

State University – Higher School of Economics

V International
Scientific Conference
“Competitiveness and
Modernization of Economy”

April 6–8, 2004
Moscow

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**COMPETITIVENESS AND
MODERNISATION OF RUSSIAN ECONOMY:
LAUNCH OF THE PROJECT**

Moscow, 2004

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This report is not a presentation of finalised results of studies. Rather, it is a start of the project, an attempt to remove the surface layer, that of the obvious. It is a claim to research the problem which is becoming more and more important in Russia. In fact, the transformation that started in Russia in 1989-92 should end up with an efficient market economy capable of ensuring a high level of individual well-being and prosperity of the country which are only possible on the basis of achieving world-class competitiveness of Russian goods and services. For this reason we decided to put the issue of competitiveness at the heart of the Vth International Conference of the State University – Higher School of Economics whose opening session will include presentation of this report. We expect that discussion at the conference will provide us with valuable insights for further studies.¹

¹ *This report absorbed the results of two expert workshops held at the SU–HSE in the early 2004 with participation of L.M. Gokhberg, A.V. Daniltsev, V.V. Drebensov, B.V. Kuznetsov, A.K. Ponomaryov, Yu.V. Simachyov, O.V. Fomichyov, and also the entrepreneurs who are members to the association “Opora Rossii”. The authors also express their gratitude to L.M. Freinkman, A.P. Belousov, N.L. Kapralova, Y.A. Kuznetsov, A.N. Klepatch, N.L. Kapranova and Y.Ch. Pappas for provided materials and valuable insights. Some calculations were performed by G. Penikas.*

1. Formulating the Objective

The problem of competitiveness of Russian goods and services, and the Russian economy in general is becoming a priority. In a speech to his agents on the verge of the presidential election, V. Putin expressed the opinion that the so called national idea was achievement of competitiveness. We share this opinion. This is actually why competitiveness was selected as the topic of the Vth International Conference of the SU-HSE.

Upon completion of the most painful stage of market reforms and after the financial crisis of 1998 came a revival of the economy which expanded over the years of reform and the crisis of transformation.

The process of formulating economic policies during all these years was marked by the collision of two alternative approaches. One of them – liberal – was focused on free interplay of market forces and minimised economic involvement of the government. Naturally, it dominated in the period of transition from a planned economy to a market economy which would involve liberalisation, privatisation, financial sustainability and emergence of institutions ensuring normal operation of market mechanisms.

The second approach would insist on a high degree of the government's involvement in the economy, not only as a reformer but also as an active agent, state entrepreneur and investor. Advocates of this approach would argue that reforms were painful in Russia precisely because the government was too quick to withdraw from the economy. They would likewise welcome active industrial policies which were understood in usual Soviet terms rather than the way they were understood in the West, i.e. the government identifying priority sectors and implementing their development programmes largely through public investments or heavy use of subsidies. These ideas came to practice only during the short period of Y.M. Primakov in office of the Russian Prime Minister when the development budget and the Development Bank of Russia saw the light.

At the onset of modernisation the same dilemma came around from a new perspective. Arguably, the liberal approach proved more adequate at the first stage of market transformation. But at the stage of modernisation when there is a need for a more profound structural adjustment but market forces do not always generate desirable structural changes, can it be that the time of dirigism has come? Should calls for more active industrial policies coming from the public at large be finally heard?

Liberal policies were still predominant during the last four years when high growth rates were observed. These were explained in terms of rouble devaluation and high oil prices which is true. But it is likewise true that competitive advantages were exploited by Russian business that revived thanks to reforms and assumed the role of the prime mover. Then the rates of recovery growth which should have come around sooner or later, started to decline from 10% in 2000 to 4.3% in 2002.

At this point it was argued that the government was not ambitious enough and that they should act more decisively. It was proposed to double GDP over 10 years though nobody put forward original ideas how to boost growth rates – these were expected from the government. Only A.N. Illarionov proposed to reduce taxes and public expenditures down to 20% of GDP and encourage depreciation of the rouble relative to the dollar.

The government welcomed the idea of economic diversification as a way to resolve the problem of raw material bias of the Russian production and exports. This only naturally raised the issue of collection of royalties which was actively pursued by the left wing of the political spectrum, especially by S.Yu. Glaziev: collect excess earnings of oil companies and reduce the tax burden on other businesses, thus encouraging growth of manufacturing sectors. However, it soon turned out that, unlike most other sectors, oil companies generated high earnings only due to the market situation and competitiveness of their commodity; that they had nothing particular as compared their international competitors and that excessive withdrawals would simply make

them non-competitive. It is only recently that Russian oil companies started to introduce new technologies already long in use with others. Meanwhile, manufacturing sectors as recipients of subsidies will have to achieve competitiveness and prove that they are able to do that within the acceptable time. What's then?

Naturally, liberals insisted on continuation of structural and institutional reforms. We believe they were right. But, once started, the reforms were slow to progress and, with few exceptions (taxes), would not bring rapid noticeable results. This was something to be expected since it is in the nature of institutional changes that, as resistance on the part of various strata of society grows, their maximum effect will diminish. Let us again point out that **many reforms on the agenda – natural monopolies, health care, pensions, public sector in general – are not specific of the transition from a planned to market economy but are rather a response to challenges of post-industrial development which is faced by many countries** including the most developed and prosperous. So, drawing on their experience is useful but not always as straight forward as it was when addressing the issues of liberalisation, privatisation and financial sustainability.

We believe that public policies cannot be linked to specific theoretical models; rather, they should be based on common sense, analysis of costs and benefits resulting from a decision, and solid forecasts including the factor of uncertainty. Having said that, we assert that market forces alone will not create in Russia an economic framework capable of ensuring the country's prosperity; they will rather encourage a raw material bias and, therefore, comparatively low growth rates (growth of demand for energy and raw materials equals the growth rate of the world economy minus energy saving effect). On the other hand, traditional industrial policy options (sectoral priorities + public investments + high taxes or large-scale subsidies) will not only encourage inefficiency, bureaucracy and corruption but will not be adequate due to high degree of changeability and uncertainty of growing points in a post-industrial economy. Concentration of resources with the use of the government to achieve national objectives which has been so often used in various countries in the post-industrial period, is now becoming ineffective: one will have to write off losses even before one can concentrate and spend.

We believe that achieving high competitiveness is the only reasonable purpose to modernise the Russian economy in this situation. It is also a large-scale national strategic objective which, once achieved, will put this country among the most developed economies in terms of individual well-being and ensure for it a decent place in the world. This is a structural policy compatible with today's challenges which will allow to determine methods and means to achieve the formulated objective.

2. Definitions

Let us conventionally call **competitiveness of goods and services** an ability to sell them at market prices with a normal margin of profit. This definition is simple but clear and conforms to intuitive ideas. We will distinguish **foreign competitiveness**, an ability to market goods and services internationally, adequate ratio of goods and services in a country's exports structure to ensure sustainability of the balance of payments, and **domestic competitiveness**, domestic market sales competing with imports and other domestic brands to ensure, together with exports, the required level of employment and individual earnings. Foreign competitiveness will normally assume domestic one but not vice versa. Domestic market sales may foreshadow foreign competitiveness but not guarantee it. This is a lower degree of competitiveness.

Competitiveness in resources – in terms of natural resources, quality of labour and capital as factors of achieving competitiveness in goods and services.

Institutional competitiveness – adequacy of a country's formal and informal institutions such as legislation, behavioural standards and traditions, power control, degree of freedom, radius of trust in requirements of production of competitive goods and services.

3. Status: Foreign Competitiveness

The situation of the Russian economy could be regarded as favourable in terms of the balance of payments. In 2002 the foreign trade balance had a surplus of USD 37.2 billion while that of current accounts – a surplus of USD 32.8 billion. In 2003 the situation looked still better, with a surplus of USD 3.9 billion (9% of GDP) according to preliminary data. But, of the entire range of Russian exports, only a few commodities, such as energy, metals and other primary processing materials, are competitive in foreign markets.

As follows from official data of Russian exports given in Table 1, in 2002 two groups of commodities – mineral products and metals – accounted for 73.8% of all exports. In 2003 their share only increased due to high prices of these commodities. Traditional CIS markets which are actually regarded as part of the domestic market would absorb approximately 15% of exports (see Table 2). Here finished items have a higher share, with 28.5% of machines and equipment and nearly 40% of textile, clothes and footwear. CIS buyers have the same demands to quality as buyers in the domestic market.

Table 1. Structure of Russian Exports in 2002

	Total		Outside CIS		CIS	
	USD million	%	USD million	%	USD million	%
Total exports	106154	100	90545	100	15609	100
Including						
- food and agricultural materials (except textile)	2732,6	2,6	1627,7	1,8	1104,9	7,1
- mineral products	58626,3	55,2	51544,7	56,9	7081,6	45,4
- chemical industry items, rubber	7381,0	7,0	5778,3	6,4	1602,7	10,3
- raw leather, furs and related items	268,5	0,3	183,3	0,2	85,2	0,6
- wood, timber and pulp						
- textile, related items and footwear	4908,3	4,6	4388,4	4,9	519,9	3,3
- metals, precious stones and related items	883,3	0,8	531,9	0,6	351,4	2,2
- machines, equipment and means of transport	19742,9	18,6	18056,3	19,9	1686,6	10,8
- other goods	10063,1	9,5	7192,9	7,9	2870,2	18,4
	1548,3	1,4	1242,0	1,4	306,3	1,9

Table 2. CIS Share of Russian Exports in 2002

	%
Total	14,7
Including mineral products	12,1
▪ textile, related items and footwear	39,8
▪ metals, precious stones and related items	8,5
▪ machines, equipment and means of transport	28,5

Food and Raw Materials

Tables 3 and 4 give more details of the main items of Russian exports. Moreover, Table 4 provides data on exports of machines and equipment as a sector developed in the USSR and claiming, along with the defence sector, to hold a leading position among other manufacturing

sectors. In addition, data of 1999-2002 help to draw conclusions of sustainability and trends of specific markets. The share of CIS markets gives an idea of their importance for this or another sector.

Let us review the items with turnover of more than USD 1 billion (other than oil and gas)

- ◆ There is a stable market for **fish and seafood**, primarily outside CIS. Fishermen prefer to avoid Russian ports because, according to M. Smirnov, journalist for Izvestia (1.07.01), this would equal “entering the enemy country’s port”. They will be met there by officers of 16 agencies to fill in a 10 cm thick package of documents and get their share.
- ◆ **Cereals** came to exceed USD 1 billion only in 2002. It is a promising market as the demand is strong but on condition of growth of output and reduction of costs in agriculture.
- ◆ Main reserves of **coal** are far from foreign markets, exports are profitable due to subsidised transport tariffs. But as domestic prices of gas grow, withdrawal of subsidies could be well compensated by growth of domestic demand for coal. In the U.S. coal remains the main fuel of power plants.
- ◆ There is a stable market, without expressed dynamics, for **chemical industry products** including mineral fertilisers. Maintaining this market will require large-scale and increasing investments as current output is produced by facilities created in the Soviet period and not renewed since that time. Moreover, prosperity of these sectors is partly due to relatively low domestic process of gas and energy. This situation is characteristic of a number of export-oriented sectors such as ferrous metals and aluminium.
- ◆ There is a stable and growing market for **timber** (growth of 36.6% in 4 years). But the level of added value is very low. Wood (processed wood, plywood, wood pulp, newsprint) collectively generated more than USD 1 billion of exports and grew 21%. It is noteworthy that in 2002 average prices of these goods were as follows (USD per 1000 m³ in markets outside CIS):
 - timber – 45
 - processed wood – 176.6
 - plywood – 243.8
 - wood pulp – 293.4
 - newsprint (for 1 thousand tons) – 332.4

The price difference between upstream and downstream levels is more than 6.5–7.3 times. A more detailed measurement by specialists would probably give a difference of 15–20 times. Meanwhile, in Finland the price difference between the highest added-value wood items and unprocessed timber may be as big as 500 times.

This is, therefore, a promising sector with abundant supply of renewable feedstock but requiring, in order to further develop, large investments and profound institutional changes, and a principally new business culture. It is also a typical case for Russia: competitiveness can be achieved only this way even in promising sectors.

Table 3. Main Export Items of Food and Raw Materials (USD million)

	Years				% CHF
	1999	2000	2001	2002	
Food and agricultural raw materials	976,0	1623,2	1886,7	2732,6	40,4
- fresh and frozen fish*	1036,6	1146,1	1211,7	1074,8	8,8
- shellfish*	215,9	270,5	222,3	247,1	0,9
- cereals	81,2	145,6	299,6	1048	129,1
- alcohol	26,8	34,7	47,0	75,0	7,6
Mineral Products	32689,0	55487,7	54653,3	58626,3	12,1
- calcium phosphate	197	159,7	133,6	129,8	12,9
- iron ore and concentrates	160,7	303	207,3	192,1	27,1
- coal	457	1163	1212	1162	12,1
- crude oil	14155	25274	24576	28950	12,6
- oil derivatives	5447	10938	9402	11247	3,8
- natural gas**				10950	2,1
Chemical industry products, rubber	6177	7392,3	7480,5	7381,0	21,7
- Inorganic chemistry products					
- Organic chemistry (petrochemistry)	2042	2125	2235	2139	7,4
	791	1236,9	1115,7	1134,8	4,1
mineral fertilisers:					
-- nitrogen	306,3	541,5	583,5	554,5	8,4
-- potassic	554	407,4	461,0	420,4	1,2
-- mixed	664	644,3	634,1	686,9	3,6
polymers and related items	589	789	714	675	45,8
synthetic rubber	297,4	330,9	339,3	395,0	13,2
Raw leather, furs and related items	207	269,7	228,7	268,5	31,7
- rawstock and leather					
- furs	152,7	205,7	162,6	195,5	34,0
	20,6	30,4	34,2	49,0	20,4
Timber and wood pulp	3716	4460	4427	4908	10,6
- Timber					
- Processed wood					
- Plywood	1202	1342,1	1331,5	1642,6	8,3
- Wood pulp	628,5	718,5	717,9	882,0	6,3
- Newsprint	233,4	222,2	244,7	283,2	3,9
	390,3	595,7	537,3	568,2	7,4
	409,9	464,8	500,9	398,4	10,9
Metals, precious stone and related items	19017	22369,7	18797,9	19742,9	8,5
- Ferrous metals	5408	6133	5973	6824	10,7
- waste and scrap ferrous metal	665	569	478,7	556,3	11,2
- semi-finished carbon steel items	1391,7	1787	1886	1904,4	18,1
- iron and steel sheets	2079	2784	2058	2758	11,1
- pipes	186,4	391	435	430	60
- building structures	67,3	51,9	106,7	127,2	25,4
- copper	917	1089	887	714	1,1
- nickel	1124	1628	1087	1712	1,6
- unprocessed aluminium	3604	4146	3650	2878	0,6

* including products shipped at sea without crossing the customs border

** estimate of 2002: 134 billion m³ x 80; price for CIS – 50

- ◆ The situation of **ferrous metals** is similar to the chemical industry. Exports are dominated by semi-finished carbon steel (nearly USD 1 billion) and sheet products (USD 2.8 billion). Soviet plants (Magnitogorsk, Cherepovets, Lipetsk, Kuzbass) targeted the needs of the metal-

intensive domestic market (construction, machine-building, defence) where the demand dramatically fell and is unlikely to recover. With the metal content of only 15–30% (Kommersant, 7.10.03), the ore base is inferior to that of Brazil or Australia. They hold a share of the world market due to a favourable market situation but are not as cost efficient as more promising manufacturers, including for reason of transport factor and technological backwardness. Long-term prospects of holding a share of the world metals trade are doubtful and, at the very least, will require a lot of effort and investment.

- ◆ The situation of **non-ferrous metals** is probably more steady, especially in nickel, copper, palladium, platinum. Exports of aluminium, a major export item in this sector, are supported by relatively cheap energy, transport subsidies and optimisation of taxes. The sector is almost free of VAT due to a high share of exports (80% and more). In addition, tolling has been widespread until recently. If these subsidies are removed or reduced, profitability of a large part of aluminium production may become questionable.

Machines and Equipment

Now let us review the major export items of machines and equipment.

- ◆ **Automobiles** – while lack of competitiveness of automobiles is the talk of the town, this sector is showing high growth rates of exports (183% over 4 years), of which more than half is CIS markets.
- ◆ **Aircraft equipment** is also showing growth of exports (which has doubled in 4 years), with CIS countries accounting for only 3.2%. Aircraft industry is currently relying on repairs and upgrading of old aircraft which are for the most part operated in those countries which were previously purchasing Soviet aircraft. Anyway, this sector should not only be disregarded but should be deemed promising.
- ◆ **Armaments** – in 2003 exports, according to disclosed data, were USD 5.4 billion, of which almost 70% were combat aircraft (Kommersant, 27.02.04). The main buyers were China and India. In 1997–2001 Russia accounted for 17% of world's shipments of armaments while in 2001 its share jumped up to 30%. The main competitor is the U.S. which steadily hold 50% of the market (Izvestia, 12.05.03). This market is extremely competitive, and the demand has been shrinking until recently. But over the last few years humankind has apparently given up the idea of the “world without war”. Many countries are building up their stocks of weapons, and winners of competition in this market will get their share. However, revenues from exports of armaments are unlikely to sizeably increase. It would be good if former positions could be maintained.

Generally, exports of machines and equipment which are associated with high technology sector can be described as follows. In 2002 they amounted to USD 10.1 billion, of which 28.5% were CIS countries. With a share of 9.5%, these exports rank third after mineral products and metals and are more welcomed by CIS and third-world countries. High technology products, for example, computers, take a minor share. Sometimes, statistics does not specify the figure either because of conservatism or simply because the value is too small.

According to the SCC data, export items totalling more than USD 300 million, apart from weapons and automobiles, will include power engineering products (boilers, turbines), electrical equipment and instruments, oil/gas and chemical equipment (including pumps and compressors). As compared to the pre-reform period, outputs fell dramatically, not only due to declining demand and malignancy of reforms but also because of lack of competitiveness which revealed itself after the economy opened up. Now, according to entrepreneurs, facilities in, for example, food or construction industry are being renewed almost completely with imported equipment, otherwise products will not be competitive. The situation of the machine exporting sector, despite all calls to encourage it, is depressing. Positive trends are almost exclusively observed where there is co-operation with foreign firms, i.e. building into value-adding chains.

Table 4. Main Items of Russian Exports of Machines and Equipment (USD million)

	1999	2000	2001	2002	% of CIS	Dynamics in 2002-1999
Machines, equipment and transport vehicles – total	7958,3	2070,9	10471,0	10063,1	28,5	
Including Aircraft equipment	1127,4	1165,1	2155,4	2243,9	3,2	+199%
Automobiles	553,6	664,2	750,7	1013,5	47,9	+183%
including cars	186,5	294,9	335	355	39,4	+190%
ships and vessels	756,5	1001,5	569,6	481,9	1,85	-36,7%
railway stock	185,6	201,0	200,4	245,6	66,5	+132%
internal combustion engines	118,1	142,7	159,1	140,7	82,4	
pumps and compressors	124,3	194,6	238,0	188,6	82,4	+151,7
electric motors and generators	51,0	82,1	120,6	97,9	47,7	+190% unstable
water stream and steam boilers	31,4	42,8	44,9	17,2	34,9	
batteries	30,4	33,8	31,3	30,6	83,3	
metal cutting machines	83,9	60,2	50,0	45,7	35,2	-45,5
wood and plastic processing machines	4,3	12,3	5,2	5,7	0,55	
computers and chips	86,1	58,9	35,6	70,4	11,5	decline within CIS +144,4
metallurgical equipment	10,6	22,2	17,2	47,1	14,9	
medical instruments including X-ray equipment and α , β , γ - emitters	25,5	59,3	37,9	35,3	24,9	
tractors	66,6	72,7	80,8	55,6	61,5	decline outside CIS
agricultural harvesting and thrashing machines	17,8	46,4	82,0	79,3	95,5	
TV sets	9,0	3,6	13,0	1,8	33,3	decline of 5 times

Revealed Comparative Advantages (RCA)

Revealed comparative advantages (RCA) are used internationally to characterise foreign competitiveness. They are calculated as a ratio of the country's share in the world market for a particular commodity to the country's share in world exports.

As a matter of comparison, Horst Zibert, a well-known German economist, observed that Germany specialises in medium technology products which makes it similar to Japan, unlike the U.S., France and UK where specialisation in high technology products is more manifested.² Medium technology products include, for example, automobiles and machines. Throughout the recent years these products in Germany has been showing positively for revealed comparative advantages while positive RCA values observed in 1970 for communication equipment, electric machines, cameras, optics and watches came to be replaced by negative values by 1999.

See Table 5 for RCA values for Russia which have been obtained so far.

**Table 5. RCA Dynamics of Russian Exports in 1999–2001
(RCA>1 gives a competitive advantage)**

Code (SITS)	Commodity	RCA value		
		1999	2000	2001
683	Nickel	17,490	13,951	10,841
341	Natural and artificial gas	16,796	12,462	13,072
247	Wood and timber	11,925	10,367	11,538
718	Electric units and parts	9,429	6,176	7,248
672	Iron/steel bars and other primary forms	8,230	7,028	6,808
684	Aluminium	7,262	6,061	5,548
562	Fertilisers	7,235	6,406	6,889
288	Non-ferrous metal scrap and waste	5,091	0,685	0,217
671	Pig, sponge and spiegel iron and ferric alloys	4,271	3,702	4,336
334	Oil derivatives	4,031	4,122	3,969
682	Copper	2,921	2,354	2,143
695	Hand and machine instruments	2,614	2,679	1,105
522	Inorganic chemicals, oxides, halogenic salts	2,027	2,121	1,897
322	Black and brown coal, processed wood and railway bars	2,003	4,052	3,539
		1,895	1,841	1,872
673	Reinforcing and shaped steel and structural iron	1,867	1,767	1,913
674	Thick- and thin-gage steel	1,779	1,692	1,557
251	Wood pulp and waste paper	1,639	1,568	1,773
793	Ships and vessels	1,354	1,529	0,550

Source: calculated on the basis of data of the 2001 International Trade Statistics Yearbook (UN, New York 2003), vol.1: Trade by Country; vol.2: Trade by Commodity

² Horst Zibert. *The Cobra Effect. St.-Petersburg University of Economy and Finance, 2003, p. 41.*

This country largely exports low and medium technology products. Normally, RCA values are greater for lower degree of processing, with exception of power engineering units, instruments and ships (the latter ceased to be competitive in 2002). It is worth noting the seemingly obvious fact which is important for policies of competitiveness: competitiveness of Russian finished products has been lower so far. It is harder to change the structure and diversify the economy than increase growth rates. This needs more time, investment and, what is especially important, a change of institutions and mentality. Not an easy thing to do.

Services

The share of services in a post-industrial economy is increasingly large. In this country they account for 50% of GDP. But their share in exports is small. In 2002, with total commodity exports worth USD 106.6, services accounted for USD 13 billion, i.e. 10.9%, of which transport was 42.1%, travel 32.1% while other services – construction, communications, insurance etc. – had a minor share. For most part, these services come as a mandatory paid addition to foreign economic transactions and are not an attractive business. We have little ability to work in the service market, it is not accidental that Russian services are called unobtrusive. Many of former positions, for example, sea transport of our own exports, were lost in the 1990-s.

Comparative data are given in Table 6.

Table 6. Cross-Country Comparisons of Commodity and Service Exports (Russia – 2002, other countries – 1999, USD million)

Country	Commodity exports	Exports of services	Structure of exports of services (%)		
			Transport	Travel	Other
Russia	106,6	13,0	42,1	32,1	25,8
Brazil	48,0	6,8	24,9	19,9	55,2
China	195,2	23,7	10,2	59,5	30,2
France	300,4	82,6	24,2	38,0	37,8
Germany	541,5	79,3	25,2	21,1	53,7
UK	269,2	101,2	18,5	22,8	58,7
U.S.	695,2	253,4	19,1	34,4	46,5
Netherlands	200,4	54,2	37,6	12,9	49,5

Source: WB. World Development Indicators, 2001, pp.210-212, 218-220, Goskomstat, Russian Statistics Yearbook, 2003.

As we see, services accounted for 36% of commodity exports in the U.S., 37.6% in the UK, 27.5% in France and 12.2% in Russia. The Netherlands exported 4 times more services than Russia. Large exports of services are characteristic of developer countries. Financial, insurance, information services have a high share of exports of services in the U.S. and UK. We buy them there, and for this reason our imports of services are twice as much as exports.

Thus, Russia's foreign competitiveness is largely supported by oil, gas and metals. Most finished products, apart from armaments, are not competitive in world markets. With available products, Russia is partially able to maintain its share of CIS markets. Exports of services do not match the size of the economy.

4. Domestic Competitiveness

Strange as it may seem, a study of domestic competitiveness turned out to be harder than that of foreign competitiveness as domestic statistics is even more lacking.

Originally, the idea was to take, wherever possible, sales data of domestic and imported goods in the domestic market in terms of their cost and amount, and arrive at the ratio of market shares and compare average sale prices. This would allow to assess comparative domestic competitiveness of Russian goods. Further, a regional comparison of these data would allow to get an idea how the ratio of demand for domestic and imported goods correlated with regional differences in prices and incomes.

As it turned out, statistics keeps record of only commodity balances in physical terms, with output and import identified in the structure of resources. These balances are constructed only for consumer goods of mass consumption. The data which can be obtained on this basis are given in Table 7. Costs of sales which would distinguish between domestic goods and imports are unknown, let alone across regions. The required data can be found, if ever, only in marketing studies commissioned by specific companies. It is surprising that a country which seemingly realises the importance of improving its competitiveness and, at least, keeps discussing it for many a year, does not care at all to get a coherent picture of the real state of things.

Table 7. Shares of Individual Imports (Product Types) in Relevant Commodity Resources (%)

Commodity (Product Type)	2000	2001	2002
Food			
Meat and poultry	34,3	47,6	47,0
Beef	23,1	34,2	34,7
Pork	24,4	39,2	46,3
Mutton	14,8	15,1	19,1
Poultry	53,5	62,0	57,3
Canned meat	10,3	10,1	9,2
Animal butter	46,0	52,0	51,1
Fat cheese (including brinzen)	23,0	34,8	33,0
Fish and seafood (without canned fish)			
Flour	10,8	13,7	15,3
Cereals	1,3	0,6	0,4
Pasta	2,8	2,2	2,0
Vegetable oil	14,6	13,3	14,0
Margarine	24,5	29,7	33,8
Tea	12,4	12,8	13,0
Salt	96,9	81,2	76,0
Sugar (except raw sugar, technical, liquid sugar and powder)	13,9	16,6	18,2
Non-food			7,1
Fabric, total			
Wool fabric	17,1	20,2	11,3
Cotton fabric	20,5	42,4	50,1
Legwear	4,6	7,4	4,4
Knitted outerwear	31,9	59,5	60,1
Garments		80,0	75,4
Fur and fur items		84,7	85,0
Leather footwear		86,3	86,7
Household soap	27,4	62,6	58,9
Synthetic detergents	7,4	9,5	4,4
Beauty soap	42,7	42,3	48,1
Perfumes and cosmetics	36,2	45,9	53,0

Watches	75,1	72,5	75,3
TV sets	62,6	70,9	70,8
Colour TV sets	54,5	71,7	61,6
Washing machines	46,8	67,6	55,0
Vacuum cleaners	33,4	55,9	64,8
Refrigerators		83,6	80,0
Bikes and motor bikes	34,9	45,2	43,0
Furniture	47,0	72,3	74,5
Carpets and rugs	37,0	34,4	50,2
Cigarettes and smokables	69,5	81,6	82,4
Medication	3,5	2,0	1,5
	64,	67,4	67,2

Source: Russian Statistics Yearbook, 2003

Let us review Table 7. First, we see in 2002 domination of domestic producers in 12 out of 17 observed markets of food items (dominant share is 2/3). Imports accounted for more than one third in three products (poultry, animal butter and tea). As to non-food consumer goods, domestic producers dominated the market in only 4 out of 22 product types (fabric, including cotton, household soap, cigarettes and smokables). They had more than half of the market in two other goods (synthetic detergents and refrigerators). It is noteworthy that this goes to the merit of companies with foreign equity (Procter & Gamble and Merloni, a factory which manufactures Stinol refrigerators in Voronezh). Thus, domestic producers prevail in the markets for food items while foreigners absolutely dominate those for non-food items.

As a matter of consolation, domestic automobiles accounted for more than one half of automobile sales in physical terms but they are positioned in the lower price segment. In 2002 car sales in Russia were approximately USD 1.5 billion and 1423 thousand units (Vedomosti, 7.10.03), of which AutoVAZ accounted for 700 thousand while Russian car manufacturers in general for nearly 1 million. The highest growth was demonstrated by plants for assembly of foreign brands and joint ventures, with 63.6 thousand cars produced last year (Gazeta, 26.01/04). With the price of at least USD 10000, new imported cars showed sales of 79 thousand in 2001, 110 thousand in 2002 and over 200 thousand in 2003 (after increase of tariffs for used imported cars). While new imported cars account for approximately 8-10% of sales in terms of quantity and 40% in terms of cost, used imported cars accounted for 10% of sales in terms of quantity and 8% in terms of cost (USD 0.7 billion) in 2000 (Expert, No. 25, 2001). In 2003 sales of used cars dropped to 360 thousand as compared to 450 thousand in the previous year but sales of new cars grew 30 thousand, with fewer sales by the main Russian car manufacturers (according to data of the Russian Marketing Association – RMA, Kommersant, 13.05.03). Our consumers destroyed protectionist plans of the government. Until recently, VAZ would have smoked the competition in its price niche (up to USD 8 thousand). But, with emergence of comparatively cheap foreign brands of domestic assembly and higher income of the population, its ability to compete will be put to a serious test (Vedomosti, 17.10.03). However, despite negative forecasts and curses of motorists, the Russian car industry stands a good chance to survive due to a harsher competition.

Table 8. Output Dynamics of Main Consumer Goods

	1990	1998	1999	2000	2001	2002
Meat and poultry incl.						
I category by-products, thousand t.	6484	1315	1113	1193	1284	1456
-beef and veal	2934	553	404	389	382	412
-pork	1804	288	232	279	275	318
-mutton	176	8,0	6,5	5,2	5,4	5,6
-poultry	1270	38,8	35,2	40,2	48,1	57,4
Animal butter, thousand t.	833	276	262	267	271	279
Fat cheese, incl. brinzen, thousand t.	458	185	185	221	255	316
Fish and seafood, incl. canned fish, mln t.	4,3	2,4***	2,6	3,0	3,1	3,0
Flour, mln t.	20,7	12,0	12,7	12,1	12,0	10,9
Cereals, thousand t.	2854	992***	899	932	994	951
Pasta, thousand t.	1159	687***	881	1375	1281	1197
Sugar, thousand t.	3758	3155*	6808	6077	6590	6165
Vegetable oil, thousand t.	1159	805*	881	1375	1281	1197
Margarine, thousand t.	808	198*	379	462	515	536
Alcohol	137****					
dehydrated alcohol, mln dl.	78,8	39,3**	73,4	74,4	83,5	90,4
Fabric, m ²	8449	1384	1666	2329	2625	2783
incl. – cotton	5624	1080	1258	1822	2094	2264
Legwear, mln pairs	43,5	2,8***	8,5	9,2	5,4	5,8
Knitwear, mln pcs.	770	44,7	80,5	121	130	132
Garments, mln pcs.	28,1	1,9**	2,3	2,3	2,7	2,4
Leather footwear, mln pairs	385	23,8	29,9	32,9	37,0	42,2
Carpets and rugs, mln m ²	43,5	2,8***	8,5	9,2	5,4	5,8
Vacuum cleaners, thousand pcs.	447	450	745	745	762	787
Refrigerators, thousand pcs.	3774	1043	1173	1327	1719	1938
TV sets, thousand pcs.	4717	329	281	1116	1024	1980
Bikes, thousand pcs.	3671	145	172	331	236	239

Source: Russian Statistics Yearbook, 2003.

*1995, **1996, ***1997, ****1998.

Table 7 also shows an increase of the share of imports after 1998 as devaluation of the rouble dramatically increased comparative competitive advantages of domestic producers. Since then the rouble has been appreciating relative to the dollar, something which changed the trend. The 2002 data, apparently, show stable parameters of domestic goods. As a matter of comparison Table 8 provides output data since 1990 across comparable product range while specifying output in 1998 or the year when output reached its minimum. It suggests that after 1998, despite growth of imports, production of pasta, legwear, carpets and bikes, apart from meat, also grew (minimum was reached in 1999). Data in Tables 7 and 8 show consumer preferences which are in line with the achieved level of prices and incomes. The 1990 output data are provided to show not so much the impressive extent of decline in output and demand as the implications of price liberalisation and economic openness which made domestic producers face the effects of laws of demand, supply and competition, thus revealing their ability to compete.

Let us take TV sets as an example. Their production was seemingly doomed. But in 2001 domestic television including imports from Belarus accounted for 38% of sales (Expert, No. 25, 2001, p. 25). Since 1998 the output has grown 8 times, only to reach 42% of the 1990 level. But these were totally different TV sets. They are largely made of imported parts but it is no longer simple assembly process as manufacturers have their own circuit designs and software products. Domestic products prevail in the low price segment of this market.

As a matter of conclusion, production facilities which remained in the domestic economy to this day are producing domestically competitive goods. A high price was paid to adapt to new market environment. But, generally, prospects are not very bright, the current state of things is not acceptable. Much effort is needed to change the situation for the better.

5. Competitiveness in Resources

Natural Resources

Russia is one of the world's richest countries in terms of **natural resources**. It is due to this wealth that we have an excellent balance of trade and are able to offer competitive raw and energy materials to the world market. This is a durable factor, and these commodities will always have a generous share of exports. It is not something to cry about. Norway and Australia, whose structure of exports is similar to ours, are getting by quite well with that.

But this situation also has its disadvantages: dependence on unstable world markets and, more importantly, weak incentives to develop an innovative economy, encourage structural and institutional changes which are critical for maintaining the country's ability to adapt and human development. Russia's oil deposits are not regarded as the most favourable to develop. At the oil price under USD10 per barrel, export production is starting to bring losses. Finally, raw materials exports governed by the world market trends are not enough to ensure high rates of economic growth and overcome the country's backwardness in terms of per capita GDP.

Labour

In terms of **labour** and human capital, Russia is assumed to be in a favourable position, with a high level of education combined with low demand of workers with regard to wages and working conditions. But there is a lack of discipline and exactitude in performing work. In fact, labour is not homogeneous and its quality is largely different across economic sectors.

The labour market is regionally segmented and characterised by low mobility, something which is due to attachment of people to homes, hence the importance of an accessible housing market.

A demographic crisis will gradually add to the deficit of labour, and migrant labour will be in demand. Moreover, labour reserves in the existing enterprises will be used only marginally. There is a surplus of labour in villages but it makes little sense to relocate this labour elsewhere. From the perspective of the country's development and competitiveness, it is important that **there will be no free labour in the market, hence a tougher competition**. This means that large investment projects aimed at higher outputs will experience problems with staffing or will create them for other sectors. Russia is doomed to rely on growth of productivity and efficiency.

It has been theoretically proved that large-scale output increases relying on massive investments without significant changes in technologies will require unlimited growth of labour. The well-known models by W.A. Lewis and his followers³ are based on a free inflow of labour to the manufacturing sector from agriculture in the period of industrialisation, something which is characteristic of many countries which achieved high rates of economic growth (South Korea, Taiwan, China, Malaysia).

Labour may be replaced with capital in a capital-intensive technical progress when the demand for labour will be lower but growth of labour in large investments will be necessary anyway. Opposite phenomena when a shortage of capital was compensated by a high quality of relatively cheap labour are also known (South-East Asia). But Russia is unlikely to enjoy these options in the forthcoming period.

Another option of rapid growth which does not require a large-scale increase of labour is to increase exports of finished goods to open markets of Western countries using low wages in exporting sectors as a competitive advantage while introducing technologies borrowed from the West. This is the experience of Japan in 1960-s and 1970-s and modern China which is likewise inaccessible to us on a similar scale as wages are higher and labour quality is relatively lower.

This also means that large-scale jumps in outputs over short periods induced by massive investments will not be possible.

Investments into science and education, development of skills and incentives for creative work and private enterprise will be ever more important.

³ R.M. Nureev. *The Economics of Development, M., Infra-M, 2001, p.p. 41-59.*

Capital

As has been noted above, the current situation is characterised by the fact that the most competitive exporting sectors (chemicals, metals) can use facilities created in the Soviet period almost free of charge, which for the time being compensates for the lack of other competitive advantages. It has been possible to get by with comparatively small investments to upgrade or partially replace the existing equipment. Once large investments are required for overhaul and a change in technologies, competitive positions may be lost. For many sectors this time is around the corner.

In the current situation, there is no significant limit to raise investments. The country has temporary available resources in search for profitable application. Foreign sources of capital are also available, especially owing to unfavourable trends in world financial markets. In today's Russia return on investments is higher, just like the risk. This, however, depends on the area of application.

Capital willingly moves to sectors regarded as attractive, such as oil, gas, trade and real estate, provided there are acceptable borrowers or trustworthy and co-operative recipients of investments. However, diversification will require investments into other sectors which are non-competitive and risky today, and fraught with uncooperative behaviour and people unwilling to exchange control for investments. Capital spillover mechanisms, lacking in Russia anyway, will not be efficient in this situation.

Paradoxically, the country needs large investments in order to modernise but is currently unable to absorb and apply them in the best way. Unlike recently when financial resources were lacking, there is a growing risk of inefficient and insecure investments triggered by the pressure of available liquidity, including from inflow of oil dollars.

At the same time, it is basically short money that is available to Russia today. Long money required for large long-term investments including into the country's infrastructure, are not there while national institutions to accumulate it (pension funds, insurance companies etc.) are only emerging. It will take them at least dozens of years to accumulate capital. It will also take time to develop financial agencies and introduce a culture of massive small investments of individuals.

Conclusions:

1) Public investments, at least on a modest scale, are needed to overcome market failures. But a growing uncertainty of technical and economic shifts does not allow to identify priorities and finance specific large-scale investment projects;

2) Because of a lack of long money in the country, it is reasonable to raise large foreign investments for purposes of modernisation and, therefore, create for them a competitive investment climate;

3) It is important to realise that a larger scale of application of these resources including capital will not by itself ensure fast growth rates or enhance competitiveness, as it was before.

6. Institutional Competitiveness

It is now widely accepted that institutions play an important role for competitiveness and successful development of the country in general. From a broader perspective, it is the question of culture which means, rather than originality of culture as a set of skills, traditions, behavioural habits, its adequacy to modern requirements of development of technology, economy and social life, and its ability to encourage or prevent negative changes in the economy and well-being of people.

Institutions are characteristically slow to change. There is a wide-spread conviction that they cannot change at all, at least within the span of human life and, even more so, the term of office of democratically elected leaders. Therefore, it is assumed that informal institutions and

culture of a country in a broad sense are facts of life to be accounted for in policy-making without attempting to change. Nevertheless, politicians and reformers here and there embark on ambitious plans to change institutions because, lacking this, it is impossible to achieve desired a result, for instance, overcome backwardness.

Experience also suggests that differences between countries in the level of well-being and competitiveness largely owe themselves to flexibility and changeability of institutions typical of their culture, and the resulting distance between formal and informal institutions, legislative provisions and social practices: the more flexible and adaptive institutions are, the less is this distance.

Productive Institutions

Practically all countries leading in terms of per capita GDP (over USD 20000 a year) and highly competitive in the post-industrial age possess the following main institutions:

- ◆ an open market economy, free prices, low customs barriers (largely tariff-based rather than quantitative), encouraging market competition;
- ◆ domination and protection of private property;
- ◆ observance of contractual obligations: market economy is a network economy of transactions and underlying contracts; exactitude allows to reduce transaction costs and is acknowledged as the critical business quality;
- ◆ a tax system accountable to taxpayers through democratic representative institutions with established tax administration. Tax evasion is regarded as a serious crime to be severely prosecuted;
- ◆ efficient public services with a low level of corruption;
- ◆ transparent public companies and financial institutions which, through disclosure and verifiability of information, are trusted by partners, creditors, investors, and can raise funds for their business with minimum costs;
- ◆ a democratic political system with political competition, separation and change of authorities, and secure mechanisms of social control over the government and bureaucracy;
- ◆ law obedience of citizens encouraged from childhood and cultivated in society; independent court trusted by citizens as to justice of rulings; a powerful system of law and order and enforcement of court rulings ensuring inevitable punishment for violation of law. Minimum distance between formal and informal standards of social behaviour.

This is, of course, an incomplete and, more importantly, strongly idealised picture. There are many reports which suggest that the above institutions are inefficient and violations abound. One can respire: these countries are not much different from ours. However, practice suggests that, despite deserved criticism, these institutions will largely perform their functions and follow democratic procedures while initiative of citizens will sooner or later result in detection and prosecution of the worst deviations from standards. Criticism finally proves to be constructive rather than destructive as it ensures high flexibility and adaptivity of social mechanisms.

These institutions and their operation finally create positive incentives for entrepreneurial activities, innovations, savings and investments. Importantly, all together they make up a system linked by internal logic.

It is hard to prove that, taken together, they ensure prosperity. But experience suggests that, once these institutions are deeply rooted, countries will prosper. If they are inefficient or work less effectively, the economy is less developed, individual well-being will be lower and there will be indications of cultural backwardness. There is no country which would possess other institutions and other culture outside them, and which would be nevertheless developed and prosperous. The only exception is oil-producing countries with comparatively small population.

However, the widely accepted slowness of institutional changes will pose a sacramental dilemma to those countries which do not possess this “treasure”: are they doomed to remain what they are? Or is there a way to change a country’s fate within acceptable time, say, a life span of one or two generations? There are positive examples such as Japan, Korea, Taiwan, or Spain on

the other end of the planet. We would not take the example of China, despite all excitement over its experience: China's per capita GDP has been so far twice below that of Russia while Chinese products are competitive largely due to cheap labour. Russia is a negative example. The way chosen by this country to overcome backwardness and based on principally new institutions – a planned socialist economy and totalitarian regime – has taken it nowhere. In terms of per capita GDP, Russia in 1990 ranked almost the same among other countries as back in 1913. We had to return to the main road.

Institutional Structure of Socialism

How can one characterise our institutional structure at the onset of reforms? It was totally different from the one described above:

- closed planned economy, state-controlled prices, no competition, monopolised foreign trade, existence of shadow economy without which, under formal rules, the legal economy could not have existed;

- domination of public property, private property to capital goods is banned;

- partners do not have to be exacting since an order from superiors is more important.

Hierarchical rather than network pattern of economic ties;

- no tax system as such, hence no taxpayers. All financial resources are held by the government which ensures their distribution while leaving one part to enterprises in accordance with the plan and paying subsistence wages to people, i.e. compensation of current expenses for reproduction of labour;

- public services, albeit relatively few, are totally inefficient and fraught with corruption: “connections pay off better than anything” – this saying was in use already under Stalin;

- state-owned enterprises conceal their reserves and attempt to reduce assignments under the plan while getting more resources; no transparency, stealing public goods is not a sin;

- formally, a socialist democracy but in reality a repressive totalitarian regime fighting any dissent but unable to control the economy;

- Soviet citizens, like subjects of the Russian Empire before, were obedient to despotism of authorities but not to the law. “Severity of the Russian law is mitigated by optional obedience” (M.E. Saltykov-Schedrin). The same idea was developed by Leonid Gaidar: “Long live Soviet justice, the most just in the world”.

Instructions of superiors are more important than law. Hence, the law becomes arbitrary and paves the way for a profound disbelief in justice. Maximum distance between formal institutions and daily practices.

We believe it was worth recalling these things, widespread until recently but almost unknown to younger generations, to underline where we are coming from. A system possessing these institutions is largely to blame for the current low competitiveness of Russian goods and services. It was crippled primarily by a lack of effective incentives to work and enterprise which stem only from competition. Hence it is only raw materials and products of primary processing that turned out competitive, and these had to be produced in abundance to compensate for lack of incentives to rationally use. Armaments also turned out competitive as there was competition in this sector, though between the military.

Institutional Changes in the Course of Reforms

What has been done so far?

First, the economy was liberalised at the start of 1990s. Free prices were introduced and prevailed. The economy opened up, with a free exchange rate of the rouble and abandonment of foreign trade monopoly of the government. Competition started to work.

Second, a large-scale privatisation was carried out. Despite widespread criticism and that up to 40% of productive assets are still in the hands of the government, the institution of private property came into being and laid the basis, together with market prices and competition, for

shaping the incentives which internationally encourage people to work efficiently and thriftily, reduce costs and innovate.

Third, the Civil Code was adopted, market-oriented, supportive of contract performance and protecting property.

Fourth, the tax system was redesigned and came to include a tax administration system, one of institutional cornerstones of a market economy. A new budget system with treasury-based budget utilisation was put in place.

Fifth, a workable (through not without failures) banking system and financial markets were established as another institutional pillar of a market economy.

Sixth, the democratic Constitution of 1993 was adopted. Though it is believed that it gives too much power to the President, it nevertheless legitimised all basic human rights and liberties, and created a stable legal framework for democratic development of this country.

This is probably the end of this list of the most important achievements. However, given such a short period, it is an enormous success as this laid down a principal framework for further evolutionary institutional changes capable of ensuring development of an efficient economy and prosperity to the country.

Adaptive Model of an Economy in Transition

In a situation of a worsening crisis, the reforms which many believe to be too radical and destructive, in a combination with previous informal institutions that are characteristically slow to change, resulted in a kind of adaptive model of an economy in transition. It encouraged people and enterprises to survive and triggered their response to signals given by the reforms and crisis. This is a description of this model.

- ◆ **A greater distance between formal and informal institutions.** Reformers would attempt to legitimise the best legal provisions of market economy and democracy. But, confronted by deeply rooted informal institutions, these provisions were either rejected or deprived of their original meaning. This, for example, happened to the legal reform in the early 1990-s. While formal rules were ignored, practices, sometimes more sustainable, would reinforce traditional neglect of law.
- ◆ **Weak governance.** In a situation of revolutionary changes, institutions and agencies of the government will always weaken. In particular, it is manifested in the fact that different social groups, including government officers themselves, start to abuse prerogatives of power.
- ◆ **Disorderly distribution of property** and power in the process of privatisation and further redistribution of property. High degree of concentration of property. Hence the legitimacy of privatisation, despite formal legality of the vast majority of provisions, remains doubtful in the public eye.
- ◆ **Deeper social differentiation.** Soviet wage-levelling gave way to a flagrant gap between the rich minority and poor majority. The decile difference grew from 4.5 times in 1990 to 14.5 times in 2002. A growing difference in terms of income and holdings is inevitable at the time of transition to a market economy and will encourage labour and business activities but in this country it turned out to be enormous and would provoke constant discontent of people with their situation and lack of power.
- ◆ **Crime** has grown sizeably due to the above factors. Social differentiation would recruit for crime those young people who could not otherwise find a place in the sun. Weak governance reduced the risk of punishment and encouraged demand for enforcement services. Shadow economy created an enabling environment. Traditional forms of crime were gradually ousted by less cruel but likewise dangerous forms of illegal use of violence including by law enforcement authorities actively involved in the competitive struggle.
- ◆ **Stronger bureaucracy.** The traditionally influential Russian bureaucracy, strange as it may seem, only grew stronger with weaker governance. Decision of a wide range of issues was now left to discretion of specific government officers. Possibilities to abuse office functions, including by explicit or hidden involvement in business, only expanded. A widening gap between formal and informal institutions, and disbelief in law also reinforced its positions. In

addition, it portrayed itself as a protector of interests of the state whose decline was taken to heart by the public.

- ◆ **Corruption** reached an outrageous scale. This is explained by both weaker governance and stronger bureaucracy, given public complacency. An assessment by G.A. Satarov was indeed impressive (corruption in business alone was USD 33 billion a year, one third of the federal budget). It is unlikely to be underscored if one takes into account businessmen rising to power to lobby their business. In addition, business abhors incorruptible bureaucrats: whether order will be established, is questionable but it will no longer be possible to solve one's own problems. Every step towards more government involvement in the economy will reinforce positions of bureaucrats (they somehow benefit from this just like from weaker governance) while a stronger bureaucracy will add to corruption.
- ◆ **Manageable democracy.** The model of manageable democracy, particularly well-developed at the time of V. Putin's first office, started to take shape since 1996 when manipulation of democratic procedures became an alternative to a coup d'état or return of communists to power. Its meaning is simple: formal compliance with democratic rules combined with practical abuse of power. This practice obviously follows from the Soviet democracy. It has been largely explained by the need to overcome the weakness of governance in a situation when there is no civil society and the public is largely inactive. However, there is a loss of social control over the authorities and actions by all new economic and political institutions. It is as if the system had lost the backbone of efficiency and prospects of development.

Generally, negative qualities of the adaptive model of an economy in transition which are logically linked between themselves make up an institutional trap, a kind of machine built into the institutional structure of a market economy and preventing it from positive development. We have listed the well-known phenomena by qualifying them as institutions of the adaptive model of the Russian economy in order to underline that their existence does not bring us any closer to institutions which contribute to prosperity and competitiveness. On the contrary, they prevent competitiveness from being enhanced and partly explain why shifts in economic modernisation and competitiveness are extremely slow to occur.

V. Putin's Reforms

After V. Putin took office of the President, it was identified a package of liberal economic reforms aimed at bringing our institutions, originally formal, closer to the standards which would ensure efficiency of market mechanisms and encourage higher competitiveness in the global economy. A set of anti-bureaucratic laws, lowering of customs barriers, liberal foreign exchange regulation and reforms of natural monopolies were meant to implement additional deregulation of the economy, expand competition-based market relations and lower administrative obstacles for entry into the market. The tax reform resulted in a considerable reduction of tax burden. The privatisation programme and tendency to reduce the number of wholly state-owned enterprises are expected to reduce the government's share in the economy and increase that of the private sector. The administrative reform, civil service reform, delineation of authority between various levels of power are aimed at increasing efficiency of the government. Not all of the planned reforms are moving forward successfully; there are too many compromises, for example, in the text of the new Labour Code. Some are simply at a standstill. But steps in the right direction are still being made.

The programme of further liberal economic reforms presented to the public after the recent presidential election, undoubtedly, merits support. In particular, it is proposing important solutions in the area of the tax system, including a considerable reduction of uniform social tax (by more than 10 percentage points) while introducing funded pensions to be financed not only by employers but employees, with the federal budget undertaking to compensate for losses of extrabudgetary social funds. Further, it is proposed to implement a reasonable soft model to increase the retirement age encouraged by the government and allowing to increase the ratio of pensions to average wages after 65 (in fact, the new retirement age) from 30 to 60-70%. It is proposed to replace numerous in kind social subsidies with cash benefits. Reforms are expected

in the energy and gas sectors, in establishing an accessible housing market and in education and health. It is intended to increase the efficiency of governance as a result of administrative reform and implement a new law on delineation of authority and financial liabilities between various levels of power. It is now important to ensure that these words are followed by actions.

As to democratic transformations, many experts believe that there is rather a downturn. The objective of overcoming weaknesses of governance and ensuring political stability resulted in restrictions of freedom of speech and practices of so-called administrative leverage in the course of election campaigns. Under the pretext of fight against crime and shadow economy and improvement of tax collection, actions were taken which deteriorated relations between business and authorities. Arbitrary justice along the lines of the Soviet tradition diminished the radius of trust in relationships between them and questioned willingness of authorities to protect private property. Thus, the process of establishing institutions of a developed market economy and political democracy was seriously undermined. Overcoming the adaptation model did not speed up but rather slow down.

Clearly, institutional changes are slow while the process of institutional transformation will be fraught with controversies, conflicts of interest, struggles of opinions. The less consistent is the policy of their implementation, the more time will be required to put in place in Russia competitive institutions attractive for capital and intellect, the more difficult will be to ensure international competitiveness of Russian goods and services.

The experience of the XX century suggests that **significant changes of the institutional structure including informal institutions and social practices will require at least 30–40 years, even in a favourable situation.** This should be taken into account in formulating national policies of competitiveness.

Now, taking into account what has been said so far with regard to the current situation and existing constraints, let us discuss possible policies of competitiveness.

7. Policies of Competitiveness

Prerequisites and Constraints

Let us summarise. The above suggests certain conclusions with regard to prerequisites and constraints to be taken into account in formulating long-term policies of competitiveness in Russia.

1. The current well-being of the Russian economy is ensured by exports of a narrow range of competitive raw materials and primary processing products plus armaments. This is not a basis for sustainable and long-term economic growth.
2. With certain exceptions, the higher is the degree of processing, the less is competitive strength of products.
3. Nevertheless, there are numerous clusters, areas and directions promising from the perspective of competitiveness.
4. Russia is rich in mineral resources while raw and energy materials will account for a large share of exports for a long time. This is our competitive advantage. But it can not be a basis for economic modernisation.
5. In the coming years Russia will face a shortage of labour and will not be able to exploit increase of employment as a growth factor. The focus will have to be made on quality and education.
6. Russia will not face a shortage of capital but domestic sources of “long money” needed for large-scale modernisation projects are only emerging. Large resources will have to be borrowed internationally, hence a need in a more competitive investment climate.
7. Desirable structural shifts in the economy cannot be achieved without a necessary minimum of public investments.

8. However, uncertainty, rapid change of promising areas of technological development in the global economy will increase the risks, especially for public investments into specific manufacturing projects.
9. Institutions and culture will play a decisive role. In fact, they will have to be largely changed to improve competitiveness internationally. But institutions are slow to change while excessive and hasty efforts to enforce such a change may cause a back fire. Therefore, policies of competitiveness should become a long-term strategy, to be implemented consistently despite a change of leaders and governments. Importance should be attached to not only economic institutions but also political ones, especially democratic institutions of separation of powers and social control over government actions.

Ten Ideas for Policies of Competitiveness

In view of the above, what should be policies of competitiveness? **First**, these policies are not a fragment of general economic policies, as industrial policies were always conceived, but the **public economic policy aimed at improving the country's competitiveness** through higher competitiveness of goods and services, resources and institutions.

Second, as we move to the stage of economic modernisation and choose between a liberal and dirigist models, between a focus on private initiative and business or on government as a prime mover of economic modernisation and growth, the choice **has to be made in favour of the liberal model** and private initiative. This follows, above all, from higher efficiency of private business and uncertainties of economic development in a post-industrial period, from the fact that markets and business can better than government identify points and factors of potential growth – drawing on one's experience or innovating. Essentially, we should avoid imposing a pattern. The role of government should be more active than has been thus far, especially with regard to encouraging positive structural shifts and institutional reforms.

Third, the experience of Russian companies proves the ability of Russian business to improve competitiveness and achieve success. Given below are extracts from presentations of entrepreneurs representing the "OPORA Rossii" Association delivered at SU-HSE seminars where they explained how they managed it.

Box 1

Doing Business in Russia: Factors of Success

Alexander Kabanov ("Mir" Company – a network of retail shops for household appliances and electronics; 2700 employees)

First, it is the selected guideline we keep heading all this time. In other words, we are heading straight forward towards a defined objective. Second, it is obviously a team. The team of specialists which has developed and gained enough experience with time to eventually realize that the future is with chain trading companies.

We then realized that in spite of that Moscow is the biggest region with the highest sales volume where almost all chain companies came into being, it is not yet the entire Russia. Russia is a non-cropland that needs to be developed by introducing the best practice achieved and selected in Moscow.

And, maybe, there is one more factor. The company's owners and shareholders didn't spend more money than they needed for their personal use. Most of the generated earnings were reinvested in the business.

Grigoriy Kozhemyakin (Starik Khottabych Company – retail and wholesale building finishes; 2500 employees)

When we started out, the market was absolutely unoccupied. So, we started as a wholesale company. Originally, we just intended to make more money until we found out that this could turn into a business. So, we kept investing in an effort to achieve some positive results. I would say that the

objective to achieve something was the key factor, because in general all participants were on an equal footing at that time. The only thing is that we were ignorant in business.

Until 1998, the retail business included only imported goods. After 1998, the production sector started to develop. At present, the share of domestic products is nearly 20%, most probably 25%.

While doing retail business we also began to invest in the Russian production industry. Our company owns a ceramic tile factory and bath-room furniture factory. Five hundred people are employed at each factory. These are the personnel employed only at the factories. I would say it is a medium-size business.

In deciding on production we were governed by the factors which could allow us to compete and oust imported goods. And I can say that our factory is ranked among the top three leading bath-room furniture manufacturers in the country. This year we put into operation the second manufacturing line, tripled production, and, maybe, we will continue to develop this business.

We try to manufacture high-quality products. And, by the way, our *Moi-Do-Dyr* trade mark is ousting bath-room furniture from Italy and Spain. Our ceramic tile products beat those from Poland, Turkey and Lithuania. The fact is that though, as they say, our costs are low and labor is inexpensive, we lack production experience. Actually, we have no skilled personnel. Neither do we employ business processes. We are constantly facing this problem. Whenever we deal with high-tech production, we have to refer to the practice of western countries. Both factories are equipped with Italian and Spanish machinery. There is no Russian equipment installed.

Oleg Novikov (Eksmo Publishing House – fiction and other literature; over 1000 employees)

We also started from scratch, and, of course, initially we were governed by external conditions at that time. It was, on the one hand, an excess interest in books early in the 1990x caused by a buoyant, uncalled market demand of the previous years. On the other hand, books used to be published by governmental publishing houses which proved unequal to their function and gradually came to naught. In these conditions, new, initially small-size participants emerged in the market, and we began to grow under fairly favorable conditions.

After a time we could realize and foresee changes in demand of our customers. At the very beginning, every book was published in hundreds of thousand copies, and there was no need to look for new authors. Then, new authors gradually became of interest. Initially, it was foreign writers, and then Russian ones. Actually, when we started publishing new Russian writers we made a huge qualitative breakthrough against ourselves and our competitors on the tide of this interest. Books of new authors, initially in detective genre and then in other genres, found quite positive acceptance in the market, and we could increase substantially our total print.

On the other hand, we developed a certain publishing know-how. Previously, all publishing houses employed the same publication procedure which was shared between several authorities: the editor was responsible for editing, art director for design, and nobody was responsible for selling. Today, we developed a technology when one person is responsible for the entire process – from negotiations with authors or idea of a serious book to sales. We managed to introduce the institution of product managers, leading editors, which are responsible for sales volume of the products they create. This technology allowed us to focus on the key trends.

Another important factor was a stable team. It means that those who came to work at our company, especially key managers, remain with the company up to now. And those who founded the publishing house remain with the company as well, though their work, key tasks and objectives differ from the initial ones.

Sergei Nikolayev (Kaskad-Via Company – production of plastic windows, doors and stained-glass windows; 270 employees)

First, maybe, it is the line of activity. In 1995 we set up our first business – manufacture of confectionery and bakery products. At that time we could find our niche because the market was not occupied yet. We kept manufacturing, within the selected niche, traditional products which customers

knew well and were ready to buy by maintaining high quality and average price without letting it touch the bottom.

In respect to production of windows and doors, we employed the technologies which ousted the out-of-date products at the market. Today, house building and wood-processing factories reduced the share of traditional old-style products to 20%, while in 1994 it accounted for nearly 99% at the market. First of all, imported up-to-date products ousted out-of-date domestic products from the market. Today, new up-to-date domestic products manufactured at imported equipment have ousted imported products from the internal market.

The second factor is a systemic approach towards company's structure and personnel's motivation. As soon as we managed to develop systems offering material incentives to the personnel, this sector of business began to prove effective and could develop on its own. In other words, it could develop without heavy support by the owners or top managers.

The third factor, as was noted above, is almost a full reinvestment of the earnings, because otherwise we could not have achieved such growth and market share.

The fourth relevant factor is economy of the enterprise. We always tried to achieve low costs and focus on most capital-intensive items to employ them to the limit at the selected niche in spite of high cost.

To summarise, it is certain that key factors of success of Russian competitive companies is selecting the right niche and maintaining business orientation; adequate staffing and keeping the team; introducing and mastering new technologies (both in manufacturing – Kaskad-Via, and management – Eksmo); and constantly reinvesting profits into development. A special point is building into value-adding chains and moving towards new segments: established by young physicists, Kaskad-Via already supplied its know-how to partners in the West. Starik Khottabych followed the path of vertical integration by investing into manufacturing to ensure good quality of shipments and sales. Eksmo, a publisher, made investments into book printing and retail network.

Given a high growth rate of the Russian economy and those of other CIS countries, it is important to adopt successful business practices and improve management which is traditionally our weak point. In a conversation with L. Freinkman representing the World Bank, a Ukrainian oligarch said: “Over the last ten years people simply **learned something**. Now people from Kiev regularly travel to Moscow in search of new business ideas and then apply them in Kiev. Then their colleagues from Kharkov, Odessa etc. steal these ideas. This process of dissemination of knowledge depends little from the government and its policies.”

It is clear that adoption of experience of others, a model of overtaking development is predominant and will long prevail but time of innovations is coming. V.V. Kadannikov told about the experience of AutoVAZ on co-operation with small innovating enterprises which helped to make internal combustion engine compatible with Euro-1 standard, develop a micro-processor system of engine control within a very short time and achieve a 35% reduction of costs (Rossiyskaya Gazeta, 26.02.04).

Fourth, a primarily liberal model of development, focus on private initiative presume a certain but necessarily active role of the government in improving competitiveness. It is, above all, **creating an enabling business environment, atmosphere of trust between business and power**. There has been little headway in this area and, possibly, even a setback. But let us give room to facts. Box 2 gives examples of serious and, sadly, reasonable mistrust of authorities.

Entrepreneurs on Mistrust of Authorities

Grigory Kozhemyakin (Starik Khottabych)

A post-graduate student from Britain visited our company not long ago. She was carrying out a survey of business security in a number of companies, along various lines: economic security, computer security. And she was strongly impressed. She said: “You know, in the West everyone is afraid of competition, and here everyone is afraid of government bodies”.

We are engaged not in developing our companies and doing business but in protecting what we have created from representatives of the state; and we have to continue to grow together with it¹. It requires a double effort, at least.

Sergei Nikolaev (Kaskad-Via)

Not only our competition, but also government agencies can see that we grow. Two weeks a month my chief accountant is busy preparing documents for the state inspectorate for all kinds of absolutely legal reasons. When will this ever end? They are telling us: ‘Come on, you are big, why should we deal with all the small fish, they are poor, and you have grown large, so stop arguing and start paying’’. As a result I have to hire a man to deal with tax inspections, I have to hire a man to deal with labour inspections. It developed that the amount of documents one should fill in for every employee is so large that I need at least two men for a company of 200 employees to deal only with this issue. It is precisely those non-productive expenses that increase the cost and impair your competitive ability.

I will cite a small example. We produce pastry in two rooms now. One is old, where we originally started, and the other is new, we have already obtained full ownership rights to it and we continue to develop. We rent the old room and now the renter has started to increase the rent all the time, and he has demanded a double rent for the next two years. Basically, this is very difficult for us, but we are afraid of losing some customer base.

Nevertheless, when I was discussing this with the manager I found out he was inclined to moving all the production to one room. He said: “At least, we would be losing less time”. I asked: “On what?” And he said that it was all very simple.

Firstly it is the inspections. Over the past two weeks, for instance, we have had visits from four control bodies, three in one room and one in the other. We have grown used to the sanitary inspection, but now you get also environmental police, municipal militia and one more body dealing with immigration issues. This is why, he continued, if we have production in one room we will be getting only half as many checks because they do not come and check a company, they come to check a specific place.

And secondly, it is the certificates. We have to obtain certificates for each product type, we have got 172 of them, and it is a separate certificate for each production room. Each time we introduce a new product – when we do not know yet whether it will sell or not, will or will not pay back – we have to stump up a tidy sum to obtain a certificate. My manager says we will be losing half as much money.

So, you can see that we have touched upon a totally different aspect in our discourse. It is not the aspect of business security, but that of where we will have less headaches and problems.

Entrepreneurs believe that anti-bureaucratic laws have failed to improve the situation so far. Corruption is spreading rather than diminishing.

This “crisis of trust” owes itself to a complicated background of relationships between business and the government which will traditionally suppress private initiative in Russia. For this reason private enterprise would manifest itself not in legal business but in inventing ways to avoid any contacts with authorities. In a situation of dramatic weakening of governance in the 1990-s, this form of relationships came to inevitably apply to the business environment which increased risks and restricted possibilities for implementing business projects. This resulted in a sustainable “poor balance” – an imperfect market in imperfect governance – when the standard formulas of economic rehabilitation tested elsewhere in the world will not work.

Another constraint is mentality of owners. In order to expand business to foreign markets, one needs to either raise funds or agree with other parties which is also feared because there is a

subconscious mistrust of not only authorities but also one's business partners. Still, there are trends for the better and towards improvement of business ethics.

Thus, growth and scale of efficient business are now constrained by issues of security and mentality of owners. But, while mentality of owners is changing positively, problems of security are only aggravating.

For creating a better business environment, it is important to take efforts to consolidate law and order, and improve enforcement. But these efforts need to take into account that market economy in Russia has only a short history, that business tends towards shadow practices, that most entrepreneurs have "skeletons in a cupboard". A desire for transparency and good business reputation is only emerging. Therefore, we need to go back to the idea to **start from scratch** and find acceptable forms of terminating prosecution of specific companies for the past sins, real or imaginary, while ensuring strict obedience of laws, above all, by representatives of authorities. The administrative, civil service, judiciary and local governance reforms should rely of measures to establish a democratic order. This will involve institutional changes to be initiated by the government. The experience of Mexico where the office of a deregulation czar was introduced can probably contribute to protecting business and building up trust between business and the government.

Box 3

International Experience: Mexico's Deregulation Czar

In 1988, the president of Mexico appointed a "deregulation authority (czar)". Each month this official reported directly to the president and his economic council of ministers. Every business in Mexico, large or small, was promised equal access to the czar's office to complain about burdens associated with government rules and regulations. When the deregulation office received a complaint, it was obliged to find out why the rule existed, how it interacted with other regulations, and whether it should continue in effect. The office operated under a strict timetable: if it did not act to maintain, revise, or abolish the disputed rule within forty-five days, the rule was made void automatically.

The work of the deregulation czar over the first four years of his tenure is widely credited with greatly accelerating Mexico's reform program. It provided struggling private business-people with an effective, responsive champion at the highest level of government. The factors behind this success included:

- Unequivocal presidential support, signaling to both bureaucrats and citizens the need to comply with the czar's decisions.
- The fact that his decisions could be overruled only at the highest level of government.
- The setting of tough penalties for officials who failed to implement the rulings.
- The time limit, which ensured quick and visible results.
- The czar's staff, who were skilled in the economic consequences of regulations, in understanding complicated interactions within the regulatory field and their administrative requirements – no single person can effectively carry out a government-wide program of deregulation.

Finally, it was critical that the czar won credibility with both officials and the public by giving a fair hearing to the powerless and the influential alike, and setting a consistent record of impartiality.

Source: World Development Report 1997, p. 73.

Fifth, taking into account the uncertainties of technological development and a need to maintain the emerging and growing areas of competitiveness, the government should organise monitoring of competitiveness and identify ways of supporting emerging and expanding companies, especially innovative ones. Moreover, it is of little importance what type of activity they pursue.

International Experience: The U.S. Government's SBIR Program

The government support for fundamental research in most countries stops before commercialization is feasible. As a result, academic scientists generally have no resources, nor stimuli to continue research beyond the point, at which it is reasonable to expect publication in a scientific journal. Business finds knowledge available at this moment as still very remote from being able to be assessed in market terms, i.e., businesses are unable to calculate any rate of return on probable investment. Bridging this gap, the so-called 'innovation barrier,' shall become a primary objective for the government.

There is a number of ways to accomplish this objective. For example, the Small Business Innovation Research (SBIR) program sponsored by the US Small Business Administration (SBA) is one approach to bridging the innovation barrier. The strategy was to provide federal R&D funding for advanced, applied research that would focus on small, high tech firms, innovation, and increasing the economic return on government-funded R&D. It is important to emphasize that SBIR funds ideas rather than companies. The objective is to determine the commercial feasibility of an idea, and to assist its conversion into a commercial application.

The program operates as follows:

- Ten participating government agencies are required by law to allocate 2.5 percent of their research budget to the SBIR program. In recent years, SBIR made 3,500 grants totaling \$1.4 billion.
- Grants are awarded at least annually on a peer- evaluation competitive basis. There are two, publicly funded phases. Phase I grants provide \$100,000 for a six month initial investigation into the technical and commercial feasibility of an idea. Approximately 1/7 of all applicants receive Phase I support. Phase II grants provide \$750,000 of support for an additional two years of commercial feasibility studies, production of a prototype, etc. Approximately 40 percent of phase I recipients qualify for Phase II support. By the end of Phase II, the project initiators should be able to attract private venture capital. Seen from this perspective, the SBIR program generates a bridge from an outcome of academic R&D to venture capital or an incubator.

The SBIR program also helps enterprises conduct government-funded R&D. This has several important advantages. First, it encourages enterprises to start conducting more research. As the innovation survey shows, most Russian enterprises are not particularly active in this regard. Such a program could help alter the status quo. Second, it encourages enterprises to find commercial outlets for the government-funded research, which they conduct. This, in turn, will help to stimulate high tech start-ups and spin-offs.

Source: Vladimir Drebensov. 'DIVERSIFYING RUSSIA'S ECONOMY – KEY TO SUSTAINABLE GROWTH.' February 2004, mimeo, pp.11-12.

Other examples are Israel's programme for support of innovative projects implemented by universities; Foundation Chile programme.

International Experience: Foundation Chile: Incubating New Enterprises

In the 70s, following bold macroeconomic reforms, Chile found itself with a liberal and stable macroeconomic climate yet with sluggish export growth. For a country with impressive mineral and natural resource wealth, agro-industry appeared to be a promising route to follow, yet institutional infrastructure (leasing companies, demand detection, market information etc.) was lacking. Agro-processing was dominated by huge enterprises created by Allende, now privatized but still monopolists. Bottom-up facilitation of new agri-processing value chains became the task of Foundation Chile – a hybrid organization combining the features of project development facility (to identify promising opportunities at the world market), technology incubator (to adapt promising agro-industrial technologies and establish firms to pilot the new technology) and a seed venture fund (to finance the firms with revenue generation once the firm is sold to private investors). Foundation Chile is widely credited for the ensuing surge of Chilean exports in reared salmon, tomato paste, table grapes and other export products.

Social returns of Foundation Chile are much higher than private returns (upside gains upon selling the successful firms) because of the demonstration effect of new SMEs (bringing new technology up to scale in a number of firms) and technology transfer effect. Hold no illusion: Foundation Chile is a rather untransparent institution and not surprisingly, it made many mistakes by investing into technologies later proved unsuccessful. It is untransparent both in its origin (it is an arranged marriage between ITT corporation which put 50% of an initial endowment in exchange for retribution of its assets nationalized by Allende and the government of Chile) and its operational transparency (a hybrid of project development facility, technology incubator and venture capital fund). But these caveats make Foundation Chile all the more interesting: it is a second-best response to a highly imperfect institutional environment.

Source: Yevgeny Kuznetsov. 'Waking up, Catching up and Forging Ahead: Mechanisms for Innovation Based Growth in Russia.' 2002, mimeo, pp. 23 - 25.

It is noteworthy that we have nothing against time-tested methods of public assistance to improvement of competitiveness such as export loan guarantees, tax credits, technological parks, economic zones and shared direct investments into promising projects, for example, promising types of new aircraft, as it was practised in 1990-s.

By the way, an attempt to hold tenders of investment projects undertaken by the Ministry of Economy at that time was a failure not because they were poorly organised but primarily because the government defaulted on its obligations and allocated only a fraction of what was promised. Our experience is often negative because we seldom go through with what we started. Probably it was premature to hold investment tenders until the financial system was stabilised. But the current situation is different. A tender of mega-projects organised by the Ministry of Industry and Science in 2002-2003 was close to this idea.

We will not dwell on these methods primarily because they are well-known, and one has only to apply them moderately within the framework of liberal policies to avoid encouraging again dependant's mentality.

We point out programmes like SBIR as something principally new for us since they solve the problem of revealing competitive ideas, people and companies which should be encouraged. It is important, rather than identify priority sectors, to **create a mechanism for identifying and encouraging areas of competitiveness.**

Sixth, the government should contribute to improvement of competitiveness in order to encourage companies to improve their competitiveness and modernise. It should also ensure ground-level conditions of competition. Studies of structural changes in the Russian industry in 1997-2002 conducted by the SU-HSE⁴ suggested that low rates of modernisation were due not so

⁴ Y. Yasin. *The Non-Market Sector. Structural Reforms and Economic Growth. The Liberal Mission Foundation, M., 2003, p.p. 11-17, 22-40.*

much to shortage of finance as to a lack of business incentives. Companies operating outside the most profitable sectors are more active and better performing. A high share of non-market sector (natural monopolies and utilities) with low state-controlled prices undermine incentives to make investments into energy-saving and introduce new technologies. In 2002 6% of manufacturing companies out of a sample of 1000 would generate negative added value. The share of such companies (which we also refer to the non-market sector) even increased. Once prices of gas and energy increase to the market level, their share would increase to 12%. A considerable part of companies would show negative net saving, i.e. would spend their capital down the drain.

This situation is typical of the entire Russian economy. There is a group of companies whose products are competitive internationally. They belong to the global economy. Their success was due not only to their sectoral association (oil, gas, metal) but also to managerial teams which were able to draw on available competitive advantages.

Companies which achieved domestic competitiveness are another group. Sometimes their success owes itself to the nature of their products: it is expensive to export construction materials or food from Germany. After the default of 1998 these companies exploited the “window of opportunities” which emerged as a result of devaluation of the rouble, and reinforced their positions in the domestic market.

Lastly, there are companies of the non-market sector mentioned above which continue to exist due to access to public budget resources, subsidies or other forms of government support, direct or indirect.

Policy of competitiveness should purport to raise the **level of requirements to company efficiency** and get rid of the third group. More exactly, there will always be a lower segment of efficiency but, rather than including loss-making dependants, it should include companies with performance below the average whose owners are thinking of selling, restructuring or liquidating their businesses because there are more profitable investment opportunities around.

To achieve this, the non-market sector should be dramatically reduced, import tariffs gradually cut down to the average rate of 3-4%, non-tariff barriers largely removed and anti-trust policies reinforced.

Before being liquidated, the Ministry of Anti-Trust Policies was blamed for inefficiency but, frankly, it was not always allowed to pursue consistent policies: monopolists would use their high connections to undermine actions of anti-trust authorities while the latter would prefer to mess around with trifles rather than conflict with the high and mighty. These problems were even more aggravated in regional markets. Unfair conditions of competition were set by the prevailing power of bureaucracy which merged with the business they favoured. This system has to be done with.

Seventh, it is important to encourage in every way foreign investments, co-operation of Russian companies with major international corporation with the purpose of building into value-adding chains, co-operation with carriers of advanced technologies, penetration into markets of increasingly sophisticated finished products, looking for own niches to develop and distribute innovative products. It is not so much about competition in already occupied markets as creating new markets in co-operation with the best firms.

It is worth pointing out a positive example of co-operation in the aircraft industry between Kaskol, a Russian company, and Airbus Industries from Europe, or between NPO Saturn and Snecma Moteurs.

Building into Value Adding Chains: Example of Aircraft Manufacturers

KASKOL Group

The experience of world market entry by efficiently building into the global cycle of development and production of high-technology products

In the 1990s, due to a dramatic decline in government defence orders, the management of KASKOL Group which was managing the assets of aerospace and defence enterprises had to ensure work load of manufacturing facilities and qualified personnel.

An important area analysed by KASKOL specialists was co-operation with international manufacturers of aerospace equipment to build Russian companies as suppliers into international manufacturing chains.

The R&D and aircraft component supply markets were quite promising as Russian companies and design bureaux, on the one hand, had the required personnel, technologies, production culture and research school while, on the other hand, manufacturing facilities capable of operating to high capacity without detriment to the main production programmes.

Aircraft component supplies are a very broad segment of the international market. U.S. and European companies will place abroad the orders worth nearly USD 25 billion for aircraft frame components alone. Winning a share of this market would ensure work load of production facilities and employment of highly skilled specialists, and will eventually provide Russia with tens of millions dollars.

In May of 2002 the KASKOL Group was selected by Airbus as the principal partner for the programme of co-operation with the Russian aerospace industry including areas such as supplies of materials, R&D, engineering development and production of components.

As a result of KASKOL's co-operation with their international partners, the ECAR engineering centre established jointly by KASKOL and Airbus Industries, a West European aircraft manufacturer, was opened in Moscow in June of 2003. The ECAR became the first design bureau established by Airbus in Europe outside the territory of participating countries while Russia became part of international division of labour in a high-technology sector such as aircraft engineering at the R&D level.

The centre will co-ordinate Airbus's development efforts with those of Russian design bureaux, and will also produce work drawings for production of Airbus parts in Russia.

A contract for production of Airbus components (A320 body structural elements) at Nizhni Novgorod's Sokol Plant (part of KASPOK Group) was signed on December 19, 2003. As a result, a Russian company for the first time became part of the production process of the world's most successful aircraft company known internationally for its high requirements to suppliers.

Nizhni Novgorod's OAO Gidromash is Striving to Participate in the Programme for Development of Western Europe's A 400-M Transport Aircraft

Nizhni Novgorod's Gidromash is striving to participate in the programme for development of Western Europe's A 400-M transport aircraft. According to Vladimir Luzianin, president, the company expects to supply landing gear components.

He said that the company had long-term and sustainable links with principal landing gear producers in Europe for which they were making the main units of landing gear. This particular form of international co-operation is expected to be used in manufacturing landing gear for A 400-M, to be shipped as early as in 2008. This work will require technical upgrading of the plant's facilities, with new jobs to be created for highly skilled specialists, something which in absence of domestic aircraft development will allow to maintain high-quality technical staff.

According to Mr. Luzianin, production of landing gear for A400-M will involve the use of new Western technologies of surface protection of parts from corrosion which will allow to almost get rid of production damaging for the region's ecology. Gidromash's president said that, apart from this and other advantages, involvement in A400-M project will ensure full co-operation of Russian companies in the international subcontractor market including on the shared risk basis.

Russian Regional Jet (RRJ)

'Sukhoi Civil Jets', a division of Sukhoi Aircraft Military-Industrial Complex and the main contractor in the Russian Regional Jet project, have organized a tender for the motor for this jet. Such companies as BMW/Rolls-Royce with BR-700, General Electric with their CF-34 and Pratt & Whitney Canada

with motor PW800 have participated. And the French Snecma Moteurs together with NPO Saturn have offered their jointly developed motor SM146 with the draught of six to eight tons. According to Andrei Ilyin, Director of Sukhoi Civil Jets, rejecting the ready-made Western motors is explained by the fact that the joint development would grant Russian motor manufacturers access to state-of-the-art technologies. Moreover, a jointly developed motor would cost 40 per cent less than imported analogs. As a matter of fact, Snecma Moteurs manufactures motors for the French air forces. But it also produces, together with the General Electric from US, a civil motor of the CFM-56 family. This motor is installed on medium-range jets Boeing 737 and Airbus A319/320/321 and the long-range Airbus A340.

In early May 2003, in Paris Yuri Lastochkin, Director General of NPO Saturn, and **Jean-Paul Bechat**, President of Snecma Moteurs, signed an agreement on the production of a new motor, SM 146. According to Mr. **Bechat**, the parties agreed to share the expenses (circa Euro 400 million), participation in the R&D and the sales revenues fifty-fifty. According to Mr. Lastochkin, if approximately 150 Russian Regional Jets are sold, the expenses will pay off, and the motor itself is the last chance for Russia to re-enter the world market of civil motors.

Jean-Paul Bechat, President of Snecma Moteurs Group

The motor project that we participate in together with NPO Saturn and the jet project in which we participate together with Sukhoi correspond to the expectation of the regional market because they have rather low cost. Unlike its competitors, this jet will have one and the same motor for an entire range of models, from 75 to 95 seats. All analyses show that in the next 20 years the regional market will ensure the sales of approximately 600 jets. (The Kommersant, 20.05.2003)

Jean-Pierre Cojan, Executive Vice-President, Snecma Moteurs

All the latest successful projects in commercial aviation were international. And all entirely national projects failed. Speaking of motors, we have developed CFM56 together with the Americans. CFM's competitor motor, V2500, is a US-Japanese-British-German product. Four countries take part in producing jets for Airbus. Even with Boeing 777, participation of the Japanese party is over 30 per cent. International cooperation allows to spread risks, use all the best that other project participants have achieved and get access to a large market. I cannot see why it should be otherwise in Russia. In the next 20 to 30 years jet construction projects that will be successful in Russia will be international. This is why I believe that RRJ is a good project.

We think that in the next 20 years the fleet of regional jets will be from 7000 to 8000. In order to derive the required amount of jets one has to multiply this by two and add spare motors. This makes approximately from 15000 to 20000 jets. According to catalogue prices, the existing jets cost from USD 3 million to USD 3.5 million. It makes approximately USD 50 billion. Naturally, we together with our partner NPO Saturn hope to obtain a certain share in this market. We will leave to NPO Saturn 20 per cent (in cost terms) of the work that has to be done. (The Vedomosti, 26.08.2002)

Yuri Lastochkin, Director General, OAO NPO Saturn

Our engine manufacturers need an access to modern technologies. Lacking these, we can only make engines suitable for the domestic market where requirements to noise and emission are comparatively low. We cannot develop a modern engine complying with international standards without outside help. Moreover, it is unlikely that we can ensure certification of an engine under U.S. or European standards without involvement of a Western partner. (Kommersant, 20.05.03).

Foreign investments can be primarily encouraged by creating generally enabling national regime for investors: low and transparent taxes, protection of property rights and performance of contracts, independent court, increasingly honest and efficient bureaucracy. There is no need in subsidies and preferences – it is important to ensure that investments in Russia bring more profit than elsewhere. Investors should have an impression that working here today is better than yesterday while tomorrow is better than today.

Eighth, there is no basis to oppose extractive and processing sectors, still less to consider the former as a permanent source of subsidies for the latter including by way of large-scale withdrawals of royalties and reduction of taxes for manufacturers of finished products. All sectors should be profitable and comparable to their international competitors in terms of their

operating environment. The issue is to increase output of competitive products with a higher added value on the basis of companies from sectors producing only raw materials and primary processing products. The most typical example is timber processing (the example of Finland is highly demonstrative), and also oil processing and petrochemistry, metallurgy.

Ninth, it is absolutely gainful to **invest into science and education**, given, of course, an efficiently organised control of expenditures, in co-operation with private business, with the share of the latter to be gradually increased. A special attention should be paid to the stage of transfer of scientific developments for production and economic application in general, i.e. commercial use of findings of applied sciences. A programme along the lined of the above mentioned SBIR can play a key role here. There should be a **focus on transfer of knowledge and technologies**. In Russia the federal government has been traditionally regarded as a source of financial support. However, many companies (especially medium-sized) are not only facing a shortage of funds but also a lack of knowledge on how to develop a business and expand into new markets. For this reason policies of competitiveness should include mechanisms for transfer and dissemination of managerial knowledge. In particular, federal funds may be used to support drafting of project proposals for federal tenders. Special training programmes on specific problems related to WTO accession, introduction of new quality standards etc. could be organised for representatives of business on the basis of partially shared financing.

Further, the generally successful experience of the Presidential Programme for retraining of managerial staff could be drawn upon. Established in 1997, it has been used to give the second financial economic education to nearly 30 thousand middle Russian managers through semestral study tours with foreign companies. As these people learned from their colleagues working for similar companies in Europe, they got the skills required to improve business processes in their own enterprises and acquired the incentives to introduce managerial innovations. We believe that a higher quality of management in Russia's real sector over the last few years largely owes itself to implementation of this programme. Meanwhile, the effect could have been greater if business circles were actively involved in identifying the programme's priorities.

Improvement of skills is a critical objective for government officers as well. Representatives of business also emphasis this factor.

Box 7

Qualifications of Civil Servants

Oleg Novikov (Eksmo Publishing House)

The main problem is not that there are too many bureaucrats but that there are no professional bureaucrats at any level. Correspondingly, people who are supposed to professionally administer a particular area and who have no understanding how they should do their job will encroach on adjacent areas. Thus, there is a kind of a vicious circle. One of the problems is that people at their jobs do not possess adequate skills and knowledge.

The only hope is to train more qualified specialists because there is a general lack of good managers and specialists. I think that there are practically no professionals among government officials.

In this context it is necessary to state that the administrative reform is a prerequisite of enhancing Russian economy competitiveness – taking into consideration the fact that inefficiency of the government causes considerable unproductive costs for business. In our view realization for the civil servants of a program similar to the Presidential managers' training Program – including internships in the ministries of other countries (see, for instance, the European Union practice) – can become an important measure in shaping a competitive government, alongside with introduction of the new government structure, restructuring of the functions and responsibilities of the authorities. Selection procedures working in Russia and abroad allow to choose for participation in these programs the best and most energetic

representatives of the respective social groups. Their personal experience can lay the foundation for creation of a new culture of partnership between public structures and business.

In a modern environment, economic rehabilitation and mechanisms for sustainable and dynamic economic development should be initiated by business and regions. The national government's function is, rather than independently define and implement long-term priorities (as it was 40 years ago but is practically impossible in the modern global and changing world), to create conditions for mobilising resources and implementing the opportunities available to the private business.

International experience suggests that a successful integration into the global market will increasingly occur at the level of individual regions rather than national states – or this process will at least start at the regional level. An example of how the regional authorities can create conditions attracting investments of large foreign companies is given in box 8.

Box 8

How did FDI Come About? Facilitating Manufacturing-driven Growth in Aguas Calientes, Mexico

In the last decades, the state of Aguas Calientes, about 250 miles north of Mexico City, has experienced an extraordinary growth performance. The state is one of the smallest in the country with 851,000 inhabitants in an area covering only 0.3% of the national territory. Traditionally, local economy had relied primarily on agriculture, complemented with some production of wine and garments. This situation has changed radically since the early 80s, when Aguas Calientes has experienced high rates of growth in both manufacturing and exports. This growth has largely been fueled by FDI inflows, particularly from the Japanese automobile and U.S. electronics industries. How did this growth come about? The process could be described in several steps.

1. Self-evaluation of needs. In 1974, the new state governor decided to pursue a radically different development strategy, and shift emphasis from agriculture to manufacturing. His first action was to determine the main needs of local manufactures. This was done by asking the business owners in what were then the most advanced sectors, as well as representatives of trade unions. The results of the initial survey were not encouraging, for they realized that the state lacked important conditions to attract investment, particularly basic infrastructure. At the same time, it revealed significant market and institutional advantages such as low land and labor prices and existence of a considerable pool of labor with some manufacturing experience. More importantly, local business and labor leaders expressed their desire to support the state government's effort towards industrialization.

2. Improving the business environment for first movers -- an industrial park. In 1973, NAFIN, the federal industrial development bank, decided to support the development of medium cities all over the country as part of the National decentralization program. The state government of Aguas Calientes took advantage of the program by creating a trust for the Industrial Park and donated 200 ha, 40 of which were urbanized with the support of NAFIN. This assistance included the creation of physical infrastructure, provision of business development services, plus a very wide array of support mechanisms such as fiscal incentives and project evaluation assistance.

3. Firms invest, private industrial parks flourish, the image of the state changes. This effort to strengthen the necessary infrastructure and services soon brought new investments and a broadening of the local manufacturing base. In the late 70s, several large national firms in metal processing and automotive components opened production in the state. Since the first industrial park was so successful in attracting new companies, 3 more parks were built. Positive investment trends were accompanied by the creation of important networking institutions, such as business chambers, where businessmen gather to exchange views that facilitated problem-solving and dispute resolution. This also led to a change in the image of the state: Aguas Calientes was no longer perceived by the rest of the country as an agricultural state. With the critical mass of suppliers and buyers present, the state became attractive for firms searching for an adequate location of new plants.

4. Attracting a first multinational corporation. The first international investor in Aguas Calientes was

Texas Instruments (TI), which started exploring options for a manufacturing plant in Mexico in 1979. The government worked intensively with TI to address various legitimate concerns of the investor. For instance, the waiver was obtained from the country president on the existing limitations on foreign ownership. Among other factors that proved to be attractive for TI were stability of the labor force and high participation of women in the labor force, particularly important for the electronics industry.

5. First multinational comes, others follow. Once TI decided to settle in Aguas Calientes, Xerox and Nissan soon followed. These three major multinational firms have all played an important development role by giving their employees access to a global knowledge networks and modern technologies.

6. Current challenge. Even though both government and firms have actively pursued vendor development programs, the amount of inputs provided by local firms to multinationals is still small. This is the current challenge.

Two institutional features were particularly noteworthy to support this progression: local development agency and public sector entrepreneur.

- *Catalyst of private-to-private and private-public coordination*

The Commission Estatal de Desarrollo Economico y Comercio Exterior (CEDECE) is possibly the most active institution promoting regional economic development in Aguas Calientes. CEDECE has acted as a catalyst and information broker for other agents: government and firms, federal and local, firms and universities. CEDECE's main objectives were attracting foreign investment and supporting local small and medium enterprises. The development of industrial park infrastructure was among the most important programs, it helped to start moving industry outside the capital city.

- *Public sector entrepreneur*

New collaborative actions were catalyzed by a small group of dedicated individuals -- champions of change, who created and then broadened a network of private and public actors involved in cooperative problem-solving. It was led by the General Director CEDECE Carlos Lozano, a dynamic individual with the ability to listen to the private sector and gets things done in most difficult circumstances. He represents an institution of public sector entrepreneurship, responsible (and accountable) for innovative solutions to improve a local investment environment and competitiveness.

Source: Freinkman, Lev. 'Instruments to facilitate private sector development and diversification: suggestions for regional governments based on international experience.' 2003. A Note prepared for the Moscow Development Center. Mimeo, pp.8-9.

Freinkman, Lev. «Instruments to facilitate private sector development and diversification: suggestions for regional governments based on international experience.» 2003. A Note prepared for the Moscow Development Center.

Specific business projects are always tied up to a specific location and have a character of their own. This character cannot be practically accounted for at the federal level, especially as regards medium-sized business which is shaping a competitive environment in the economy. In this respect, much will depend on regional and local authorities which may create conditions for business development and implementation of efficient business projects or fail to do so. Essentially, there should be regional policies of competitiveness which are increasingly a critical factor of development in those sectors where medium-sized business is predominant.

Here regional authorities (once they are competent and motivated) have the advantage of being close to the potential project, its sales and capital markets, and also of being interested in implementation of each specific project capable of producing a rapid economic, budgetary and social effect. Moreover, small and medium-sized projects which mean a serious success for practically any region may be inconspicuous and of no interest from the federal government's perspective.

Therefore, the federal government should encourage the initiative of regional and local authorities in improving the business environment, identify and disseminate the best practices of this kind. This objective can be achieved through a **tender of regional projects for improving competitiveness**⁵ which would assume distribution of federal transfers to regions on the basis of new principles – not only to the poor and weak but also to those which are doing something for their own development, improvement of the business climate, raising investments etc. This approach was successfully tested in large federal states such as Argentine, Mexico and Brazil, and was also implemented in Russia, on a more narrow scale, within the framework of the Programme of Regional Finance Reform organised by the Ministry of Finance on the basis of the World Bank's loan.

The principle of shared financing will ensure rational use of funds. Regional authorities and private business will confirm their undertakings by allocating the required resources, in cash or in kind. The tender will be held for the amount to be contributed by the federal government. One of the criteria for selecting projects is how much private business and regional authorities are going to contribute.

To summarise, it is certain that this tender can perform three functions:

- ◆ An investment tool for regional administrations and private sector which will allow them to jointly implement meaningful initiatives and transformations.
- ◆ A tool for co-ordination of activities of the federal government, regional governments and interested private companies within the framework of joint public-private projects for improvement of competitiveness.
- ◆ A mechanism for dissemination of the best practices. The idea is that promising innovative solutions emerging in a region may be rapidly transferred elsewhere through the mechanism of the tender.

This report does not attempt to put forward well-founded recommendations on policies of competitiveness. It is a presentation of results of a research project. We have only attempted to summarise what is known and give a general picture of the situation. We would like to underline that, once competitiveness is a right national idea, the underlying policies should be focused at long-term perspectives, decades of development with an understanding that it is not a percentage of growth, not tomorrow's bread that matters but profound changes of mentality, national culture and destinies of the people of Russia, and, respectively agreement of all groups of the national elite.

⁵ See in more detail: Y. Kuznetsov. *Waking Up, Catching Up, Going Up: Mechanisms for Launching Russia's Investment Growth*. Preprint WP5/2002/07 – M., SU-HSE, 2002.