11.85</td>
<td>1.82</td>
<td>8.63</td>
<td>96.6</td>
<td>15.94</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td></td>
<td></td>
<td>4.99</td>
<td></td>
<td>17.39</td>
</tr>
<tr>
<td>Lower middle income countries</td>
<td>44.6</td>
<td>36.35</td>
<td>36.69</td>
<td>11.46</td>
<td></td>
</tr>
<tr>
<td>OECD countries</td>
<td>76.28</td>
<td>88.51</td>
<td>73.22</td>
<td>6.72</td>
<td></td>
</tr>
</tbody>
</table>


Russia’s total banking system in terms of assets amounts to $78 billion, which is comparable to the asset size of a medium size bank in countries like the U.S. The largest Russian bank has assets of about $18 billion and the second largest about $4 billion. Reflecting the small scale of the Russian banking system, even the largest banks are very small on a global scale. The total assets of the three largest Russian banks, for example, amount to only around 60 percent of assets of the three largest banks in the Czech Republic and Poland and only 1.1 – 1.5 percent of the asset size of their European counterparts in UK, France or Germany.

The numerous, small banks have limited deposit and funding bases to lend to the new and existing enterprises. While the overall Russian banking system is very small, Russia has more than 1,200 banks, many of which are very small. Out of these, only 93 banks have paid-in capital over $10 million and only the top 50 banks have assets exceeding $100 million. Most of the banks are thus too small to cater to the financing and investment needs of large and medium Russian enterprises. In fact, the average Russian bank has assets of only $51 million, and total capital of $9 million, much too small to be profitable, assuming the bank wants to intermediate effectively. Most of the banks today are little more than pocket institutions for local, regional and federal government authorities, oligarchs, and financial industrial groups.
The banking system has a very limited outreach. At the start of 2001, banks operating in Russia had a total of 3,869 branches, or only 2.8 branches per 100,000 inhabitants. This compares to an average for the EU of 48 per 100,000 inhabitants. The government-owned savings bank, Sberbank dominates the branch network, with 1,564 branches and over 34,000 small outlets throughout the country. No other bank except the near-bankrupt, state-controlled SBS-Agro which has 1,200 branches, has a nationwide branch network. The rest of the banking sector has limited access and distribution points for enterprises and households.

The majority of the banks are concentrated in Moscow and St. Petersburg. Approximately 50% of the banks that have no branches are headquartered in Moscow. Central and Northwestern Russia has 35% of the branch network and 60% of the banks in Russia. The Eastern regions (Urals, Siberia and Far East) of the country have only 16% of banks and less than 30% of branches, of which more than 80% belong to Sberbank. Given this limited and geographically concentrated bank and branch network, newly established enterprises outside of the urban centers have very limited access to the formal financial channels, even for simple banking transactions.

The banking sector is also recovering from a severe crisis that has eroded the public's confidence. The August 1998 crisis did not result in a consolidation in the sector, as the corporate and banking laws and the general political economy and institutional setup did not allow for the resolution of many failed banking institutions in an orderly way. Instead, the principals of major failed banks simply transferred the assets of their 'failed' banks to bridge banks. This weak resolution effort has further undermined the limited trust in the banking sector among the population that already suffered from a series of high inflation and large devaluation episodes during the last decade.

Furthermore, there is little interest in the banking sector in lending and development of new products and services. The sector is dominated by Sberbank, which holds more than 80% of the total deposit base and around 35% of the lending. With its relatively large deposit base, Sberbank remains the major supplier of corporate finance to all sizes of enterprises in Russia (Box 1). Since the 1998 crisis, there are very few other banks that enjoy the confidence of households and business, and there is no bank competition to speak of. Most small companies, especially outside of large urban centers like Moscow and St. Petersburg, have no choice but to use Sberbank for all their transactions.

Most Russian banks, except for Sberbank, are not fulfilling the traditional intermediation functions of a commercial bank. Instead they concentrate on (and/or are directed by their shareholders to perform) a much more limited set of functions (Box 2). Furthermore, banks in Russia are relatively new organizations, with limited skills in evaluating enterprise risks and no capacity to design and offer financial products and services that meet enterprises’ needs.

Enterprise finance from the banking sector is scarce and rarely allocated in a market-based fashion. The small financial sector and the poor way in which it allocates resources means many firms do not get financing. At the start of 2001, loans to the real sector were around $32 billion, 41% of total banking sector assets and approximately 12% of GDP. For comparison, the loan to GDP ratio for Poland is around 20%, while it is 80-120% in most developed countries. Recent estimates by the Central Bank of Russia indicate that the share of bank credits for financing of fixed investments during 2000 was around 10%. And this scarce lending from banks is primarily directed toward either own-shareholder enterprises or large and often state-controlled enterprises, many of which are in the fuel and energy industries; see Box 3.

Available official data generally understate the problems of financing for the second-tier and small and medium Russian enterprises, as large firms take up the bulk of the available financing. These top tier Russian enterprises, as well as those that have multinational ownership and/or buyer/supplier relationships, have access to a relatively competitive short-term loan supply, although seldom on market-based terms. While long-term resources through either equity, bonds and/or bank credit are limited, even for these enterprises, preferential access to the limited savings is crowding out
other, smaller enterprises or making their access more costly. Apart from the very limited supply of savings, micro-factors are also serious constraints to the financing of smaller and medium firms. These include high spreads, excessive collateral requirements, and many CBR requirements, including that banks cannot lend without collateral.

**Box 1: Sberbank**

Sberbank held a quarter of all banking system assets and more than 60% of household deposits at end-1997. Its ownership was controlled by the State through 58% ownership by the Central Bank of Russia and its privileged status included an implicit state guarantee on all household deposits held by the bank. While it was the primary repository for household deposits throughout Russia, the bank did not channel these funds into loans for investment in the economy. In mid-1998, prior to the financial crisis, loans to businesses were only 14 percent of its total assets. Currently, however, Sberbank holds 30% of the total banking system’s loans to the enterprises and the share of loans to the industry on Sberbank’s books has increased to 35% from 14% in 1998.

Following the 1998 crisis, CBR encouraged the transfer of household deposits from a number of failed Moscow-based and regional banks to Sberbank on a voluntary basis while at the same time explicitly announcing a deposit guarantee for Sberbank. Some R 10 billion (representing around 70% of local currency and 30% of foreign currency deposits of the largest commercial banks in Russia) was transferred from commercial banks through this scheme. In addition to the household deposits, many enterprises also shifted their accounts from other banks to Sberbank during 1998/99 to protect themselves against any payment illiquidity or risks. In some regions, many enterprises were instructed by their state suppliers to shift their accounts to Sberbank. As a result, Sberbank currently controls around 85% of ruble and 46% of hard currency deposits.

In addition to its government subsidy (through the implicit deposit insurance) in the deposit market, Sberbank also has monopoly rights on the processing of settlements on municipal services and the pension fund receivables/payables. Its assets (26% of the total banking sector in Russia) exceed those of the next largest bank (Vneshtorgbank) by five times. Its large branch and sub-branch network, about 37,800 outlets in every region of Russia, far exceeds that of the next largest network, that of the near-bankrupt SBS-Agro, with about 1200 branches, and vastly exceeds the networks of the most private commercial banks, which have at most 25-30 regional branches each.

Traditionally used as an instrument for budget finance, Sberbank is increasingly diversifying its assets from government bonds to domestic corporate lending. The equity capital of the bank (around $2.1 billion-or 15% of the total banking sector capitalization) is 2.1 times the capital of the largest bank (Vneshtorgbank). The relatively large capital base makes Sberbank practically the only source of financing for Russia’s largest corporate borrowers and/or exporters without violating the single borrower limits of the Central Bank. Some recent noted transactions were Sberbank loans of $300 million to Tyumen Oil Company; a loan for equivalent of $200 million to UES (Unified Energy System of Russia) to finance its arrears to Gazprom and tax authorities; a loan for $80 million to Vymelkom and one for $50 million to Severstal. Sberbank may also have priced these loans below market and there appears to be an increasing tendency to perceive of Sberbank’s relatively large deposit base as a source of cheap funding to support the ‘strategically important’ industrial sector in Russia.

For those that can access the lending market, loans are expensive and take many steps. The majority of lending is short-term, up to 1-6 month maturities. In mid 2001, rates for 1-month loans in rubles were around 36-40%, and for 6-month loans between 42-46%, compared to a Central Bank refinancing rate of 25% and MIBOR (Moscow Interbank Overnight Borrowing Rate) rates of around 13-15%. Most companies report that their profit margins are not sufficient to cover the cost of capital. Lending is burdensome in other ways. Banks usually requires the borrower to have kept their accounts with the bank for a minimum of 1-2 years, in order for the bank to track the borrower’s cash flows and to have some idea of the repayment ability of the borrower. In addition, collateral is required, typically 1.5-2 times the amount of the loan. The collateral is required to be liquid, with only securities, veksels, goods in process or finished goods acceptable. Immovable property and motor vehicles are problematic as collateral, and perceived as carrying excessive resale risk. Third party guarantees are often required in case of loans of more than 6 months maturity. Finally, loan application and negotiations take a long time.
Capital markets function very ineffectively in Russia. This ineffectiveness extends to all the normal dimensions of a capital market: allocating funds, pricing claims, diversifying risks and disciplining management in Russia. The evidence of poorly functioning capital markets is plentiful. Capital markets exhibit low depth, with the stock market representing less than 10% of GDP (Table 2), and trading is inefficient, with high bid-ask spreads. The corporate governance framework is poor, with only few of the OECD corporate governance principles enforced. Enforcement of minority shareholder rights is especially weak, resulting in large-scale expropriation (Black et al, 2001). As a consequence, few investors are willing to allocate any of their wealth to Russian capital market instruments. According to official figures, less than 0.5% of new company financing in 1998 was from the issue of shares.

**Box 2: The Typical “Bank” in Russia**

Apart from Sberbank and a handful of large banks, one can distinguish between four types of “banks” in Russia according to the functions they perform:

1. **Act like a financial arm of large enterprises or groups of enterprises.** These type of banks settle payments for shareholder and/or ‘client’ enterprises, providing banking services to their managers and employees, and engage in investment activities on behalf of these enterprises. Some of the industrial FIG banks or ‘pocket’ banks of large enterprises (e.g., Gazprom) are examples of these banks. Most of these banks provide these functions only to their main owners or affiliated companies.

2. **Manage or support the Russia’s quasi-money and/or non-monetary system, issuing veksels or structuring as well as brokering transactions to help companies and government agencies manage intricate operations of barter, credit and taxes.** Numerous small banks owned by regional governments or municipalities are active in these types of transactions.

3. **Act like a lender to the government, federal as well as local.** Some banks held as much as 70% of their assets in government (federal and local) paper prior to the August 1998 crisis.

4. **Perform treasury functions for the governments, local and federal.** If they meet minimum reserve requirements at the federal level or compete successfully in the bidding process (local and federal level) banks can qualify as repositories and/or transfer agents for state funds—budget subsidies, salary, wage and pension payments, tax payments, various budgetary funds, customs revenues, etc.

**Box 3: “Barriers” to Bank Finance: Several Firms’ Experiences**

In Novgorod oblast an organic fertilizer producer was refused the guarantee of the regional administration and was thus unable to finance a productive facility of the size the founders had planned. The firm will nevertheless start construction of the new facility.

A software firm in Novosibirsk oblast borrowed from a bank seven years ago. The bank went under in the middle of the loan repayment, and the creditors of the bank used criminal methods in order to collect their debts from the bank’s clients / borrowers. As all other borrowers, the firm’s founders got pressured to repay fast. The company has avoided bank credit ever since.

A Vladivostok fishing company was refused credit for purchasing second hand a fishing vessel, even though the project was economically viable, because the loan amount requested was too small to warrant the attention of the bank.

Equity markets are especially thin. Market turnover, defined as the value of trading over market capitalization, is low, amounting to only 3.9 percent. This makes the Russian stock market less liquid than its comparators in almost all other transition and emerging markets. For example, market turnover is 93 percent in Hungary, 81 percent in the Czech Republic, and 69 percent in Poland. And market turnover in Russia trails developed countries’ markets significantly. Market turnover is 167 percent in Germany, for example, and 127 percent in Portugal. The low market turnover in Russia is due the large concentration of ownership, implying a relatively limited free float, a lack of institutional...
investors, and the migration of trading of shares in some large firms to international financial centers. Many of the existing enterprises also do not want to attract new shareholders for fear of losing control or for preference to keep a low profile in an uncertain environment.

Bond markets are dominated by state-issued paper. From the mid- to late-1990's, many regional and federal authorities resorted to bond issues to finance their budgets deficits. As of mid-2000, federal domestic and international bond issues amounted to $73.6 billion nearly equal to the size of the banking sector, about $78 billion, and the large presence of government securities has crowded-out the corporate sector from the bond markets. Private bond issues have been few and in small amounts (Table 2). Private corporations most often do not have the expertise to properly structure cash flows to back up bond issues, nor do they have sufficient liquid collateral. Banks and other financial institutions have not been able to provide investment-banking services to guide the enterprises. Unclear articles in the Civil Code on the tax deductibility of non-bank borrowing interest have also discouraged potential issuers.

The supply of funds from institutional investors is also very limited. There are currently around 80 foreign investment funds that have invested around $7-8 billion in Russia. By way of comparison, 59 funds exist in Hungary, a much smaller economy, with a market value of around $4 billion in 1998. Domestically, there are 229 licensed non-state pension funds with total assets of about $300 million; 28 unit investment trusts with an value of about $20 million, and one shareholder investment fund with investments of about $700 million.²

Table 2: Russia's Capital Markets Size by Type of Assets Relative to Other Capital Markets

<table>
<thead>
<tr>
<th>Country</th>
<th>GDP</th>
<th>Total Equities</th>
<th>Bank Claims on Private Sector</th>
<th>Total Bonds</th>
<th>Government Bonds</th>
<th>Corporate Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>In billions of US$</td>
<td>In billions of GDP</td>
<td>% of GDP</td>
<td>In billions of US$</td>
<td>% of GDP</td>
<td>In billions of US$</td>
</tr>
<tr>
<td>Russia (2000)</td>
<td>277</td>
<td>21</td>
<td>8%</td>
<td>29</td>
<td>12%</td>
<td>76.2</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>56</td>
<td>12</td>
<td>22%</td>
<td>35</td>
<td>63%</td>
<td>7</td>
</tr>
<tr>
<td>Hungary</td>
<td>48</td>
<td>14</td>
<td>29%</td>
<td>8</td>
<td>17%</td>
<td>12</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>20</td>
<td>1</td>
<td>5%</td>
<td>9</td>
<td>45%</td>
<td>3</td>
</tr>
<tr>
<td>Poland</td>
<td>158</td>
<td>20</td>
<td>13%</td>
<td>31</td>
<td>20%</td>
<td>13</td>
</tr>
<tr>
<td>France</td>
<td>1,455</td>
<td>991</td>
<td>68%</td>
<td>1,122</td>
<td>77%</td>
<td>1,210</td>
</tr>
<tr>
<td>Germany</td>
<td>2,123</td>
<td>1,093</td>
<td>52%</td>
<td>2,673</td>
<td>126%</td>
<td>2,006</td>
</tr>
<tr>
<td>Italy</td>
<td>1,186</td>
<td>569</td>
<td>48%</td>
<td>741</td>
<td>62%</td>
<td>1,580</td>
</tr>
<tr>
<td>The Netherlands</td>
<td>378</td>
<td>603</td>
<td>159%</td>
<td>469</td>
<td>124%</td>
<td>244</td>
</tr>
<tr>
<td>UK</td>
<td>1,399</td>
<td>2,374</td>
<td>170%</td>
<td>1,690</td>
<td>121%</td>
<td>853</td>
</tr>
<tr>
<td>Japan</td>
<td>3,787</td>
<td>2,495</td>
<td>66%</td>
<td>5,046</td>
<td>133%</td>
<td>5,214</td>
</tr>
<tr>
<td>USA</td>
<td>8,511</td>
<td>13,451</td>
<td>158%</td>
<td>5,413</td>
<td>64%</td>
<td>13,973</td>
</tr>
</tbody>
</table>


The weakness of the domestic financial system is confirmed in the large offshore financial intermediation. Many large, publicly listed companies, mostly involved in resource extraction or telecommunications have successfully raised equity financing abroad. The total share of capital raised abroad was some 15% of all capital raised. Trading is also migrating abroad. The turnover of Russian depository receipts is significantly higher abroad than is trading in the underlying shares on the
 domestic market. For example, the turnover of Russian depository receipts was in 1999 more than twice as high as the turnover of the same instrument in Moscow.

Continued capital flight discourages domestic financial intermediation. Due to large capital outflows since the start of the transition, the size of flight capital is estimated to exceed Russia's financial system by a factor two and much intermediation is thus happening outside of Russia. Estimates of capital flight during 1995-2000 are about $20-25 billion annually.\(^1\) Officially recorded capital flight (estimated as the sum of non-repatriated export earnings, unredeemed import advances, and errors and omissions in the balance of payments) was about $6.5 billion in the first half of 2000, up from $4.2 billion in the first half of 1999. According to government's own sources, capital flight from Russia increased to some $28 billion during 2000. An important role of the Russian financial sector is then also the facilitation of an outflow of capital, rather than mobilization of domestic savings and allocation of funds domestically.

**Internal and Non-Bank Financing Sources**

As the formal financial sector is providing little financing for new and existing firms, a variety of sources is being used by enterprises to meet their financing needs. Most of financing for investment comes from internal earnings and shareholder funds. Working capital financing is often financed in this way as well. Much of these sources, especially the trade financing arrangements, are, however, neither transparent nor market-based. And the total amount of financing falls far short of the financing needs.

Given the lack of financing from the formal financial system, companies source capital mainly out of their own or related sources. A survey among the largest companies in Russia in 1998 found that about 50% of the liabilities of these companies are equity provided. Suppliers' credit and long term credit from shareholders averaged 20% and 15% respectively. After tax and other arrears, short-term bank credit represented only 2-3% of the total liabilities of these large companies.\(^4\) A survey of the leading 100 companies in 2000 (by the Investor Protection Association) found that 91% of corporations reinvested their profits fully while only 14% issued new stock for financing of expansion of operations. Another survey among leading manufacturing enterprises from diverse sectors in Russia indicated that 57% of these enterprises expected to use internal funds and 41% loans from own suppliers and/or municipal/government funds to finance their new investment in 1999. Only 2% expected to borrow long-term funds from banks.\(^3\) The lack of external financing is even more severe among medium sized and smaller firms. New firms obtain some financing from outside the banking system for start-up and working capital needs. Our case studies show that *De novo* firms in Russia have financed their start-up investment in one of several ways (see Box 4).

Many new firms start on the basis of trade-based activities, with little need for external financing. They then use the accumulated internal earnings to expand into production activities. Widespread pressures from local inspectors and other controlling authorities, however, to share in the SME earnings—via health, fire, sanitation, and licensing graft—dramatically reduce any chance of profitability for small business start-ups, and discourage investment. SMEs are the easiest target for such activities, not least because of the unclear and complex regulatory framework, limited local enforcement of federal laws, and the large number of controlling agencies. (See the earlier chapter on competition.)

Another source of financing for *de novo* firms are existing enterprises. Some enterprises with excess cash flows are expanding their business empires and are interested in investing or providing supplier credits to new firms. Although a source of financing, this strategy is inefficient to the extent that cash-rich firms are likely to promote projects that are not necessarily profitable or are often benefiting from regulatory or other protection from competitive market conditions. Evidence from Russia and elsewhere shows that internal markets do not necessarily allocate funds in the most efficient manner. And, much of this financing is at very high interest rates.
Box 4: Five Start-Ups and Their Financing

This Novgorod food processing and distribution firm was established as a greenfield investment in 1991. The founders, who previously held positions as state administration employees, had extensive contacts with regional banks, dating from pre-1991. Thus the firm was able to secure a series of small credits without offering collateral. These funds were used as working capital as the company started a small-scale operation in the food-stuffs trade. The entire profits from trading were reinvested in the following several years, as the firm expanded into foods-stuffs production, purchasing shops, trucks, and a facility for food processing.

This Novosibirsk design and construction company was able to secure a start-up hard currency loan from foreign sources (including BNP, France). The firm backed up the loan with guarantees from the federal government. In 4-years’ time, the company closed its obligations to the foreign banks using retained earnings.

Two large SOEs established a large Novgorod wire producer in 1989. The founders provided the start-up with technology and equipment.

This Vladivostok business had been trading imported fabrics for 4 years when they decided to expand into clothes production. In 1996, they identified a sewing factory with relatively new equipment, but with serious tax arrears, 9 months of unpaid wages, and accumulated payables to suppliers. Using their trading revenues, the firm was buying shares in the sewing factory for 2 years before they attained 50%. Once the firm had a majority stake, it called a general shareholders meeting and offered employees to get the factory operational again and pay all wages, if in return the employees sold to the firm all of the remaining shares. The firm then acquired completely the sewing factory. The company sold off some of the sewing factory’s property to cover the wage and tax arrears, and took the suppliers to court arguing (successfully) that the new owners are not responsible for the accumulated debt to suppliers.

This organic fertilizer producer in Novgorod was established in 1998. One of the founders had been previously managing his own trading firm, whose assets were fully used at the new company’s start-up. The two founders were unsuccessful in negotiating a loan in the amount they needed for new equipment, since they were denied a loan guarantee from the regional administration. Instead, they obtained a smaller loan from Sberbank for 6 months at 80% (the refinancing rate was 60%), against the collateral of their personal property, and bought second-hand equipment.

An alternative of securing investment funds is to partner up with a foreign firm and procure equipment and know-how in return for an equity share. Such deals are more difficult with foreign partners because the issue of control is sensitive, and as FDI has been limited to a few big cities and selected industries; see Broadman and Recanatini (2001). Further, federal level laws are restrictive and present problems to regions that have chosen to pursue policies more open to foreign investment. For example, Novgorod oblast, where some $800 million foreign capital is invested, equal to 62% of the region’s GDP, is forced to look for “loopholes” in the federal laws in order to ease the foreign investment environment at the regional level. Buying up or merging with a Russian enterprise is more widely practiced. Successful and liquid companies often expand geographically, buying up firms in their business line in other regions, and making those operational with infusions of working capital (see Box 5).

Retained earnings, the main source of capital investment for existing firms, are very limited as well. Most operating privatized enterprises face the problem of old equipment (on average 75% is fully depreciated due to wear and tear). Only 4.5% of the equipment in the manufacturing sector is estimated to be less than 5 years old, and most of the equipment is more than 10 years old. As a result, productivity in the real sector is extremely low, with production non-competitive and of low quality. Profitability and demand for many goods has been low and operating funds continue to fall short of capital investment needs. Investment has been largely limited to equipment maintenance and repair, and has precluded major renovation of the production base. Nevertheless, the supply of internal financing has improved for many firms as their profitability has improved.
Box 5: Some Strategies Used for Financing Expansions

A Novgorod food processor and marketer has used leasing extensively in the past several years, among others to acquire German meat-processing equipment and an Italian macaroni minifactory. The company currently plans a $300,000 investment in a minifactory for production of mayonnaise, ketchup, and sauce. The leasing terms quoted were 30% cash down payment, 8% annual service cost on the foreign exchange contract, for a 3-year maturity.

This firm, part of a holding company, once the largest milk factory in Primorsky Krai, was modernized upon a control change. The parent invested DM 1.5 mln in German sterilization equipment and a further $300,000 for packaging equipment. In both cases, neither leasing nor long-term credit was used.

This building component manufacturer in Novgorod attempted to obtain funds for equipment renewal and working capital from a Finnish partner, in exchange for a 50% or higher equity share. The negotiations, however, stalled. The company found financing recently in a private deal with several St. Petersburg companies. The financing costs that the deal offers are markedly lower than those offered by banks. The deal is structured as a loan, where the firm’s parent is to provide its own production (residential housing) as collateral.

This Novosibirsk pasta and brushes producer was all but removed from the pasta market in 1998 because of the low quality of their product, which was manufactured using worn-out equipment. It considered buying Italian pasta equipment, but the leasing or bank credit options seemed unaffordable. It therefore undertook to construct the equipment in-house, following the Italian model, and the quality of their pasta is reported to have improved.

This Novosibirsk wood processing firm needs funds for capital investment. The company cannot afford a long-term bank loan. It attempted to procure investment funds from suppliers and clients, but was refused since it had no way to guarantee repayment. The company likewise attempted to find a foreign source of capital investment funds, via the regional administration, unsuccessfully. Next, the company applied for a government-subsidized loan, to no avail. A $200,000 loan is being negotiated with Alphabank Leasing for equipment purchase, at the terms of 24% interest, 18-month maturity, and 20% cash down payment.

This once-dominant clothes manufacturer in Primorsky Krai, has been refusing foreign investors’ offers for capital infusion in exchange for equity due to the reluctance of its management to allow some control transfer to the foreign partner.

Lease terms are more affordable than bank loan terms for comparable sums and maturities, as well as more flexible, faster, and simpler in terms of arrangements. After own-financing, leasing is the second most popular source of equipment financing. Still, leasing activity in Russia is relatively very small, financing only 1.5% of capital investment, compared to some 30-40% in OECD countries. Out of roughly 1000 registered leasing companies, only 30% are active, and those are heavily concentrated in European Russia, particularly Moscow. Private and donor-funded initiatives are helping develop leasing as a source of finance for the small and medium enterprises. One example is the Volkhov Business Incubator Project (Box 6). But the amounts remain small. Given that most leasing deals involve the purchase of foreign-sourced equipment, another important limiting factor is the exchange rate risk that leasing companies, equipment sellers, and non-exporting lessees alike are very reluctant to assume. Lease terms currently also require additional collateral, in addition to the customary retention of the title of the leased equipment. Finally, secondary markets for property and equipment are thin, adding considerable resale risk to leasing operations.

Government Support Programs and Donor Credit Lines

Some of the currently large firms that we studied (among others) were created in the early 90s from subsidized government loans and guarantees. This strategy has proven inefficient and politically and financially untenable, both in view of the favoritism that is typically involved in the selection of loan recipients, which surely creates opportunities for corruption, and the undermining of the nascent
commercial banking sector. Notwithstanding the salutary fiscal impact of high oil prices currently, it is also not prudent financial budgetary practice.

### Box 6: Micro-Leasing: The Volkhov International Business Incubator Project

Volkhov is a small city with a population of 50,000, about 120 kilometers from St. Petersburg. The employment in the city had fallen dramatically during the first half of the 1990's due to closures or capacity decline in the local state enterprises. Many residents have, however, started their own businesses and the number of people working in small and medium sized enterprises doubled each year during 1993-95. The Volkhov Business Incubator was created in 1995 on the initiative of the local municipal government and the Alliance of American and Russian Women. In addition to fulfilling the functions of a traditional business incubator (consulting, office space and office services for new entrepreneurs), the organization also serves as a training center and provides micro leasing through its Leasing Fund. In order to provide lease finance, the Incubator obtained a leasing license from the federal Ministry of Economy and Trade. A grant from USAID was used to set up the fund. When the grant expired, a two-year loan from US-Russia Investment Fund (TUSRIF) was obtained to support the program. The borrowers under this program are private entrepreneurs and small businesses from St. Petersburg, as well as farmers from the Volkhov area and other cities and towns in the Leningrad region. Since the leasing program began, the business incubator has financed 80 deals. Of these, 32 lessees were involved in trade, 12 in industry, 24 in services and 12 in agriculture. As of April 2000, the Incubator Lease Fund had 50 active agreements and plans to increase to 120 within the year. The program allows for the lease of old or new equipment. The value of the leased equipment can range from $400 to $25,000. The lease terms are usually for two years with 12.5-25% advance payment and 20-25% annual percentage rates in dollar terms. The repayments are monthly at the prevailing CBR exchange rate. The Volkhov Business Incubator insures the equipment in its favor for which the lessee pays the premiums. No other collateral is taken. Delays in payments were experienced in only 2% of the portfolio. One agreement had to be terminated prematurely due to the lessee's insolvency, but the lessee returned the leased equipment voluntarily and the incubator was able to resell it.

Source: Likhachova, Irina. 'Volkhov International Business Incubator' IFC Leasing-Courier Russia. April 2000

A more effective approach has been initiatives for start-ups on the regional and municipal levels. Novosibirsk’s regional authorities are discussing the implementation of business incubators, as well as the setting up of a system for transfer of state and regional property to start-ups at favored conditions. In Vladivostok, the regional government set aside a notional sum for financing a Fund for Support of Small Business. The Fund provides information, (paid) legal services, education, and (paid) consulting to help with organizing the business, drafting a business plan, developing accounting, processing registration and licensing, and providing some very limited financing. Finally, credit unions are starting to appear in Russia. Those are funded by their members and lend to members at relatively low interest rates, using simplified loan approval procedures. The volume and reach of these credit unions remains very limited, however.

Donor credit lines remain small as well, but they show that there is scope for viable lending. Private and donor-funded initiatives have also been a source of finance for the small and medium enterprises. One example is the EBRD-initiated Russia Small Business Fund (Box 7). These initiatives have been small in terms of the overall needs of the Russian economy, but they show that there is some scope for productive lending.

### Trade Credit and Non-Monetary Forms of Exchange

Today, corporations in Russia rarely use normal forms of trade financing. Often arrears will be labeled “trade credit”, but these are “extended” involuntarily, for lack of liquidity of the trade partner. The lack of normal trade finance is mainly due to the weaknesses in dispute settlement mechanisms and credit rating and tracking mechanisms for non-payments. Although there are some efforts underway, so far there is no centralized system to keep track of defaults or other negative information and a private credit rating agency has not yet been established. Due to non-existing credit record tracking mechanisms, virtually all firms require new clients to pay in cash, part in advance, with
the balance on delivery. Charging interest on trade credit is more the exception than the rule. Some companies are, however, offering a discount if payments are made in cash.

**Box 7: EBRD’s Russia Small Business Fund (RSBF)**

The RSBF program was conceived as a way to stimulate new, viable production and employment. It received a great boost in 1993 when the G-7 pledged $150 million, to be matched by $150 million from EBRD. The RSBF program has three components: (1) Micro Loans—from $100-30,000 for a period of 1-36 months to enterprises in all sectors up to 20 employees; (2) SME Loans—up to $150,000 for a period of 1-36 months to enterprises in manufacturing and services, typically with fewer than 80 employees; and (3) Small Enterprise Equity Funds (SEEFs) to provide a combination of debt and equity financing up to $500,000 for small businesses employing up to 150 people in the production and service industries. Since 1994 the RSBF has made more than 36,000 loans totaling more than $400 million to entrepreneurs in more than 60 towns and cities across 25 regions of the Russian Federation. The average loan disbursed is $14,000, the largest loan issued was for $150,000 and the smallest just $30. The average tenor has been 9 months and average amount $7500 for micro loans, and 18 months and average $58,000 to SME’s. The borrowers have been a very diverse group of enterprises in all sectors, from retail kiosks to high-tech medical manufacturing. Many of the small loans had also been fully repaid within one year of disbursements with limited repeat borrowings. The loans are on lent through selected intermediary banks for 2-5 years maturity. Currently RSBF works with 4 partner banks and EBRD’s own SME-finance Bank, KMB Bank. The goal of RSBF is to disburse 3000 loans per month through the existing and future intermediary banks spread across Russia within the next two years. The RSBF Program provides intensive technical assistance to the participating banks where external experts and consultants on credit risk analysis train loan officers. Loan officers are trained to analyze the management, the market and the financial situation of the borrower, including cash flow forecasts before they examine the collateral. The program stresses the value of repeat loans for developing credit history and for loan officers to see the client as a client for life. This is essential in micro and small lending, where loans are often too small to cover the transaction costs of the bank. The participating banks are also encouraged to consider non-traditional forms of collateral. Loans under the RSBF have been made with many forms of collateral, for example, real estate, automobiles, television sets, porcelain, jewellery and, in one case, pure bred dogs. The high repayment rate has justified the flexibility. The Russian banks participating in the program have learned to change their conservative lending behavior, stressing collateral and connections to one based on cash flow and credit analysis. They have also learned that lending to small and micro enterprises can be profitable if successfully structured and risks are properly managed. Some also had to change their centralized credit approval structures since small-scale finance requires decentralized structures and delegation of authority to trained staff at the branch level.

To the extent, trade credit is being offered, it is either between entities within the same business group or to buyers with whom there is a long-term relationship; see Box 8. Frequently the terms for this form of trade finance are 3 weeks and for between 10% and 30% of the amount due. The length of the trade relationship is of paramount importance to the terms of trade credit. Relative market power of the trade partners (and thus ability to bargain) is also an important factor in trade credit. For example, a seller will extend trade credit if the client purchases a major part of the output. If that client is further liquidity constrained, as is likely, the term of the trade credit can reach several months or generally up to the turnover period of the client. Foreign partners offer trade credit with much more willingness than domestic ones. Many companies are uncomfortable and unequipped to deal with issues like sales, placement, marketing, credit checks, collections, etc.

**Box 8: Two Examples of Trade Credit in Russia**

This Novosibirsk wood-processing firm has three Tomsk-based suppliers, with whom the company has worked since the 70s. The Novosibirsk firm makes large purchases in the fall, to stock up for the winter and assure uninterrupted production. The company usually finds it difficult to finance this bulk purchase. Supply payments are made with a lag of 3-4 months, 70% in cash and 30% in exchange for the new production. No interest is charged for the late payments.

This Vladivostok milk and yogurt products manufacturer is required to pay all suppliers up front, in cash. However, it pays its foreign packaging company three months after receipt of goods with no interest charges.
In an environment of limited bank finance and no formal trade credit and liquidity, non-monetary forms of payment provide the liquidity and credit for the exchange and sales among enterprises. To a large extent enterprises build in premiums or discounts into the prices of the goods or liabilities exchanged, thus substituting trade terms (payment and interest) for price gains, and where the exchange of goods or offsets serves as immediate collateral. Substituting barter for trade credit should be no surprise in Russia, also given the weak contract enforcement environment. But, it is having long-run costs as it prevents the development of market-based financial transactions and a real financial system.

Although declining, non-monetary payments are still much used, especially in the remote regions for conducting trade transactions, to resolve arrears or for continued non-transparency reasons as well as to sustain non-viable enterprises. For the manufacturing industry as a whole, the share of barter in total sales is estimated to be some 20%, down some 15-percentage points from 1999. Non-monetary payment forms can be grouped in one of three categories: barter, exchange of goods or exchange of a good against a debt; debt offsets, exchange of goods or veksels of third parties against tax or wage arrears or inter-enterprise payables/receivables; and veksels, either own or third party veksels in exchange for goods or payables (tax, wages, etc.).

There are many structural reasons for the continued use of non-monetary forms of payment in Russia. One is the restriction on large volumes of cash payments and lack of near-cash instruments within the system. Also there is no large or automated bank branch network that would make clearing/payments less costly and efficient for enterprises. Except for Sberbank, there is no single operating national bank with a branch network covering all parts of Russia. Furthermore, some monopoly suppliers of goods to illiquid regional governments often request higher prices for their goods to offset tax liabilities. And enterprises with previously established sales and distribution networks can often continue operating even if they are loss making and need financial and operational restructuring.

Today there are two types of veksels in Russia, corporate and bank veksels. Some of the bank veksels are like certificates of deposit as they are redeemable at sight or at a later date. However, bank veksels can also be issued against credit extended (veksel credit loan) giving the banks limited capacity (up to 100% of charter capital) to create money. Corporate veksels can be in the form of promissory notes sold at a discount or with fixed rate coupons for longer periods. Although regulations stipulate that a corporation can issue own veksels only up to 30% of its chartered capital, there is no central oversight over veksels issued by enterprises. Both bank and corporate veksels are used for collateral against bank lending, trade credit among enterprises and non-monetary means of netting of inter-enterprise receivables/payables. The total volume of primary issue of corporate veksels is estimated to be about several billion dollars, mainly issued by Gazprom (Russia’s largest enterprise). Gazprom veksels are issued to pay its own suppliers but much of the paper is then sold in the secondary market to the buyers of Gazprom who in turn use them to offset their own payables. The high secondary market demand for Gazprom veksels have created a premium for this paper and today Gazprom can issue its own veksel to the suppliers at a discount of its actual obligation. There is a secondary market, centered in Moscow for bank and corporate veksels of prime names. The most in-demand bank veksels are those of Sberbank and most in demand corporate veksels are those of Gazprom. The daily turnover in this market is estimated to be around $50 million.

While there are some of improvement in the framework for inter-enterprise lending, much of the non-payments starts with budgetary agencies. Recently, the federal government has been presssing for cash settlement of taxes, and in general reducing the scope for transfers coming from government related agencies. Thus, relative to earlier years, the share of barter payments has declined somewhat and the federal government, utility providers, and the railroad monopoly are pressing for settlements in cash and financial instruments. Telephone providers and the railroad monopoly are refusing in-kind payments almost entirely. Increasingly, electricity providers are refusing barter settlements to all enterprises that are judged liquid enough to settle in cash. The recent reduction in government arrears
is affecting the corporate sector positively. In Novgorod, a major wire producer, for example, has seen the share of barter deals in its business fall from 40% in 1996 to 5-10% in 2000.

Suppliers and business clients' transactions, barter payments to utility providers, and tax offsets at the federal and local level all turn often complex. In settlements with suppliers, illiquid enterprises pressure for in-kind payments. Usually heavy industry is more prone to settling in barter, due to the lack of a liquid market for their production. Suppliers who are more dependent on a single big client are more willing to tolerate in-kind payments. On average, 30-60% of supplier payments is barter deals, as opposed to 5-10% for more liquid companies.

There are also some attempts to create alternative mechanisms that could provide some form of credit certification and payment enforcement. One such mechanism is a voluntary association of enterprises (usually with the support of the regional administration) where all members accept the association's power of contract enforcement among the members. However, this mechanism has limited enforcement power (e.g., usually only among the association's members), and may further have the problem of limited self-enforcement (e.g., when a powerful member has no interest in enforcement, he could not be stopped from dropping out of the association). This alternative would be effective to the extent that reputation concerns are becoming important among Russian businesses. Several regions in Siberia, for example, have united their administrations and business associations in annual identification of credit-worthy companies. Currently, there are some 360 firms in Siberia that possess a "credit-worthy partner" certificate issued by two administrative authorities and two business associations.

In addition to regional business organizations, associations within the same industry are being created, comprising all of Russia, for credit quality tracking. Those associations are used mainly to disseminate information. Both regional and industrial types of associations are being used as a forum for lobbying and communication with different levels of government. For those enterprises that cannot yet afford to set up their own networks, using intermediaries can increase cash collections and improve turnover.

Despite setbacks, some companies have been able to set up dealer networks to support sales and collections. Own-dealer networks, if a company can afford them, are useful for both sales related marketing information gathering as well as for assistance in collection activities (Box 9). They have thus some function in improved credit allocation.

Specialized companies have sprung up to arrange "barter chains"—clearance mechanisms that attempt to create a closed chain of mutually needed goods—that provide liquidity. The principle of those chains is that illiquid firms will accept product to be sold at a discount, while cash rich firms will only participate in the chain if offered a premium. Alternatively, if the organizer manages to create a closed chain among only illiquid firms, the organizer collects the profit from all discounts offered by participants in the transaction (see Box 10 for an illustration). The demand for such chains comes from illiquid enterprises or budgetary organizations that either cannot pay cash for their supplies, or are forced to make payments for essential inputs such as gas, electricity, and telephone. Thus the chain usually involves a utility provider, and the municipal or oblast government.

Policy Recommendations

Moving forward, the government should start with improving the basics for commercial transactions. This means a basic, legal framework for any commercial transaction, whether among corporations or between corporations and financial institutions. This legal framework of course also needs to be enforced. To date, the legal basis for many commercial-to-commercial transactions in Russia is very weak and enforcement very limited, leading to large-scale barter, non-payment, and high transactions costs. In the short to medium term, given the limited state of development of the
financial system, intra-firm credit, whether for trade-finance or for investment purposes, will have to be the most important source of external financing for most firms. To achieve this will require building up a truly independent judicial system with well paid judges that have the incentives to enforce the legal framework; see the chapter on dispute settlement. And it will require a better functioning system for transacting payments. With more efficient and reliable intra-firm financing, a basis for a more productive role of the banking system in Russia can be established.

Box 9: Dealer Networks as Surrogate Credit-Tracking and Payment Collection Mechanisms

This Novgorod wire producer sells both directly and through dealers. Any direct sale requires 100% payment in advance. As for indirect sales, initially the firm used many dealers, among them some small ones. Most were dropped soon, and currently the company sells via three dealers in the Northwest part of Russia: in St. Petersburg, Tver, and Novgorod. The firm has worked with those dealers for two years. The company has concluded dealership agreements, according to which the dealer gets 20-25 days to sell, and then needs to transmit the money to the firm, keeping the dealer's margin. The firm has even attempted to encourage the dealers to repay (and sell) faster. The dealers get a “discount” according to how much they have sold last month.

This Novgorod fertilizer producer sells via a dealership network that is currently being established. Dealers are required to deal only in its product, but have otherwise no ownership or governance ties. One dealer in each city or town is given exclusive rights to distribution of the product. Dealers set their own price for the product, and pay the firm a fixed pre-determined asking price. Dealers pay exclusively in cash, via the firm’s corporate settlement account at the bank. The first year the firm sold directly, but did not find it optimal, because it was difficult to study the market in each locality. Dealers have a comparative advantage in that they know and can control the market in each city or town, and maintain contact with local stores.

This building component manufacturer in Novgorod does not obtain payments from clients affiliated with the company’s parent. Instead, at end-month, the firm draws up a total of sales receivables from the parent’s affiliates, and all sales receipts are sent out to the parent, who either collects payment or clears out mutual payables with its affiliates.

This Novosibirsk sewing company has created a 100% owned subsidiary that deals with sales, where all employees work for a percentage of sales.

Box 10: Barter Chains – A Costly Source of Liquidity

This Novgorod foodstuff producer presents its “offsets” business as one of its core activities. The firm creates barter chains among enterprises, gas and electricity providers, and local and oblast authorities. As an example of a barter chain, the firm sells foodstuffs to another firm, who cancels the respective amount of its outstanding receivables with a brick producer, who in turn "pays" with brick production to a metallurgical plant. The latter uses the bricks as inputs and pays for it with metal that is shipped to a budget organization, which in turn uses that for construction and repair. The regional administration pays for the metal by offsetting the taxes of the foodstuff producer’s suppliers, who complete the chain by providing raw materials to the firm. There are usually 6-10 pieces to a barter chain.

**Strengthen Creditors’ Rights.** Across countries, in addition to a stable macro-economic environment, the legal and regulatory environment in which financial institutions operate is the most important determinant of financial development, and in turn for economic growth. The rights of secured and unsecured creditors, the rights of equity holders and the enforcement of these and other contracts are the most important components of this legal and regulatory environment. Credit market development depends crucially on the ability of creditors to enforce their claims on borrowers. The weaknesses in many components of its legal and regulatory framework, combined with the general lack of contract enforcement and poor macro-performance over the past decade, largely explain the low-intermediation trap in Russia and the feeble contribution of the financial sector to growth.

**Strengthen Equity Investors’ Rights.** Similarly, Russia’s capital market development is impeded by weakly enforced equity rights. Significantly, in countries where there are strongly
enforced shareholder rights, there is a greater number of listed firms and higher stock market capitalization. Also, across countries, firm valuation is found to be a declining function of the degree of shareholder protection. Correspondingly, the cost of capital for firms is higher in weak corporate governance settings, which has social costs as profitable investment opportunities are bypassed. Russia ranks among the lowest of all countries in terms of effective minority shareholder protection; as a result, market valuation of its firms will likely be only a fraction of that in comparison with developed countries' capital markets. Indeed, this is confirmed for a sample of Russian firms where the deviation of local valuation from international benchmarks varies greatly depending on a firm's corporate governance behavior (see Black, 2001).

**Adopt International Accounting Standards.** The non-transparency and the inefficiencies of non-monetary forms of payments are further hindering the development of normal, market-based financial transactions. Adopting International Accounting Standards (IAS) and applications in both the real and financial sectors would decrease the non-transparency and allow financial institutions to start intermediating funds more productively. A normal set of contractual relationship among enterprises will be a requirement for the eventual development of a functioning financial system. And, without a functioning financial system yet, normal contractual relationships among corporations is the only way to some sustainable enterprise growth in the near future. The lack of transparency is also a major deterrent for other external financing sources for the real sector. In a May 2000 survey, Price Waterhouse has estimated that non-transparency costs Russia around $9.8 billion annually in foreign direct investment.

**Implement Auditing Reform.** Audit reforms are also necessary to encourage transparency and full disclosure of information by the corporations. The majority of the companies are unlikely to undertake the efforts necessary to achieve full and timely disclosure of information, such as implementing generally accepted international accounting standards and changing the management mentality, until audit reforms have been implemented. Harsh treatment by the Tax Police and the threat of expropriation act as disincentives for disclosing information by companies as well as revealing fully the identity of key shareholders. A more rationally enforced tax system will be a necessity for better quality financial information and fuller disclosure.

**Proceed with Comprehensive Banking Reform.** Increasing confidence in and capitalization of the financial system is a must for the longer-term. The development of a fully functioning financial sector in Russia will be a long-lasting effort. One crucial prerequisite for any meaningful reform is the full political commitment of the Russian government (GOR), including the Central Bank (CBR) and the Ministry of Finance (MOF), to banking system restructuring and financial reform. This will be a necessity to create greater confidence over time among households and investors in the Russian financial system, thereby increasing the available financial savings and capital, and thus make greater financing available for the corporate sector.

Building confidence requires that the government enforces its own set of rules. Enforcement of existing rules includes the closure and liquidation of insolvent banks according to already set procedures. Up to the present, instead of liquidating insolvent banks the government has, through various means, supported favored banks and through generally limited actions allowed other insolvent banks to remain in business as "zombies." The government also has only made limited efforts in stopping asset stripping in defunct or even officially intervened banks. Before any active restructuring, the liquidation of insolvent banks has to proceed first. Without the political will to take the minimum steps necessary to liquidate insolvent banks and stop asset stripping, support for building a legal or institutional framework for more active bank restructuring will be ineffective, and is most likely counterproductive.

Recent changes in the banking legislation are steps in the right way but questions still remain about their implementation. Several amendments to the banking legislation have been approved by the Russian Parliament. In addition to clarifying the existing definitions for bank capital and insolvency, these amendments also give more powers to CBR to properly intervene and resolve problem banks.
All of these amendments could improve the transparency of the banking sector and the supervisory oversight and powers of the CBR. However, the passage of these amendments does not necessarily mean that banking reform has become a priority. Progress toward adopting international accounting standards in the banking sector is very slow, with 2004 estimated to be the earliest date of its adoption by the full sector. And the idea of building a systemwide deposit insurance, while already repeatedly delayed, remains being discussed, although this remains an undesirable measure given the supervisory weaknesses in Russia. Any deposit insurance scheme will also need to take into account the still large role of Sberbank in deposit mobilization.

*Foster Competition in the Banking Sector.* The state should be the regulator and supervisor of the financial sector, rather than a direct participant. State-ownership in the banking system is still large with more than 45% of assets and nearly 90% of the deposits. The large state dominance in the banking sector continues to stifle competition and encourages directing the funds of the state banking sector into politically important projects, sectors or enterprises. While the government has recently made announcements with respect to its intention to privatize some of these banks, it has yet to provide more specific information. Recent history in Russia has shown that poorly executed privatization strategies entail large risks. The government could signal its commitment to deeper reforms by, for example, announcing its intention to privatize some state banks to reputable strategic investors. Encouraging further foreign bank entry in general would also increase the available capital and confidence in the banking sector. To date, however, nothing has been done about easing foreign access to the banking sector.
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In 2000, the share of loss-making enterprises declined from 1999 by 7 percentage points, the majority (54%) of managers assessed their financial position as good or normal, and only 22% of managers believed their enterprises was facing bankruptcy in the next one or two years, down from 27% in 1999 (source: Russian Economic Barometer).

Endnotes


6. In 2000, the share of loss-making enterprises declined from 1999 by 7 percentage points, the majority (54%) of managers assessed their financial position as good or normal, and only 22% of managers believed their enterprises was facing bankruptcy in the next one or two years, down from 27% in 1999 (source: Russian Economic Barometer).


8. La Porta et al. 2000.

9. The IMF estimates that foreign direct investment to Russia in 2000 was around $2.7 billion.
V. Dispute Resolution in Russia: 
A Regional Perspective

Kathryn Hendley* and Peter Murrell**

Introduction

The reality of institutional performance often differs markedly from the assumptions of the conventional wisdom. It is often even markedly different from the conventional wisdom held by those in the knowledge business, such as academics, journalists, and policy practitioners. Frequently, all institutions become tarred with the general brush of a country’s reputation. Assumptions on how specific institutions are functioning are often based on the general economic performance of a country or on general observations of the character of government and politics, rather than on detailed observations of the specific institution. In the case of legal institutions in Russia, there is another factor: some deem the phrase ‘Russian Law’ to be an oxymoron. Tsarist and Soviet history and tales of the modern Russian mafia seem to provide a filter, which excludes the possibility that there can be some bright spots amid the Russian legal and economic gloom. Views on the arbitrazh courts, the courts pertinent to businesses in Russia, seem more reflective of these factors than of detailed evidence on the use and functioning of these courts.

An odd consensus has emerged among commentators that the arbitrazh courts are simply not up to the task before them and irrelevant to the needs of the economy. With few exceptions, the literature on Russian legal developments contends that the arbitrazh courts are not being actively used, and that their pervasive flaws have doomed these courts to peripheral status. Commentators have argued that law is not terribly relevant in the emerging Russian market and that the shortcomings of the legal system are a key factor stymieing development. The arbitrazh courts, according to this consensus, are compromised by judges’ lack of competence, by the taint of outside influence, by slowness of decision-making, and by the difficulty of enforcing judgments. As a result, enterprises are shunning the courts, even turning to private enforcement to resolve disputes.

Such views might be justified if all parts of the Russian legal system exhibited the same properties, on average, as Russian institutions in general. Such views would be conceivable if the arbitrazh courts exhibited the same properties as Russia’s courts of general jurisdiction, which are pertinent to legal matters outside the business sphere. But as we will show in the pages below, the arbitrazh courts are quite distinctive. The views that are summarized in the previous paragraph could not now arise from a careful consideration of the evidence on the use and functioning of these courts.

A central premise of this paper is that a sound empirically based assessment of existing institutions is a crucial input into policy and reform. Without such an input, conventional wisdom, which sometimes reflects prevailing dispositions rather than detailed empirical work, can affect important decisions, as it insinuates itself into the informational base used by policy makers and advisers. Thus, in a paper written this year for an international financial institution, the authors commented that “The legal system is not a useful route for settlement of any dispute...” in Russia and referred to a “lack of...dispute settlement mechanisms.” This is an example of an instance where the conventional wisdom on the courts has reached a position where it can influence the direction of policy and reform, given the important role of the international financial institutions in guiding reforms in developing and transition countries.

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Thanks are due to Alla Mozgovaya of the Institute of Sociology of the Russian Academy of Sciences and to Catherine Weaver. We gratefully acknowledge the support of the National Council for Eurasian and East European Research.
In this paper, we take issue with the prevailing views and argue that the arbitrazh courts play a role in the Russian economy that is widely underestimated. They are used extensively and they are viewed relatively benignly by business. We do not argue that the arbitrazh courts are without problems, indeed far from it. This is to be expected, they are embedded in a society in which the historical legacy is far from helpful for legal processes, in which many of the institutions that are complementary to the arbitrazh courts function poorly, in which the central government has frequently reneged on financial commitments, and where conflicts between central and regional governments can cause problems even for the best designed institutions. Nevertheless, the arbitrazh courts must be examined as a distinctive institution and general perceptions on the functioning of these courts are far from reality.

Consistent with the tenor of the overall study of which this paper is a part, we pursue our argument using empirical information obtained on the ground, reflecting circumstances in a variety of Russian regions. The points we make are driven by information collected on the day-to-day operations of enterprises and courts, from enterprises and from the courts directly, rather than from more generally available published sources of information.

There are three primary sources of information. First there is the regional case-study field research conducted by Hendley at various times over the past decade. In keeping with the spirit of the other essays in this volume, we place particular emphasis on the findings from the field research in 2000 and 2001 (but we are able to put these results in a broader context). This field work has taken place in enterprises and in the courts themselves, observing judicial proceedings, interviewing judges and litigants, and examining upwards of a thousand case files. Second, there are the data that the individual arbitrazh courts submit annually to the Higher Arbitrazh Court. These data are not published regularly and therefore this information will be new to all but a tiny number of readers. We are able to provide a picture of the functioning of the regional arbitrazh courts that reflects a variety of experience across regions, a picture that is based on the behavior of individual courts. The third source of information comprises the results gained from a survey of 220 Russian enterprises. The sample was drawn from four cities (Moscow, Novosibirsk, Yekaterinburg, Saratov), with each represented equally. This third source of information provides evidence that is based on the behavior of individual enterprises in different regions of the country. This type of field research, reflecting the circumstances of many enterprises, offers information that is less detailed than derived from case studies on individual enterprises, but provides information that is much more specific to the questions being addressed than contained in any standard enterprise data-base. Although this survey was conducted in mid-1997, before the 1998 financial crisis, the results are still highly pertinent today. As we will show below, the interactions between enterprises and the legal system did not evidence any strong structural shifts in response to the 1998 crisis. Moreover, the legal system itself did not change in any dramatic way between 1997 and the present. Therefore, the results of this survey are still pertinent for current deliberations.

We emphasize that our data examines the courts from a variety of different perspectives using information from the three different sources. It is the consistency of the composite picture that emanates from the varied information that argues most strongly for our conclusions. We do not pick upon a single aspect of the arbitrazh courts nor do we rely on a single source of information, but still we are able to obtain a consistent message, at odds with the conventional wisdom. This conclusion is reinforced when pursuing the second theme of our argument, the variety of experience at the regional level. We examine how the arbitrazh courts are functioning across a variety of Russian regions and find a consistent picture across the regions.

We begin the presentation of the evidence by providing a background to the paper in the next two sections, placing the arbitrazh courts in the Russian institutional landscape and discussing the characteristics of the regions that are examined in this study. We then turn to the presentation of data on the arbitrazh courts. Sections 4, 5, and 6 examine the intensity and the patterns of use of the arbitrazh courts, noting changes over time, variations between regions, and the growth in the number of cases that involve the government. Sections 7-11 study the empirical evidence on features of the arbitrazh courts that are most often mentioned in the standard criticisms of these courts. We examine whether the courts are slow and expensive. We look for evidence of lack of competence of the judges and of corruption. We examine the issue of enforcement of decisions. We find, in most cases, that these standard criticisms are over-stated, and in some instances there is virtually no evidence supporting the criticisms. We do not conclude, however, that the arbitrazh courts are
without problems. There are clearly identifiable areas of the operations of the arbitrazh courts that could be addressed by suitable reforms. Section 12 considers some policy implications of our findings.

The Arbitrazh Courts

In Russia, arbitrazh courts are the state-sponsored tribunal charged with resolving economic disputes. Arbitrazh courts are not entirely new to post-Soviet Russia. They are the institutional successor to state arbitrazh (gosudarstvennyi arbitrazh or gosarbitrazh), which existed during the Soviet period. Gosarbitrazh was a quasi-administrative agency that resolved disputes between state enterprises. Like all Soviet-era judicial organs, gosarbitrazh was politicized. It operated within the confines of the administrative-command system, with the underlying goal always plan fulfillment. As a result, the arbiters who decided cases looked more often to the implications of the case for the economy than to the law when making their decisions.

This Soviet legacy is one source of the pervasive criticisms of the Russian legal system. Under the old system, legal institutions were highly permeable. Laws bent to the political winds, as did the courts. In view of this history and the difficulty of quickly legitimizing carryover legal institutions, many commentators have argued that law is not terribly relevant in the emerging Russian market and that the shortcomings of the legal system are a key factor stymying development.

The inadequacies of gosarbitrazh were apparent from the earliest days of the transition. The introduction of new property forms in the late 1980s and early 1990s required a similar expansion in jurisdiction. Consequently, new procedural rules were adopted and put into effect in 1992. One of their most important institutional innovations was to discard the administrative agency persona of gosarbitrazh and, in its place, to create arbitrazh courts (arbitrazhnye sudy). In addition, these newly constituted arbitrazh courts were no longer limited to resolving disputes between state enterprises, but were empowered to resolve disputes between all types of legal entities, and even between legal entities and the state. Although this new arbitrazh procedure code (APK) represented a step away from gosarbitrazh, it also proved inadequate. The arbitrazh procedure code was again rewritten and, in July 1995, a new set of rules took effect. The profound transition from gosarbitrazh to arbitrazh courts was not achieved overnight. To some extent, judges and litigants were adjusting to the new institution throughout the period under consideration in this paper. In May 2001, this draft code had its first reading. According to officials at the Higher Arbitrazh Court, more than one thousand comments and proposed amendments were generated. Consequently, at this point, it is impossible to know which aspects of the new law will survive. In the text that follows, we note where the current draft would change practice and relate the predictions of court insiders as to its prospects for ultimate success.

The present-day arbitrazh courts remain institutionally distinct both from the courts of general jurisdiction and from the constitutional court. The courts of general jurisdiction hear cases involving individuals, while the arbitrazh courts consider cases filed by legal entities. Thus, most commercial litigation in Russia is concentrated in the arbitrazh courts. One area in which the jurisdiction of the two courts has overlapped is corporate governance. Because the arbitrazh courts are generally barred from hearing cases involving individuals (except when they have registered as entrepreneurs), claims brought by shareholders who are physical persons are shunted off to the courts of general jurisdiction. The draft procedural code adjusts the jurisdictional boundaries to allow the arbitrazh courts to hear all corporate governance cases. In a June 2001 conversation with officials at the Higher Arbitrazh Court, we were cautioned that the Russian Supreme Court had not yet agreed to this adjustment. Whether the courts of general jurisdiction will give up their right to hear these cases is unclear.

At present, arbitrazh courts hear two basic types of cases: (1) economic disputes between legal entities, including bankruptcy (these disputes between enterprises or other non-governmental entities are referred to as "civil" cases); and (2) economic disputes between legal entities and the government. Disputes that pit enterprises against the government are known as "administrative" cases.
As market reforms have progressed, the disputes submitted to the arbitrazh court have grown more and more complicated. Not surprisingly, cases now take longer to process. The increased use of penalties means that the amounts being demanded are no longer symbolic. The arbitrazh courts have struggled to come up with mechanisms for ensuring compliance by the losers.\(^2\) In the view of Russian lawyers, the inability to enforce judgments is the single biggest shortcoming of the arbitrazh courts. The chairman of the Higher Arbitrazh Court, which stands at the apex of the arbitrazh court system, has acknowledged that implementation is the Achilles' heel of the system.\(^2\)

One interesting question, not fully addressed in the literature and obviously important for this paper, is the place of the arbitrazh courts in the much vaunted struggles between federal and regional authorities. Hendley, Murrell, and Ryterman (2000) provide some insights into this issue based on the results of a 1997 survey in six different regions. In examining the strategies that enterprises pursue in addressing transactional problems, they find that enterprises who rely more on the vestiges of the old Soviet planning and ministerial system are more likely to resort to the federal government for help. Appeals to the regional government are associated with use of the arbitrazh courts. This suggests that, despite the fact that the arbitrazh court system is a national level institution, patterns of use have a local dimension that should be investigated.

The Regions under Study

Following the orientation of the overall project of which this paper is one part, the discussion here has a significant regional dimension to it. There are several sets of regions that appear in this paper. The basic set of regions contains those oblasts that are the subject matter for the overall study of which this chapter is one part: City of St. Petersburg, Leningradskaya Oblast, Novgorodskaya Oblast, City of Moscow, Moskovskaya Oblast, Volgogradskaya Oblast, Samarskaya Oblast, Saratovskaya Oblast, Sverdlovskaya Oblast, Novosibirskaya Oblast, Omskaya Oblast, and Primorskii Krai. We will also consider subsets of these regions in individual analyses, where the limited availability of data dictates. The reader should assume that where a subset is considered then the decision is dictated by the availability of data.

Tables 1-3 provide some summary information on the regions under study. Table 1 focuses on politics. There is substantial variation among the regions in terms of the length of tenure of governor, the support that governor received in the region when elected, and the extent to which the region is politically aligned with winning presidential candidates. It is clear that the data in this paper will reflect a variety of experience on the issue of federal-regional relations.

Table 2 focuses on basic economic statistics and reveals somewhat more homogeneity among the regions. They are all large in terms of population and none of the regions is at the lowest level of development relative to the spectrum of Russian regions. All these regions are highly urbanized and in all of them there is a significant industrial component to the economy, although there has been a substantial decline in industrial production over time.

Table 3 focuses on the enterprise sector, which of course is the sector that is pertinent to the arbitrazh courts. The relative size of this sector in the economy will be one ingredient in the relative patterns of use of the arbitrazh courts. Patterns of use are also likely to vary with the relative importance of joint-stock enterprises, which are more likely to be privatized, older, and large, versus non-joint-stock enterprises, which will primarily be new private businesses that are quite small. The effect of the relative importance of different types of enterprises on patterns of use of the courts will reflect two countervailing effects. The older firms will more likely have the legal resources to use the court system and experience with that system,\(^2\) but they will also have established relationships that can be used to solve disputes without going to court. The regions in the study do have sufficient variation in this respect to give us confidence that the results appearing below reflect a variety of Russian experience. Let us take Novgorod and St. Petersburg/Leningrad (skipping the extreme of Moscow). The latter region has nearly double the number of enterprises per capita and a greater proportion of workers in the enterprise sector who are in small enterprises (6 times the number of small enterprises per capita as Novgorod).
In sum, the statistics below on the use of arbitrazh courts reflect the situation in a variety of Russian regions. To the extent that we can find patterns that are consistent across these regions, one can be sure that these patterns are not anomalous, but rather provide a general picture of what is happening in Russia at present.

**Intensity of Use of the Arbitrazh Courts**

For 1999 and 2000, Table 4 details the total number of cases filed and decided in the arbitrazh courts. The data presented in this table have been gathered from the official statistical forms that the individual arbitrazh courts submit annually to the Higher Arbitrazh Court. The number of cases decided represents a good indicator of demand for the services of the arbitrazh courts. At the same time, one should note that the number of cases decided is less than the number of petitions filed. Cases drop out for a variety of reasons. Some parties reach negotiated settlements, in which case the court could be providing a valuable service since the negotiations would be carried out under the shadow of the expected actions to be taken by the court. In other instances, the petitions are improperly drafted and cannot be accepted for consideration by the court.

The large absolute number of cases is the first striking impression from Table 5. If enterprises are shunning the courts in favor of private enforcement as is commonly stated, then the data on use of the courts does not seem to reflect a lack of demand for the courts. Note also that 1999 does not seem to be an exceptional year (as one might imagine given the aftermath of the August 1998 crisis). Eight of the eleven regions have an increase in the number of cases from 1999 to 2000.

To provide some scale to these data, the last columns of Table 4 compare the number of cases to numbers of enterprises in the region. We use two counts of the number of enterprises (see Table 3), first the total number of private enterprises in the region and second the number of joint-stock companies. The latter would be the category that contains the larger companies who are more likely to use the courts intensively. Even when the very smallest enterprises are included in the analysis, the regional median number of cases per enterprise is 0.2. Using the number of joint-stock companies as the base, all but one region has more than one case per enterprise and the median across the regions is 2.57.

Table 4 can give some initial insight into the causes of regional variation in the intensity of court use. Moscow and St. Petersburg/Leningrad have much higher numbers of cases per inhabitant, but one factor causing this is the number of enterprises in these regions. The litigation rate per enterprise is actually lowest in these regions. But factors other than regional differences in the number of enterprises must come into play. Consider the contrast between Saratov and Samara, the former having a higher litigation rate per enterprise and double the litigation rate per joint stock enterprise. A glance at Tables 2-3 suggests that the differences might be because Saratov has a much larger number of privatized enterprises and a much more depressed economy than does Samara. Of course, a study using multivariate analysis with a larger number of regions would be necessary to explore this observation more fully.

Table 5 strongly reinforces the message from Table 4, presenting results from our 1997 survey. In all four of the regions in that survey, more than 70% of enterprises had been a plaintiff or defendant in the two years prior to the survey and more than 60% had been a plaintiff. The cross-regional patterns in the intensity of court use are also broadly consistent between the two tables, with Moscow evidencing lower litigation rates per enterprise than other regions.

**Temporal Patterns in the Use of the Courts**

Table 6 examines how the use of the courts has changed over time. The number of cases decided decreased significantly in all regions from 1992 to 1994, and then began to recover. The drop-off was most precipitous outside Moscow. It is hardly surprising that the decline occurred simultaneously with the institutional rebirth of the arbitrazh courts. Enterprises needed time to familiarize themselves with the new "rules of the game." The percentage of petitions that have been dismissed for not complying with the procedural rules has steadily declined, indicating that enterprises are successfully absorbing these new rules.
The end of the planned economy brought a fundamental change in the function of the arbitrazh courts. When appealing to gosarbitrazh, Soviet state enterprises were less interested in monetary recovery than in signaling their ministerial superiors that fault for poor performance was not theirs. Soviet-era managers did not have to be concerned with mounting debt, since soft budgets would compensate for any shortfalls. Privatized enterprises, by contrast, are necessarily more financially constrained. Inter-enterprise arrears emerged as a serious problem in the early 1990s. Yet the sharp decline documented in the table suggests that enterprise management initially looked away from the courts for relief.

By 1997, the level of demand for the courts had risen above the 1992 level on a national basis and by 2000 the level of demand was above 1992 levels in all regions, with Sverdlovsk, at the lower end, 16% above the 1992 level, while Novosibirsk was fully 63% above the 1992 level. Since demand for the courts in 1997 was already higher than in 1992, this rise in the number of cases from 1994 onward cannot simply be ascribed to the 1998 crash. Thus, Table 6 suggests that enterprises in all regions of the country are availing themselves of the opportunities provided by the courts. This is not a picture that would be expected were the arbitrazh courts irrelevant in the affairs of enterprises.

### The Increase in Administrative Cases

One common criticism of the courts is their complete powerlessness in the face of pressures from federal and regional governments. Were the courts hopeless in this respect, then one would not expect to see enterprises bringing suits against the government, because of the supposed futility of such an action, and one would not expect the government to need to bring suit against enterprises, since the courts could not add to their power. In fact in contrast to this prediction, Table 7 shows one very significant factor in the rise in demand for the courts in the last half of the 1990s, the rising proportion of administrative cases. Arbitrazh court cases can be divided into two categories. Disputes between enterprises or other non-governmental entities are referred to as “civil” cases. Disputes that pit enterprises against the government are known as “administrative” cases.

What accounts for this astonishing increase in administrative cases? This surge suggests that enterprises and other legal entities are growing bolder. They are more willing to challenge governmental decisions that affect them (e.g., confiscations of property by the tax inspectorate) when they believe them to be illegal or arbitrary. Perhaps the lack of authority that has characterized the post-Soviet state has contributed to a perception that state institutions are more vulnerable and/or less competent. There may also be a demonstration effect at work, e.g., when enterprises observe their trading partners prevailing in disputes with the government, it may inspire them to pursue similar claims. At the very least, the data indicate that suing the government is not regarded as futile or quixotic.

Although the number of claims brought by enterprises against state agencies has increased steadily, the explosion in administrative cases in 1999 and 2000 is the result of a somewhat artificial increase in state-initiated cases. Traditionally, the tax authorities were not required to seek judicial approval for the confiscation of the property of alleged tax delinquents. With the new tax code, which went into effect in 1999, the tax authorities have been reined in. They can now act only in accordance with judicial decision. Not surprisingly, the number of tax cases has risen precipitously. For the two Moscow courts, tax cases account for the entire increase in administrative cases between 1999 and 2000.

### Are the Courts Slow?

One of the most common criticisms of the arbitrazh courts is that cases are not decided in an expeditious manner. The law requires that cases be resolved within two months of being filed. Detailed records are kept on compliance. Table 8 sets forth the percentage of cases in which the deadline was violated from 1993 and 2000. The data paint a remarkably different picture than emerges from conventional wisdom. Delays have not been commonplace. Nationally, delays have never exceeded 5%.
There is regional variation in the levels of delays, for example Moscow city always more tardy than the national average and Saratov always quicker. The disparate levels of delays may result from poor management and/or inadequate staffing and/or the complexity of the cases heard. Court personnel constantly complain about meager funding. The difficulties in filling vacancies on the arbitrazh courts are well-known, the chairman of the Higher Arbitrazh Court estimating that as many as 24% of judicial posts are vacant. Naturally, these vacancies are not spread evenly across all courts. Some courts are more severely affected and these would be less capable of processing cases quickly. (See Box 1 on insights into the causes of delays in certain courts.)

How well a given court copes with personnel shortages and with demanding caseloads depends, to some extent, on how well the court is managed. The chairman of each court is basically a manager, assigning cases and generally facilitating the work of the court. Some place a high priority on meeting the two-month deadlines, while others have a more casual attitude. At the Saratov arbitrazh court, which consistently had low levels of delay, the chairman of the court placed great emphasis on speed. In interviews conducted between 1993 and 1997, the Saratov judges seemed obsessed with not violating the deadline. Information about the compliance levels of judges was known within the court, and affected the reputation of judges among their colleagues.

Complexity is a likely explanation for the higher level of delays in Moscow. The combination of the concentration of corporate headquarters and the widely held opinion that the Moscow City court is more competent than many regional courts leads potential litigants to file cases raising cutting edge legal arguments in Moscow. Complicated cases take more time to process, given that they often involve legal issues of first impression and additional third-party participants who, depending on their level of legal sophistication, may engage in adversarial strategies specifically designed to delay the proceedings.

The evidence on delays can be backed up by data from the survey. The general directors were asked whether private enforcement or arbitrazh courts were speedier in resolving disputes. In Moscow, 64% of respondents said private enforcement was speedier, but the corresponding figures were only 38% in Novosibirsk, 48% in Saratov and 28% in Yekaterinburg. Since the popular image of private enforcement is speed without concern for due process and procedure, it is remarkable that in three of the regions under study the arbitrazh courts are rated as superior to private enforcement even on speed. Even justification for the conventional wisdom relied on the data for Moscow, that justification would not be very strong, since it would still be quite a surprise to find that only two-thirds of enterprises thought that private enforcement was speedier than the courts.

Some of the reforms proposed by the draft procedural code threaten to undermine the courts' ability to dispose of cases swiftly. The draft code introduces a new stage in the judicial process for preparing the case for a hearing. As currently conceived, the parties would meet with the judge in order to explore the possibility of working out a settlement. In theory, this reform would seem to be helpful, given that it is aimed at achieving quicker resolutions of cases with less acrimony. Similar reforms have proven helpful in the U.S. judicial system. The Russian reality is different. The majority of civil cases involve non-payments. In our case studies of non-payments cases arising in 2000 in the Moscow city, Saratov, and Sverdlovsk courts, three-fourths of the cases reviewed were resolved at the first hearing, indicating that delay is not a pressing concern. Further complicating matters is the high percentage of default judgments. Given that the defendants took no part in more than half of civil cases reviewed, the value added of an additional hearing is questionable.

Are the Courts Expensive?

Another commonly encountered criticism of the arbitrazh courts is that the cost of filing lawsuits is prohibitive. In interviews, Russian enterprise managers usually emphasize filing fees as a key obstacle to using these courts (second in importance after problems with enforcement).

When filing a case in arbitrazh court, a petitioner (istets) is required to pay a fee (gosudarstvennaia poshlina or gosposhlina) equal to a statutorily set percentage of the value claimed for the case by the petitioner in the complaint (iskovoe zayavlenie). If the petitioner prevails, then the court will order the defendant
(otvetchik) to reimburse the petitioner for these expenses. If the petitioner loses, then the fee is forfeited to the state. Given that the amount of money involved in such cases can be quite substantial, gosposhlina is not an insignificant concern for petitioners. Requiring payment in advance is not a market-driven innovation, but was a standard feature of gosarbitrazh. In fact, payment of court fees by the petitioner in advance is commonplace throughout continental Europe and in other countries that share the civil law or Romanist tradition.

Beginning in 1996, gosposhlina was lowered, and a sliding scale was established based on the amount being sought in the case. The change in the law was prompted by a concern that cases were not being brought due to the inability to pay the filing fee. Lowering gosposhlina did not solve the problem. Enterprises fighting for survival found it difficult to justify using their scarce resources to pay gosposhlina, even when the enterprise believed it would win the case.

**Box 1: Delays**

The regional data for 2000 show a marked increase in delays in the Sverdlovsk court, where the percentage of cases that did meet the statutory deadline doubled. In a February 2001 conversation, the chairman of this court lamented this trend, but saw it as unavoidable given what she sees as the persistent increase in the number of cases filed without a corresponding increase in the number of judges. Over the past two years, the number of judges has increased from 48 to 54, but this is still substantially less than the number of 64 positions that are authorized (but not funded). She pointed to bankruptcy cases as particularly problematic. They are inevitably time-consuming and, in her view, the easing of the threshold requirements for initiating a bankruptcy action has opened the floodgates. At the time of the conversation, there were 500 bankruptcy cases pending in the Sverdlovsk court.

The complaints about judges' workload have some basis in fact, through it does not explain why delays have spiked in Sverdlovsk in particular. Among the regions we are analyzing, the monthly per judge caseload for 1998-2000 is consistently highest in the Leningrad court, where it averaged 42.2 cases per judge in 2000 (up from 33.7 cases in 1998). More typical is Saratov, where judges heard 38 cases per month in 2000 (up from 27.8 cases in 1998). By contrast, arbitrazh judges in Ekaterinburg heard an average of 36.6 cases per month in 2000 (up from 24.1 cases in 1998). The increase in the Sverdlovsk court has been dramatic, but the actual workload is not unusual.

In Sverdlovsk, delays are substantially more common in cases involving the government than in contractual disputes. In 2000, more than one-third (36.5%) of these so-called administrative cases encountered delays, compared with a delay rate of only 4.4% for contractual disputes. The same phenomenon can be observed in 1999, when the delay rate for administrative cases was 24.8% and for civil cases was 3.1%. Prior to that, the discrepancy is not noticeable. Administrative cases can take longer because the procedural code requires that they be heard by a three-judge panel whereas contractual disputes are generally heard by a single judge. Scheduling multiple-judge panels can be difficult and can give rise to delay. In fact, a similar disparity in delay rates in 1999 and 2000 can be observed in a number of other courts, including Moscow City, Moscow Oblast, St. Petersburg and Leningrad Oblast, and Novosibirsk. Though nowhere else has it had the profound impact found in Sverdlovsk.

Another explanation for the increase in delay may be that judges are beginning to pay attention to the admonitions within the opinon that gosposhlina be paid when the case was filed in favor of collecting these fees from the losing party at the conclusion of the case (otsrochka). Judges responded to these requests in a variety of ways. Significantly, however, in interviews conducted with arbitrazh judges in Saratov and Yekaterinburg in 1996 and 1997, no judge claimed to reject such requests out-of-hand. As opposed to interpreting the requirement to pay gosposhlina prior to hearing the case as an absolute statutory requirement, they regarded the decision as to whether to grant the waiver as being completely within their discretion. This sort of flexibility goes against the usual practice of Russian judges to interpret the rules narrowly. In response to the evident demand from cash-poor enterprises for relief from the burden of paying gosposhlina, the Higher Arbitrazh Court reviewed this question in a plenary session in 1997, and issued a decree that established a standard procedure for seeking a delay ("O nekotorykh voprosakh" 1997). The reaction of the arbitrazh courts—both at the trial and appellate
level – to this problem indicates that they are able to make systemic responses that might prevent their playing their assigned role within the Russian institutional framework.

Box 2: Postponement of Filing Fees

When enterprises first began to ask that the obligation to pay filing fees be postponed until the resolution of the case, some judges responded with suspicion. In a 1996 conversation, the chairman of the Saratov arbitrazh court expressed skepticism about enterprise claims of poverty. He cited examples of enterprises requesting relief, but then mysteriously finding the necessary resources when their request was denied. The affidavits from banks attesting to the empty coffers of enterprises, which are routinely offered as evidence, did not persuade him. In his opinion, enterprises deliberately drain their bank accounts in order to evade taxes, and then use this apparent illiquidity to escape other obligations. He pointed to the increase in filings during the summer of 1995, when trial courts were forbidden to delay payment of gosposhlina, as demonstrating the absence of a link between filing fees and litigiousness.

In 1996, one Saratov trial court judge related an incident when she refused to allow a petitioner to delay payment. She said that she had a feeling that the enterprise had money squirreled away. She felt vindicated when the petitioner did find the money and paid the fees. I asked whether she punished the petitioner for having lied to her. She had not. In fact, though she conceded that complete honesty was rarely encountered, the idea of fining liars struck her as bizarre. The link between fining litigants for material misrepresentations made to the court and building respect for the court as an institution that is often taken for granted in Western contexts is not apparent to Russian arbitrazh court judges.

The requirements for delaying the payment of gosposhlina are now straightforward. The plaintiff merely has to submit affidavits from its bank(s) confirming that its coffers are empty. In order to be certain that information is sought from all relevant banks, an affidavit is also required from the Tax Ministry detailing the banks at which the plaintiff has open accounts. Of 55 non-payments cases reviewed in Saratov in 2001, delays were sought and granted in 40 (73%). In some cases, the plaintiff tried to tug on the heartstrings of the judge. For example, in a case filed by the Ukhtinskii Experimental Mechanical Factory against the Saratov subsidiary of Gazprom, the plaintiff went on at some length about their financial predicament:

"The plaintiff requests a respite during the case from the payment of gosposhlina ... in connection with the extraordinarily difficult financial condition, the absence of funds in the bank account, the existence of a kartoteka, the refusal of the bank to provide credit. We have done everything possible to repay the kartoteka and to eliminate our debts to creditors, however, due to the lack of monetary resources of our debtors, we have no choice but to conduct transactions through non-monetary exchanges. We ask ... that you grant us the delay in paying above all in the interests of the labor collective, bearing in mind its priority to receive wages."

This appeal was successful. Then again, the following one-sentence request in the complaint made by Elektrotekhkomplekt in its lawsuit against Ozinskii kombinat stroitel'nykh materialov was also successful.

"In connection with the complicated and difficult material condition at the enterprise, we ask that full payment of gosposhlina be delayed until the decision is entered by the court in this case."

A review of recent cases in Saratov, Moscow, and Ekaterinburg shows that the decision on granting a delay in paying gosposhlina has been removed from the discretion of the trial court judge and routinized. A new issue may be whether judges will begin to reduce fees imposed on losing parties. We uncovered three cases in Saratov – all with the same judge – in which he unilaterally reduced the gosposhlina to a nominal 1000 rubles due to the enterprise’s difficult financial situation. Two of the three losing defendants were unrepresented at trial, indicating that the initiative to reduce the fees was with the judge. We found no analogous cases in Moscow or Ekaterinburg, but this trend bears monitoring.

Table 9 shows that the petitions for postponing the payment of gosposhlina are being filed with great regularity. Moreover, they are being accepted in over 80% of cases in all regions and in some regions almost without exception.

Is Lack of Competence an Important Problem?

One common criticism of the arbitrazh courts is that their judges evidence a lack of competence in the law and the economics of market economies. In fact, of course, it would be astounding, given the heritage of the courts and the educational institutions that train lawyers, if this criticism were not technically correct. (In Box 3, we cast the criticism of judges’ levels of competence in more general perspective by presenting
were being decided within the 2-month statutory deadline, indicating that length of time to judgment was not
court fees, suggesting that expense was not a large barrier to using the court. In addition, over 99% of cases
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expense rate as greater obstacles to using the courts than perceived knowledge of the judges on market
obstacles and the answers to this question appear in Table 10. In all four regions, speed and
slowness.

When questioned, judges complained that this sort of lackadaisical attitude toward procedural detail and a more general
unpreparedness was standard. Sometimes the exchanges between judges and unprepared parties devolve into shouting
matches. In a May 2001 hearing in Saratov, the judge began in typical fashion by asking the plaintiff to state the legal basis
for its claim, i.e., what legal norm had been violated. The plaintiff’s representative, who was the manager appointed during
the bankruptcy process, kept going back to the facts and the basic unfairness of the situation. When the judge advised him
to get a lawyer, he responded that he was, in fact, a lawyer. Yet he was unable to respond to this basic question. Finally the
judge grew so frustrated that she declared a five-minute recess and gave the plaintiff a copy of the Civil Code and told him
to find a legal basis for his complaint. He was unable to do so and she ended up dismissing the lawsuit. In the hundreds of
cases observed from 1994 through 2001, these sorts of incidents emerge as relatively common, though certainly not typical.
The frustration exhibited by the Saratov trial judge is mirrored by almost every judge interviewed in the field work. One
judge in the Sverdlovks court said that, in the days of gosarbitrazh, she would send criticisms (chastnoe opredelenie) of in-
house lawyers who came to her hearing unprepared. Now she feels this is a waste of time—she feels that no one would pay
any attention.

At the same time, arbitrazh judges at all levels recognize that improving the quality of legal representation cannot be
accomplished overnight. There is a general consensus that there has been a steady improvement over the life of the
arbitrazh courts. A comparison of the three courts observed in the filed work indicates that the improvement is most
obvious in Moscow where a business bar seems to be developing and thriving. Yet in all of the courts it is becoming
increasingly rare to have enterprises send non-lawyers to serve as their representatives, though this is allowed by the APK.

We have previously presented evidence on the intensity of use of the courts. The high level of use
itself suggests that the level of competence of the judges cannot be a fundamental barrier to the demand for
court services. We can also present some comparative evidence. The two previous sections have used direct
evidence to argue that one cannot use expense and slowness to back up the conventional wisdom that the
arbitrazh courts are hopeless. Our survey evidence examines the issue of competence versus expense and
slowness.

On the enterprise survey, we asked enterprise lawyers how important various obstacles were to using
the courts. They were asked to score the strength of the obstacle on a scale of 0 to 10, with 10 being a very
large obstacle. The obstacles and the answers to this question appear in Table 10. In all four regions, speed and
expense rate as greater obstacles to using the courts than perceived knowledge of the judges on market
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survey was conducted, over 30% of enterprises were successful in their petitions to postpone the payment of
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<th>Box 3: The Role of Lawyers in the Arbitrazh Process</th>
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<td>The literature tends to focus on the competence of arbitrazh judges to handle disputes arising from complicated market transactions. Given that approximately half of the current judicial corps previously worked as arbiters in the Soviet-era gosarbitrazh, a fear that they would not be up to the job of acting as referees in the market economy is certainly legitimate. After having observed literally hundreds of cases in Moscow, Ekaterinburg and Saratov from 1994 through 2001, it is difficult to deny that mistakes are occasionally made by judges. But what is more striking is the frequently poor quality of representation of litigants at these hearings. For example, a hearing in the Moscow City court in February 2001 was cut short when the judge determined that the defendant was located outside the city limits, which meant that the Moscow Oblast court had jurisdiction. This rule that, absent a specific agreement to the contrary, disputes are heard in the locale of the defendant is elemental. Yet the plaintiff's lawyer was unaware of it and, even more striking, did not seem even slightly embarrassed by this display of legal illiteracy.</td>
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We have previously presented evidence on the intensity of use of the courts. The high level of use itself suggests that the level of competence of the judges cannot be a fundamental barrier to the demand for court services. We can also present some comparative evidence. The two previous sections have used direct evidence to argue that one cannot use expense and slowness to back up the conventional wisdom that the arbitrazh courts are hopeless. Our survey evidence examines the issue of competence versus expense and slowness. |
an important issue. Nevertheless, in Saratov in 1997 as Table 10 shows, the enterprises in our survey rate the competence of the judges as less of an obstacle to using the court than either lack of speed or expense.

Foreign lawyers from highly developed countries might be especially sensitive to the issue of competence, given the sophistication of law and legal theory in those countries. And indeed, use of the arbitrazh courts by foreigners, especially outside Moscow, is still quite limited. Hendrix (2001) has surveyed the available evidence relating to use of the courts by foreigners and the perceptions of foreign litigants. Here we simply paraphrase some of these perceptions:  

* A foreign party should not fear appearing in a Russian ordinary court or arbitrazh court . . . We have found Russian judges to be intelligent and objective... The courts are quite reliable, with a level of integrity and efficiency that you might not expect... They are not corrupt and we have won a number of cases in them against the tax authorities... There are many experienced and fair judges... Russian judges are reasonable and make reasoned decisions.*

Hendrix’s conclusion, based on the evidence of the interaction between courts and foreigners is consistent with the overall perspective of this paper: “In the wake of the financial crisis, which engulfed Russia in the middle of 1998, it has become fashionable to dismiss Russia’s post-Communist reforms as a sham. With regard to the judicial system, at least, these views do not appear to be well-founded.”

Is Corruption an Obvious Problem?

Some commentators allege that corruption is rife in the Russian judicial system. For example at a 1999 OECD conference, the figure of 70% was put forward as an estimate of the percentage of judicial decisions tainted by corruption.

We first examine the issue of corruption in exactly the same way as the previous one: using the insights from Table 10. The pertinent question from the survey is whether judges not being impartial is an obstacle to using the courts—corruption, of course, being one element of possible partiality. The analysis and conclusion is the same as in the previous section: enterprises in our survey rate the partiality of the judges as less of an obstacle to using the court than either lack of speed or expense. Since we have argued in the previous sections of the paper that expense and speed do not stand out as egregious problems with the courts, we do not see levels of corruption as posing an insurmountable barrier for enterprises. Of course, we do not claim that corruption is absent from the courts: this would be a very unlikely proposition given the problems of corruption that Russia is perceived as having in general. But perhaps corruption is less of a problem in the arbitrazh courts than elsewhere. This is an issue that we can consider using survey data.

To examine the question of the relative importance of corruption in the courts, we take a comparative approach, comparing Russia to other countries and comparing Russian legal institutions to other Russian institutions. To implement this approach on our 1997 survey we used a question that had been previously asked in Canada: “How would you rate the honesty and ethical standards of the types of people listed [in the survey question]?” Unfortunately, the Canadian survey did not ask directly about judges, but there is sufficient information to place the Russian results in context. The pertinent results appear in Table 11. It is clear that the arbitrazh judges receive a fairly high rating in terms of honesty and ethical standards. The data in Table 11 could hardly have been obtained if corruption in the arbitrazh courts were as rife as the conventional wisdom maintains.

Can Decisions be Enforced?

The ability to enforce decisions without having to expend undue time or money is critical to the willingness of litigants to use any legal system. As we noted above, complaints about the difficulty of implementing decisions of the arbitrazh courts is frequently voiced by enterprise managers. As Table 11
illuminates, the difficulty of enforcing judgments is regarded as the greatest barrier to using the courts in all the regions surveyed. Indeed, according to the results of the survey, fully 58% of enterprises believe that it is the single largest problem. Although the problem of enforcement is often laid at the door of the courts, the reality is that, in Russia (as in most countries), judges have no responsibility for enforcing their decisions. Indeed, judges share the frustration of litigants, complaining that their hard work is in vain if the end result is a decision that is never enforced. (See Box 4 on the difficulties of enforcement in the Russian situation).

Box 4: Enforcement

Review of the case files of approximately 100 non-payment cases in the Moscow City, Sverdlovsk, and Saratov courts suggests that enterprises have a variety of expectations when they initiate lawsuits in the arbitrazh courts. For some plaintiffs, merely filing the claim seems to be enough to spur the desired repayment. It seems clear that additional claims for penalties or interest are coupled to the demand for debt repayment as an incentive to quick action and are then forgiven when settlements are reached. For example, in a case filed by Kalinovskii zavod rezinovykh izdelii in the Sverdlovsk court against Komproduktsiya, the plaintiff agreed to forego the demand for interest (assessed pursuant to article 395 of the Russian Civil Code) once the debt had been repaid. In cases that are dismissed because neither side shows up, it can be concluded that repayment had likely been forthcoming. A particularly intriguing example involved a regional branch of the Ministry of Internal Affairs in Moscow, which had been supplying security services for a state enterprise and now wanted to be paid. It is worth noting that even security firms are making use of the arbitrazh courts.

Of course, some enterprises resist to the end. A good example is provided by a case filed by the firefighting service in Saratov against the Saratov Aviation Plant. The defendant acknowledged the debt, but pleaded poverty in its correspondence with the plaintiff. After waiting more than a year for the debt to be satisfied, the firefighters went to court and asked for interest as well. Within a month of filing the case, the aviation plant arranged for its debt to be satisfied through an account receivable from Gazprom (which resulted from refitting several planes for the use of its executives). The court sanctioned this barter transaction, but still awarded the firefighters the interest. The aviation plant waited for the sudebnye pristav to ask them to pay this additional obligation. The final twist to the case relates to the aviation plant's obligation to pay the filing fees (gosposhlina). Although its lawyers had been present when the decision was issued and so knew full well of the plant's obligation, this fee (which was less than 4,000 rubles) was not paid voluntarily. The tax inspectorate (which has the obligation to collect gosposhlina) failed to keep a receipt of having sent a demand for payment to the plant and thus, when the tax inspectorate appealed to the court for an extension of time to collect these fees, the request was denied. In a letter from its chief financial officer, the aviation plant claimed ignorance of the obligation. This sort of scorched-earth strategy is perhaps understandable among enterprises that are barely hanging on. Whether it will persist as enterprises return to financial health is unclear.

Enterprises always have the option of paying judgments voluntarily. The lack of liquidity of many Russian enterprises makes them resist paying until no other choice is available, which raises the specter of state-sponsored enforcement. From 1998 on, this function has been carried out by sudebnye pristavy (loosely translated as "bailiffs"). These officials are charged with carrying out decisions of both the arbitrazh courts and the courts of general jurisdiction, and are subordinate to the Ministry of Justice. In fact, the vast majority of decisions handled by the sudebnye pristavy originate in the courts of general jurisdiction and involve the payment of child support and alimony. In any given office, there may be one or two bailiffs who specialize in enforcing judgments in contractual disputes. Only in Moscow is there a special office that deals only with arbitrazh court decisions, and it only handles judgments in excess of 3 million rubles. This lack of attention to the special skills and knowledge needed in order to get enterprises to pay judgments no doubt contributes to the less-than-stellar record of enforcement.

Sudebnye pristavy become involved in the collection process at the request of the party who prevailed in the litigation. Even once they become involved, the law still builds in an incentive for the losing side to comply more-or-less voluntarily. If the judgment is paid within 5 days of receipt of an official request, then the losing side does not have to pay a fee to the sudebnyi pristav. If not, then in addition to paying the judgment, the losing side is assessed an additional fee amounting to 7 percent of the judgment. This five-day grace period is somewhat controversial within the bailiff hierarchy. In conversations that took place in April 2000, one Moscow official argued that it gives unscrupulous enterprises enough time to hide their assets and when the sudebnyi pristav returns, nothing is left. On the other hand, a top official in Saratov contended that it was not enough time for law-abiding enterprises to gather the resources necessary to pay the judgment, and that the 7 percent fee sometimes eats up funds that should go to the winning side in the dispute (and not to the state).
Assessing the true state of affairs is complicated by the refusal of the Ministry of Justice officials in charge of the sudebnye pristavy to make systematic data available on the effectiveness of enforcement efforts.

Conclusions and Policy Recommendations

A central premise of this paper is that a sound, empirically based assessment of existing institutions is a crucial input into policy and reform. Such an assessment enables reformers to understand more fully the nature of institutions and the ways that businesses use them. Then, reforms can be suitably designed to build on existing strengths and address present weaknesses. Conventional wisdom, even that held by those in the knowledge business, is often a poor basis for conducting institutional reform.

The effective reform of an economic institution, such as the business-related elements of the legal system, requires obtaining answers to a number of questions. Is the institution used by businesses? What do the businesses value in the institution? In what ways is the institution not performing adequately, given its intended function in the economy? Why is the institution not performing adequately? What features of the institution would potentially be valued by businesses (and other users) if the institution functioned better? These are factual questions that cannot be answered purely on a theoretical basis or from casual study. To answer these questions requires systematic information gathering and careful research, using the gamut of modern social science methods. If the pertinent empirical analysis is not undertaken, it is quite plausible that a reform could be ineffective or even make matters worse, for the businesses that use the legal system and for the participants who work in the system.

Of course, if an institution is ineffective and serves no purpose for its putative users, reformers would be justified in taking greater risks and could proceed with reforms using somewhat less knowledge than would otherwise be appropriate. However, this is not the case for the institution examined in this paper. One of the policy implications of our paper is that the arbitrazh courts do play a significant role in the affairs of many businesses. Therefore reform of these courts should be preceded by intensive study of their functioning. The information presented above is only one small element of that intensive study and therefore we will be conservative in offering policy recommendations. The following seem consistent with such an approach:

Procedural Rules. Some of the reforms proposed by the draft procedural code threaten to undermine the courts' ability to dispose of cases swiftly. The draft code introduces a new stage in the judicial process for preparing a case for a hearing. As currently conceived, the parties would meet with the judge to explore the possibility of working out a settlement. In theory, this reform would seem to be helpful, given that it is aimed at achieving quicker resolutions of cases with less acrimony. Similar reforms have proven helpful in the U.S. However, the Russian reality is different. The majority of civil cases involve non-payments. In our case studies of non-payments cases arising in 2000 in the Moscow City, Saratov, and Sverdlovsk courts, three-fourths of the cases reviewed were resolved at the first hearing, indicating that delay is not a pressing concern. Further complicating matters is the high percentage of default judgments. Given that the defendants took no part in more than half of civil cases reviewed, the value added of an additional hearing is questionable.

Fining Unprepared Litigants. The ability of the arbitrazh courts to operate effectively has been undermined by the tendency of litigants and their counsel to appear for hearings without being fully prepared. The most common reason for postponing cases is the failure of the parties to bring relevant evidence. Other countries have found that imposing fines on those who appear unprepared serves to discourage such behavior in the future. The current rules place substantial procedural obstacles in the way of imposing these sorts of fines. The drafters of the new procedural code ought to be encouraged to work out a procedural mechanism for fining the unprepared.
Implementation. The “bailiffs” (судебные приставы) charged with implementing arbitrazh court decisions ought to be institutionally distinct from their colleagues charged with implementing the decisions of courts of general jurisdiction and/or protecting judges. The enforcement of judgments in disputes involving enterprises requires knowledge and experience that is different from that required to enforce the child support and alimony judgments that comprise the bulk of the work arising from the courts of general jurisdiction.

Funding. The draft procedural code calls for a substantial expansion in arbitrazh court personnel. Each judge is to be provided with an assistant, who will take care of preparing the documentation (протоколы) of judicial hearings and will meet with litigants in anticipation of the trial to seek out a settlement. If such reforms are to go forward, then additional funding will have to be provided to the courts for salaries and office space. To mandate such officials by statute and then be unable to carry through would likely have the effect of undermining confidence in the courts.
Bibliography


Endnotes

1 See below for the few exceptions.


5 For more details on the nature of this field research, see for example Hendley, 1996, 1998a, and 2001.

6 These data are used by the staff of the Higher Arbitrazh Court to prepare the annual statistical summary of the arbitrazh courts that is published in the Vestnik Vysshego Arbitrazhnogo Suda. However, only the Federation level aggregations are published regularly.

7 Making judgments based on caseload statistics is always problematic, since they represent only disputes that have been pursued to the fullest extent of the law, and fail to take account of the vast majority of disputes that are resolved through negotiation. The fragmentary nature of the arbitrazh court data make them even more problematic. Though we know how many, and what sort of, cases are filed, no specifics about the enterprises involved are provided. Notwithstanding the shortcomings of these data, they provide us with an indication of the trends in usage. Moreover combining them with other sources of information allows us to present a relatively complete picture of the effectiveness of these courts.

8 In each enterprise, surveyors administered different survey instruments to four top managers: the general director, the heads of the sales and purchasing (supply) departments, and the official responsible for legal issues. The enterprises span ten major industrial sectors. Size ranged from 30 to 17,000 employees, with a median of 300. Most of the enterprises were established during the Soviet era, and about three-fourths (77%) are privatized.

9 We report the results here only for the four regions that are included in the broader study of which this paper is a part. The original survey actually included six regions and 328 enterprises.

10 We use the transliterated Russian term deliberately. Others have translated arbitrazh courts as arbitration courts but such a translation only confuse matters because the English words chosen fail to capture the essence of how the Russian arbitrazh courts operate.


12 There were two types of gosarbitrazh. The first was organized geographically, and heard disputes in which at least one of the state enterprises was local. The second was organized through the system of economic ministries that was integral to the Soviet administrative-command system. This was known as departmental (vedomstvenny) arbitrazh. The present-day arbitrazh courts are the successor to the former.

13 Hendley, 1996.


16 Traditionally, state enterprises did not have the right to sue the state. The Gorbachev-era law on state enterprises ostensibly changed the rule by allowing state enterprises to sue a ministry when it issued an order that violated the rights of the enterprise, and that the enterprise could recover losses that are a consequence of the improper exercise of the higher-level agency's duties with respect to the enterprise. O gosudarstvennom predpriiatii (ob'edinenii) (1987). In practice, however, few lawsuits were filed. During the Soviet era, the ministries controlled access to key supplies, and enterprises were unwilling to risk their ire.

Hendley, 1998b.

This structure is also found in France and Germany, and in some other continental European legal systems.


The in-house statistical forms of the arbitrazh courts list 21 different categories of so-called economic disputes. Almost all of them are some type of contractual dispute.

From 1993 through 1995, the arbitrazh courts included bankruptcy cases within the category of “civil” cases when compiling statistics. Obviously it was not a perfect fit, since bankruptcy is not an adversarial process. Beginning in 1996, bankruptcy was broken out as a separate category of case, equal in status to the “civil” and “administrative” disputes.

These so-called disputes in the sphere of governance (spory v sfere upravleniia) are quite varied, including tax cases, appeals from a refusal to register legal entities, and problems relating to privatization. The in-house statistical forms list seven different categories of disputes. See generally APK, art. 22.

See Hendley, 1998b.

Vasil'eva, 1996; see also Hendrix, 1997, pp. 1098-1100; Hendley, 1998a.


See generally, arts. 102-11, 1995 APK.


Hendley, 1998b.

Ickes and Ryterman, 1993.

From 1993 through 1995, the arbitrazh courts included bankruptcy cases within the category of “civil” cases when compiling statistics. Obviously it was not a perfect fit, since bankruptcy is not an adversarial process. Beginning in 1996, bankruptcy was broken out as a separate category of case, equal in status to the “civil” and “administrative” disputes.

E.g., Schwartz, 1997; Weinberg, 1997.

Between 1999 and 2000, the number of tax cases resolved by the Moscow City court increased by 3,297, whereas the total number of administrative cases increased by only 2,102. Along similar lines, for the same period, the number of tax cases resolved by the Moscow Oblast' court increased by 2,718, whereas the total number of administrative cases increased by only 1,353.

For example, tax cases comprised 57.3 percent and 82.2 percent of the increase in administrative cases resolved by the Sverdlovsk court in 1999 and 2000, respectively.


Art. 114, 1995 APK.

By contrast, the delay rate of the courts of general jurisdiction has averaged about 14 percent for the years from 1992 to 1997. Solomon and Foglesong 2000, p. 119.


40 Enterprises are more likely to include a special clause requiring that disputes be litigated in the Moscow City court than other courts. For example, of the 33 non-payment case files heard in this court reviewed in early 2001, 13 (39%) were based on a contract that had a forum clause ceding jurisdiction to the Moscow City court. By comparison, in only 2 of the 34 case files reviewed in the Sverdlovsk court did the contract specify that court.

41 E.g., Greif and Kandel, p. 311; Hay et al, pp. 560-61.

42 O vnesenii izmenenii i dopolnenii v Zakon RF “O gosudarstvennoi poshline,” (1996). For claims up to 1 million rubles, fees were equal to 5 percent of the amount sought. For claims between 1 and 10 million rubles, the fees were 50,000 rubles plus 4 percent of the amount sought in excess of 1 million. For claims between 10 and 50 million rubles, the fees were 410,000 rubles plus 3 percent of the amount sought in excess of 10 million. For claims between 50 and 100 million rubles, the fees were 1,610,000 rubles plus 2 percent of the amount sought in excess of 50 million. For claims between 100 and 500 million rubles, the fees were 2,610,000 rubles plus 1 percent of the amount sought in excess of 100 million. For claims in excess of 500 million rubles, the fees were equal to 1.5 percent of the amount sought. Id., art. 4.

43 Hendley, 1998c.

44 See Hendrix 2001 for citations, full quotes, and a great deal more evidence.

45 See the references in Hendrix (2001).

46 Hertzfeld, 1999.


48 Two new laws were passed in mid-1997 and went into effect in 1998 (“Ob ispolnitel’nom proizvodstve” 1997; “O sudebnikh pristavakh” 1997). Prior to that time, enforcement was handled by sudebnye ispolniteli (“judicial enforcers”) who were housed in, and subordinate to, the courts of general jurisdiction, though they also enforced arbitrazh court decisions. As a rule, they were women who handled child support issues and who had little knowledge of the intricacies of business law. According to the deputy director of the bailiff service, between 50-90% of these former officials have become sudebnye pristavy in the new system, though he was quick to note that many young men have been attracted to the reformed institution. He regards the gender shift as indicating the enhanced importance of the institution.

49 According to a top official in the bailiff service in Saratov, 80% of the 478,000 claims they handled in 1999 involved child support, while only 5,000 originated in the arbitrazh courts.
Table 1: The Regions and their Politics

<table>
<thead>
<tr>
<th>Region Name</th>
<th>Governor</th>
<th>Years in Office</th>
<th>Political Party Affiliation</th>
<th>Date of Most Recent Regional Election</th>
<th>Percent of votes won in most recent regional election</th>
<th>Percent of Votes for Putin in 2000 Presidential election</th>
<th>Percent of votes for Yeltsin in the first round of the 1996 Presidential elections</th>
</tr>
</thead>
<tbody>
<tr>
<td>St. Petersburg</td>
<td>V. A. Yakovlev</td>
<td>1996 - present</td>
<td>All Russia</td>
<td>May 2000</td>
<td>72.69</td>
<td>62.4</td>
<td>49.6</td>
</tr>
<tr>
<td>Novgorodskaya Oblast</td>
<td>M. M. Prusak</td>
<td>Appointed 1991 elected 1995-present</td>
<td>Our Home is Russia</td>
<td>May 1999</td>
<td>91.56</td>
<td>64.73</td>
<td>35.68</td>
</tr>
<tr>
<td>City of Moscow</td>
<td>Y. M. Luzhkov</td>
<td>1992 - present</td>
<td>Fatherland</td>
<td>Dec. 1999</td>
<td>63.88</td>
<td>46.22</td>
<td>61.16</td>
</tr>
<tr>
<td>Moskovskaya Oblast</td>
<td>B. V. Gromov</td>
<td>Jan 2000 - present</td>
<td>Fatherland</td>
<td>Jan 2000</td>
<td>48.09</td>
<td>47.99</td>
<td>44.15</td>
</tr>
<tr>
<td>Samarskaya Oblast</td>
<td>K. A. Titov</td>
<td>Appointed 1991 elected 1995 - present</td>
<td>Union of Right Forces</td>
<td>July 2000</td>
<td>53.25</td>
<td>41.06</td>
<td>36.13</td>
</tr>
<tr>
<td>Novosibirskaya Oblast</td>
<td>V. A. Tolokonskii</td>
<td>Jan 2000 - present</td>
<td>Independent</td>
<td>Jan 2000</td>
<td>44.32</td>
<td>39.91</td>
<td>25.61</td>
</tr>
<tr>
<td>Omskaya Oblast</td>
<td>L. K. Polezhaev</td>
<td>Appointed 1991 elected 1995 - present</td>
<td>Unity</td>
<td>Sept 1999</td>
<td>57.03</td>
<td>38.14</td>
<td>32.8</td>
</tr>
<tr>
<td>Primorskii Krai</td>
<td>Acting Governor: Valentin Dubinin</td>
<td>Appointed February 2001</td>
<td>***</td>
<td>**</td>
<td>40.12</td>
<td>29.55</td>
<td></td>
</tr>
</tbody>
</table>

*** Following the resignation of the previous governor of Primorskii Krai, elections for his successor are currently underway. The first round was held in May 2001. The runoff between the two top contenders will take place after this draft is finalized.

Source: Central Election Commission of the Russian Federation; Orttung, ed. (2000).
<table>
<thead>
<tr>
<th>Region Name</th>
<th>Population 1999</th>
<th>Annual growth rate of pop 92-99 (%)</th>
<th>Population Density (people per square km) 1999</th>
<th>% of population in urban areas 1999</th>
<th>Recorded crimes (per 100,000 persons) 1998</th>
<th>Provision of telephone access per 100 families 1998</th>
<th>Gross regional product per capita 1000 rubles 1997</th>
<th>Industry as % of gross regional product 1998</th>
<th>Industrial production 1998 as percentage of 1990 industrial production</th>
</tr>
</thead>
<tbody>
<tr>
<td>City of St. Petersburg</td>
<td>4728</td>
<td>-0.83</td>
<td>100</td>
<td>1898</td>
<td>88.8</td>
<td>15908.5</td>
<td>34.4</td>
<td>33.07</td>
<td></td>
</tr>
<tr>
<td>Leningradskaya Oblast</td>
<td>1681</td>
<td>0.07</td>
<td>66</td>
<td>2228</td>
<td>46.2</td>
<td>11580.4</td>
<td>24.4</td>
<td>52.66</td>
<td></td>
</tr>
<tr>
<td>Lenin. Ob. &amp; St. Pete.</td>
<td>6409</td>
<td>-0.60</td>
<td>74.1</td>
<td>1984</td>
<td>77.7</td>
<td>14783.2</td>
<td>31.2</td>
<td>40.16</td>
<td></td>
</tr>
<tr>
<td>Novgorodskaya Oblast</td>
<td>736</td>
<td>-0.31</td>
<td>13.3</td>
<td>2135</td>
<td>39.8</td>
<td>10460.8</td>
<td>30</td>
<td>53.29</td>
<td></td>
</tr>
<tr>
<td>City of Moscow</td>
<td>8630</td>
<td>-0.54</td>
<td>100</td>
<td>806</td>
<td>101.6</td>
<td>37073.0</td>
<td>42.7</td>
<td>37.15</td>
<td></td>
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<tr>
<td>Moskovskaya Oblast</td>
<td>6547</td>
<td>-0.35</td>
<td>120</td>
<td>1178</td>
<td>44.3</td>
<td>14824.1</td>
<td>26.2</td>
<td>31.08</td>
<td></td>
</tr>
<tr>
<td>Volgogradskaya Oblast</td>
<td>2694</td>
<td>0.27</td>
<td>23.6</td>
<td>1588</td>
<td>38.6</td>
<td>12026.3</td>
<td>26.1</td>
<td>33.86</td>
<td></td>
</tr>
<tr>
<td>Samarskaya Oblast</td>
<td>3308</td>
<td>0.22</td>
<td>61.7</td>
<td>1604</td>
<td>36.0</td>
<td>21935.2</td>
<td>18</td>
<td>58.07</td>
<td></td>
</tr>
<tr>
<td>Saratovskaya Oblast</td>
<td>2721</td>
<td>0.05</td>
<td>27.1</td>
<td>1426</td>
<td>27.4</td>
<td>11654.8</td>
<td>23.9</td>
<td>41.06</td>
<td></td>
</tr>
<tr>
<td>Sverdlovskaya Oblast</td>
<td>4641</td>
<td>-0.41</td>
<td>23.8</td>
<td>2078</td>
<td>36.7</td>
<td>15853.5</td>
<td>25.7</td>
<td>33.92</td>
<td></td>
</tr>
<tr>
<td>Novosibirskaya Oblast</td>
<td>2752</td>
<td>-0.04</td>
<td>15.4</td>
<td>2297</td>
<td>43.8</td>
<td>14220.1</td>
<td>36.1</td>
<td>36.52</td>
<td></td>
</tr>
<tr>
<td>Omskaya Oblast</td>
<td>2178</td>
<td>0.05</td>
<td>15.6</td>
<td>1908</td>
<td>35.6</td>
<td>15526.5</td>
<td>27</td>
<td>37.62</td>
<td></td>
</tr>
<tr>
<td>Primorskiy Krai</td>
<td>2197</td>
<td>-0.73</td>
<td>13.2</td>
<td>2274</td>
<td>32.7</td>
<td>13720.9</td>
<td>33.1</td>
<td>44.53</td>
<td></td>
</tr>
</tbody>
</table>

Source: Goskomstat (1999).
Table 3: The Regions: Basic Statistics on the Enterprise Sector

<table>
<thead>
<tr>
<th>Region</th>
<th>% of employed population in private non-joint-stock firms</th>
<th>% of employed population in joint-stock firms</th>
<th>Number of enterprises and organizations per 1000 pop. 1998 end of year</th>
<th>% of enterprises and organizations that are private non-joint-stock</th>
<th>% of enterprises and organizations that are joint-stock firms</th>
<th>Number of small enterprises per 1000 population 1999</th>
<th>Number of enterprises privatized 93-98</th>
<th>Return on assets in active enterprises, 1998 (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>City of St. Petersburg</td>
<td>46.3</td>
<td>14.9</td>
<td>35.22</td>
<td>78.53</td>
<td>12.57</td>
<td>23.65</td>
<td>3009</td>
<td>-5.6</td>
</tr>
<tr>
<td>Leningradskaya Oblast</td>
<td>46.6</td>
<td>14.9</td>
<td>15.36</td>
<td>76.12</td>
<td>7.37</td>
<td>7.20</td>
<td>858</td>
<td>0.2</td>
</tr>
<tr>
<td>Lenin. Ob. &amp; St. Pete.</td>
<td>46.6</td>
<td>14.9</td>
<td>30.02</td>
<td>78.21</td>
<td>11.88</td>
<td>19.33</td>
<td>3867</td>
<td>-4.8</td>
</tr>
<tr>
<td>Novgorodskaya Oblast</td>
<td>38.5</td>
<td>18.7</td>
<td>17.66</td>
<td>60.68</td>
<td>8.14</td>
<td>3.67</td>
<td>795</td>
<td>-13.2</td>
</tr>
<tr>
<td>City of Moscow</td>
<td>42.1</td>
<td>21.6</td>
<td>72.49</td>
<td>81.38</td>
<td>11.77</td>
<td>20.30</td>
<td>4174</td>
<td>-2.7</td>
</tr>
<tr>
<td>Moskovskaya Oblast</td>
<td>37.6</td>
<td>15.1</td>
<td>15.95</td>
<td>77.71</td>
<td>8.13</td>
<td>5.44</td>
<td>2545</td>
<td>-1.6</td>
</tr>
<tr>
<td>Volgogradskaya Oblast</td>
<td>49.1</td>
<td>16.6</td>
<td>19.00</td>
<td>76.15</td>
<td>4.54</td>
<td>5.01</td>
<td>1621</td>
<td>-0.5</td>
</tr>
<tr>
<td>Samarskaya Oblast</td>
<td>35.4</td>
<td>30.2</td>
<td>18.61</td>
<td>77.58</td>
<td>7.73</td>
<td>6.56</td>
<td>1657</td>
<td>1.7</td>
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<tr>
<td>Saratevskaya Oblast</td>
<td>48.6</td>
<td>10.2</td>
<td>16.39</td>
<td>77.56</td>
<td>4.17</td>
<td>4.81</td>
<td>2281</td>
<td>-5.9</td>
</tr>
<tr>
<td>Sverdlovskaya Oblast</td>
<td>40.6</td>
<td>15.7</td>
<td>17.30</td>
<td>75.01</td>
<td>5.71</td>
<td>5.58</td>
<td>3316</td>
<td>1.9</td>
</tr>
<tr>
<td>Novosibirskaya Oblast</td>
<td>37.4</td>
<td>15.8</td>
<td>23.32</td>
<td>75.65</td>
<td>8.46</td>
<td>7.41</td>
<td>1410</td>
<td>1.6</td>
</tr>
<tr>
<td>Omskaya Oblast</td>
<td>46.7</td>
<td>14.7</td>
<td>17.67</td>
<td>75.21</td>
<td>6.91</td>
<td>5.51</td>
<td>1034</td>
<td>-0.7</td>
</tr>
<tr>
<td>Primorskii Krai</td>
<td>38.2</td>
<td>19.6</td>
<td>17.41</td>
<td>70.86</td>
<td>12.04</td>
<td>4.60</td>
<td>1030</td>
<td>-4.9</td>
</tr>
</tbody>
</table>

Source: Goskomstat (1999).
<table>
<thead>
<tr>
<th>Region</th>
<th>Cases Filed 1999</th>
<th>Cases Filed 2000</th>
<th>Cases Decided 1999</th>
<th>Cases Decided 2000</th>
<th>Cases filed per enterprise, 1999</th>
<th>Cases filed per joint stock company, 1999</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lenin/St. Pete.</td>
<td>33105</td>
<td>34545</td>
<td>28642</td>
<td>29869</td>
<td>0.17</td>
<td>1.45</td>
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<tr>
<td>Novgorod</td>
<td>3519</td>
<td>3482</td>
<td>3346</td>
<td>3026</td>
<td>0.27</td>
<td>3.33</td>
</tr>
<tr>
<td>Moscow City</td>
<td>52191</td>
<td>47700</td>
<td>43014</td>
<td>40012</td>
<td>0.08</td>
<td>0.71</td>
</tr>
<tr>
<td>Moscow Oblast</td>
<td>17023</td>
<td>18293</td>
<td>13848</td>
<td>15225</td>
<td>0.16</td>
<td>2.01</td>
</tr>
<tr>
<td>Volgograd</td>
<td>11393</td>
<td>14347</td>
<td>9085</td>
<td>11034</td>
<td>0.22</td>
<td>4.91</td>
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<tr>
<td>Samara</td>
<td>12420</td>
<td>17400</td>
<td>11179</td>
<td>14991</td>
<td>0.20</td>
<td>2.61</td>
</tr>
<tr>
<td>Saratov</td>
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<td>13030</td>
<td>9552</td>
<td>11630</td>
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<td>5.80</td>
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<tr>
<td>Sverdlovsk</td>
<td>17739</td>
<td>21670</td>
<td>14579</td>
<td>17158</td>
<td>0.22</td>
<td>3.86</td>
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<td>Novosibirsk</td>
<td>10080</td>
<td>11421</td>
<td>8579</td>
<td>9743</td>
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<td>1.86</td>
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<td>Omsk</td>
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<td>11683</td>
<td>8871</td>
<td>8917</td>
<td>0.26</td>
<td>3.77</td>
</tr>
<tr>
<td>Primorskii krai</td>
<td>11823</td>
<td>10318</td>
<td>10080</td>
<td>6628</td>
<td>0.31</td>
<td>2.57</td>
</tr>
</tbody>
</table>

Table 5: The Intensity of Use of Arbitrazh Courts, Based on an Enterprise Survey

<table>
<thead>
<tr>
<th>City</th>
<th>% of enterprises that had been a defendant in <em>arbitrazh</em> court in previous 2 years</th>
<th>% of enterprises that had been a plaintiff in <em>arbitrazh</em> court in previous 2 years</th>
<th>% of enterprises that had been either a plaintiff or a defendant in <em>arbitrazh</em> court in previous 2 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moscow city</td>
<td>40.00</td>
<td>61.82</td>
<td>70.91</td>
</tr>
<tr>
<td>Novosibirsk</td>
<td>63.64</td>
<td>74.55</td>
<td>74.55</td>
</tr>
<tr>
<td>Saratov</td>
<td>61.82</td>
<td>61.82</td>
<td>70.91</td>
</tr>
<tr>
<td>Sverdlovsk</td>
<td>52.73</td>
<td>78.18</td>
<td>85.45</td>
</tr>
</tbody>
</table>

*Source:* Authors' survey.
Table 6: Temporal Changes in the Use of the Arbitrazh Courts

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>National</td>
<td>338,162</td>
<td>275,304</td>
<td>208,081</td>
<td>237,291</td>
<td>290,094</td>
<td>341,537</td>
<td>398,622</td>
<td>496,739</td>
<td>539,490</td>
<td>160%</td>
<td>259%</td>
</tr>
<tr>
<td>Moscow City</td>
<td>N/A</td>
<td>24,604</td>
<td>17,427</td>
<td>18,208</td>
<td>26,996</td>
<td>29,348</td>
<td>34,467</td>
<td>43,014</td>
<td>40,012</td>
<td>163%</td>
<td>230%</td>
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<tr>
<td>Moscow Oblast</td>
<td>10,578</td>
<td>8,595</td>
<td>5,729</td>
<td>6,154</td>
<td>7,722</td>
<td>9,087</td>
<td>10,333</td>
<td>13,848</td>
<td>15,225</td>
<td>144%</td>
<td>266%</td>
</tr>
<tr>
<td>Lenin/St. Pete.</td>
<td>18,662</td>
<td>14,473</td>
<td>8,916</td>
<td>8,813</td>
<td>12,651</td>
<td>16,651</td>
<td>21,361</td>
<td>28,642</td>
<td>29,869</td>
<td>160%</td>
<td>335%</td>
</tr>
<tr>
<td>Novosibirsk</td>
<td>5,963</td>
<td>4,925</td>
<td>3,311</td>
<td>4,655</td>
<td>4,779</td>
<td>6,774</td>
<td>7,026</td>
<td>8,579</td>
<td>9,743</td>
<td>163%</td>
<td>294%</td>
</tr>
<tr>
<td>Sverdlovsk</td>
<td>14,730</td>
<td>10,453</td>
<td>7,869</td>
<td>8,000</td>
<td>7,980</td>
<td>8,464</td>
<td>10,120</td>
<td>14,579</td>
<td>17,158</td>
<td>116%</td>
<td>218%</td>
</tr>
<tr>
<td>Saratov</td>
<td>7,354</td>
<td>6,193</td>
<td>3,686</td>
<td>4,002</td>
<td>3,999</td>
<td>5,412</td>
<td>7,469</td>
<td>9,552</td>
<td>11,630</td>
<td>158%</td>
<td>316%</td>
</tr>
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</table>

** 2000 as % of 1993 for Moscow city.

Table 7: Changes in the Proportion of Administrative Cases in the Arbitrazh Courts

<table>
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<tbody>
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<td>National</td>
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<td>3.9</td>
<td>8.5</td>
<td>10.0</td>
<td>15.3</td>
<td>13.5</td>
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</tr>
<tr>
<td>Moscow City</td>
<td>1.9</td>
<td>3.8</td>
<td>4.0</td>
<td>7.0</td>
<td>12.0</td>
<td>17.8</td>
<td>34.8</td>
<td>42.7</td>
<td></td>
</tr>
<tr>
<td>Moscow Oblast</td>
<td>7.6</td>
<td>10.8</td>
<td>12.6</td>
<td>14.5</td>
<td>10.6</td>
<td>17.0</td>
<td>28.6</td>
<td>34.9</td>
<td></td>
</tr>
<tr>
<td>Lenin/St. Pete.</td>
<td>3.1</td>
<td>7.1</td>
<td>9.3</td>
<td>11.0</td>
<td>15.2</td>
<td>22.3</td>
<td>48.1</td>
<td>47.8</td>
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<tr>
<td>Novosibirsk</td>
<td>2.7</td>
<td>6.0</td>
<td>7.0</td>
<td>13.9</td>
<td>19.7</td>
<td>16.8</td>
<td>33.4</td>
<td>49.6</td>
<td></td>
</tr>
<tr>
<td>Sverdlovsk</td>
<td>3.3</td>
<td>8.4</td>
<td>10.6</td>
<td>15.9</td>
<td>20.6</td>
<td>20.0</td>
<td>34.8</td>
<td>40.8</td>
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</tr>
<tr>
<td>Saratov</td>
<td>2.7</td>
<td>8.6</td>
<td>4.9</td>
<td>14.8</td>
<td>28.5</td>
<td>48.5</td>
<td>48.3</td>
<td>55.1</td>
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Table 8: Percentage of Cases Not Decided Within the Two Month Statutory Deadline  
(Delay as Percentage of the Total Number of Cases Decided)

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<th></th>
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</thead>
<tbody>
<tr>
<td>National</td>
<td>3.4</td>
<td>1.5</td>
<td>1.6</td>
<td>3.6</td>
<td>4.1</td>
<td>3.3</td>
<td>3.9</td>
<td>4.6</td>
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<td>Moscow City</td>
<td>13.3</td>
<td>3.2</td>
<td>2.2</td>
<td>5.5</td>
<td>7.2</td>
<td>4.5</td>
<td>5.4</td>
<td>8.3</td>
</tr>
<tr>
<td>Moscow Oblast</td>
<td>9.1</td>
<td>3.8</td>
<td>4.6</td>
<td>10.4</td>
<td>6.4</td>
<td>5</td>
<td>6</td>
<td>6.6</td>
</tr>
<tr>
<td>Leningrad/St. Petersburg</td>
<td>1.9</td>
<td>1.1</td>
<td>1.0</td>
<td>3.3</td>
<td>4.8</td>
<td>3.8</td>
<td>5.4</td>
<td>4.1</td>
</tr>
<tr>
<td>Sverdlovsk</td>
<td>2.9</td>
<td>1.9</td>
<td>1.1</td>
<td>1.9</td>
<td>1.7</td>
<td>3.4</td>
<td>10.6</td>
<td>20.7</td>
</tr>
<tr>
<td>Novosibirsk</td>
<td>2.6</td>
<td>0.5</td>
<td>1.3</td>
<td>5.4</td>
<td>3.4</td>
<td>3.1</td>
<td>3.3</td>
<td>3.5</td>
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<tr>
<td>Saratov</td>
<td>0.1</td>
<td>1</td>
<td>1.2</td>
<td>0.4</td>
<td>0.8</td>
<td>1.1</td>
<td>0.8</td>
<td>0.9</td>
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</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Moscow City</td>
<td>20.1</td>
<td>22.9</td>
<td>18.4</td>
<td>14.4</td>
<td>11.8</td>
</tr>
<tr>
<td>B: % of petitions granted</td>
<td>71.6</td>
<td>66.3</td>
<td>71.4</td>
<td>77.1</td>
<td>80.2</td>
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<tr>
<td>Moscow Oblast</td>
<td>18.6</td>
<td>18.5</td>
<td>12.4</td>
<td>12.5</td>
<td></td>
</tr>
<tr>
<td>B: % of petitions granted</td>
<td>76.4</td>
<td>85.6</td>
<td>91.8</td>
<td>93.2</td>
<td></td>
</tr>
<tr>
<td>Leningrad Oblast &amp; St. Petersburg</td>
<td>16.2</td>
<td>14.8</td>
<td>9.2</td>
<td>11.5</td>
<td></td>
</tr>
<tr>
<td>B: % of petitions granted</td>
<td>97.7</td>
<td>87.2</td>
<td>91.1</td>
<td>66.9</td>
<td></td>
</tr>
<tr>
<td>Novosibirsk</td>
<td>17.0</td>
<td>24.3</td>
<td>28.4</td>
<td>24.6</td>
<td>22.5</td>
</tr>
<tr>
<td>B: % of petitions granted</td>
<td>65.6</td>
<td>91.2</td>
<td>96.1</td>
<td>95.8</td>
<td>98.7</td>
</tr>
<tr>
<td>Sverdlovsk</td>
<td>24.6</td>
<td>28.5</td>
<td>22.1</td>
<td>15.5</td>
<td></td>
</tr>
<tr>
<td>B: % of petitions granted</td>
<td>70.7</td>
<td>78.2</td>
<td>74.1</td>
<td>79.1</td>
<td></td>
</tr>
<tr>
<td>Saratov</td>
<td>33.7</td>
<td>26.5</td>
<td>32.3</td>
<td>31.1</td>
<td></td>
</tr>
<tr>
<td>B: % of petitions granted</td>
<td>93.9</td>
<td>55.2</td>
<td>95.4</td>
<td>98.7</td>
<td></td>
</tr>
<tr>
<td>Samara</td>
<td>35.5</td>
<td>32.6</td>
<td>20.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>B: % of petitions granted</td>
<td>81.6</td>
<td>96.6</td>
<td>96.4</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

A: Petitions for delay of *gosposhlina* as a percent of cases filed.
B: Percent of petitions granted.

*Source:* Annual Reports on Activities, submitted by *arbitrazh* courts to the Higher *Arbitrazh* Court for 1996, 1997, 1998, 1999, and 2000. Although the statistical form began soliciting this information only beginning in 1997, the Moscow City and Novosibirsk courts provided this information on a voluntary basis for 1996.
### Table 10: Importance of Various Obstacles to Using the *Arbitrazh* Courts: Average Scores on a 0-10 Scale

<table>
<thead>
<tr>
<th></th>
<th>Filing a claim is expensive</th>
<th>The time between filing a claim and judgement is too long</th>
<th>Judges are not knowledgeable about market transactions</th>
<th>Judges are not impartial</th>
<th>Judgements of the court are not enforced</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moscow city</td>
<td>6.16</td>
<td>5.73</td>
<td>4.36</td>
<td>4.86</td>
<td>7.76</td>
</tr>
<tr>
<td>Novosibirsk</td>
<td>7.25</td>
<td>5.23</td>
<td>4.19</td>
<td>3.82</td>
<td>7.77</td>
</tr>
<tr>
<td>Saratov</td>
<td>6.23</td>
<td>4.96</td>
<td>4.13</td>
<td>4.73</td>
<td>6.87</td>
</tr>
<tr>
<td>Sverdlovsk</td>
<td>6.61</td>
<td>4.8</td>
<td>3.96</td>
<td>4.44</td>
<td>6.96</td>
</tr>
</tbody>
</table>

*Source:* Authors' survey.

### Table 11: Perceptions of Honesty and Ethical Standards in Various Professions

Percentage of respondents reporting various levels (high, average, low) of honesty and ethical standards of different professionals.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>54.1</td>
<td>3.9</td>
<td>23.2</td>
<td>15.1</td>
<td>11.1</td>
<td>4.2</td>
<td>16.7</td>
</tr>
<tr>
<td>Average</td>
<td>38.8</td>
<td>33.0</td>
<td>46.3</td>
<td>64.8</td>
<td>39.4</td>
<td>34.3</td>
<td>66.7</td>
</tr>
<tr>
<td>Low</td>
<td>7.1</td>
<td>63.1</td>
<td>30.5</td>
<td>20.1</td>
<td>49.5</td>
<td>61.5</td>
<td>16.7</td>
</tr>
</tbody>
</table>

*Note:* The Canadian survey sampled 1027 members of the general public.  
*Source:* Survey Research Consultants International (1993); authors' survey.


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