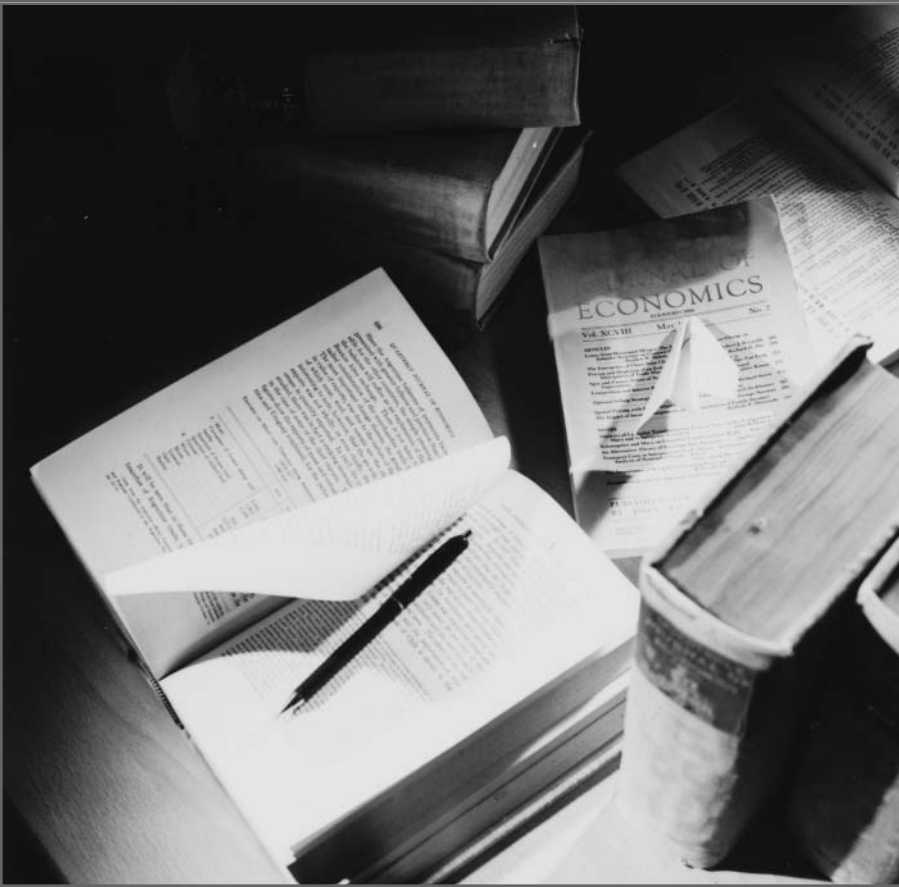




Center for Economic and Financial Research
at New Economic School

№ 24

January 2006



Analytical Report on Growth and Investment in Russia's Regions "Unleashing the Potential"

CEFIR Policy Paper series

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Executive summary

Progress in investment and growth in Russia's regions has been limited and highly uneven, despite the many potential opportunities

The pace and nature of reforms has contributed to the weak and uneven progress in the regions

Progress in investment and growth in Russia's regions has been limited and highly uneven, despite the many potential opportunities. The institutional, political, fiscal and social structures in the country are all contributing to the gap between potential and performance. Although there have been some improvements lately — in deregulation, fiscal reform and some poverty reduction — the differences persist and in some areas even seem to have increased. This report helps explain why, and discusses how the regions might effectively address these issues.

What explains regional development in Russia?

Apart from the obvious factors, such as geographical location, urban-rural differences and the availability of natural resources, the pace and nature of reforms has also contributed to this weak and uneven progress. A number of structural reforms have had regional impact, but are driven mainly from the center.

The choice of reforms

The current reform process in Russia deals mainly with state institutions. It is an ambitious and very complex process. Although the Russian Government has acknowledged the importance of these reforms, it has not demonstrated the capacity to implement them all, at least not prior to the elections in 2007 and 2008. In the best case scenario, the realization that reforms must be prioritized and sequenced will help the government to identify the most urgent reforms and to implement the reforms already introduced.

Moreover, it is not certain that all reforms are conducive to growth and investment. We have found that some reforms have been offset by countervailing reforms. The Putin administration has, for instance, simultaneously implemented political and fiscal reforms that seem to be working in opposite directions.

The fiscal federalism reform is aimed at the stricter division of responsibilities between the center and the regions in order to (i) decrease the motivation and technical opportunities for the regions to use political and social threats

while bargaining for transfers from the central government, and (ii) improve the incentives for the regional governments to develop their own tax base. The reform was designed for a political system with elected governors, and it is not yet clear how it will work in the new system of appointed governors, but it is very likely this political centralization will offset some of the incentives created by the fiscal decentralization.

Lack of structural problem-solving

There are also a number of structural problems limiting the impact of reforms. The fight against poverty, inequality, and unemployment would be much more effective if certain structural issues were addressed coherently. The institutional development of the labor market is an illustrative example. Although there is a new labor code, the labor market is still underperforming due to remaining structural problems resulting in labor market segmentation and low levels of labor mobility. This is important as labor migration could eliminate some of the variation in real income, wage, and unemployment rates. Segmentation results in the creation of primary and secondary labor markets with more secure and well-paid jobs concentrated in the former. The mobility from primary to secondary market is very restricted. Certain groups and regions may therefore be permanently stuck with low-paid jobs. There are some important structural explanations to these institutional imperfections.

First, capital does not reallocate to regions with cheap qualified labor because Russia lacks developed capital market institutions and capital mobility is very low. Second, migration may not be worth the costs. These consist of differences in rents, the cost of registration at the destination (*propiska*), the fixed cost of moving, and the cost of job searching. Third, the financial constraints effectively attach the population to the region, reducing outside options and wages. A third of the Russian population is locked in such poverty traps. Undeveloped housing and mortgage markets have made migration even more difficult for the poorest groups. Moreover, firms that inherited local monopsonistic or oligopsonistic control over workforces can obstruct workers' ability to migrate through various attachment schemes.

The extent of reform capture

The current relationship between business and the state in Russia is characterized by crony capitalism and corruption. Big and politically connected firms influence the rules of the game, create obstacles for the emergence and development of competitive (and often more productive) businesses and change the direction and speed of economic reforms. The politically powerful firms have, in other words, captured the state bureaucrats who benefit greatly from their influence. This impedes small business development and the growth of firms lacking political power. As state capture increases, the output of small businesses and retail turnover declines. Moreover, growth in profitability, productivity, sales, employment, and investment of firms without political connections slow down in environments with high state capture. Regional budgets are negatively affected as tax collection decreases and arrears to the budgets increase.

The level of capture is found to depend on industrial concentration, level of education and voter awareness. A firm's political power is determined by its size, both in terms of finances (ability to bribe) and employment (social significance), as well as ownership structure. Given the initiatives introduced by the Putin administration, including tax and administrative reforms, one could expect a significant decrease in the level of capture in the regions and a reduction of the negative effects on the regional economy. However, surveys show no significant change in the level of capture in the regions: the level of state capture grew gradually during Yeltsin's first term and remained almost unchanged during Yeltsin's second term and Putin's first term.

During Yeltsin's terms, firms with bigger workforces, larger output and capital, firms in extract industries, and firms that belonged to bigger financial-industrial groups were more likely to have political influence. Things have not changed dramatically since then. During Putin's presidency a concentration of political power in the center can be seen: enterprises that belong to the federal government have become the most effective lobbyists under Putin's governance, whereas firms engaged in loans-for-shares schemes and firms that belong to regional government lost their political power.

What can regions do to boost regional development?

Although much of the development affecting Russia's regions is driven from the center, research has produced evidence showing that the willingness to implement reforms and a clear understanding of the determinants of new sources of growth on a regional level matter as well.

Improving the willingness to implement reforms

Actual implementation of sound and necessary reforms has been a substantial challenge in most transition countries, and Russia is no exception. Based on evidence from the crucial administrative, land, and customs reforms, we conclude that actual implementation has clearly positive results for growth and investment, yet there are substantial regional variations in this implementation.

The evidence from an administrative reform survey shows that the regulatory burden for small businesses remains high, and that the problems stem from regional and local enforcement rather than federal legislation. There are big variations in regional performances, but one cannot simply rank regions as "good" or "bad," since there are significant differences in the severity of each problem connected with administrative burdens within any one region. We see three regional determinants for administrative reform progress: local fiscal incentives, less concentration of output, and a high pre-reform presence of small business in a region.

The land reform survey shows that Moscow oblast and Nizhny Novgorod have the largest shares of firms owning their premises, a factor that has resulted in increased investment and small business growth. This seems to indicate that regions can boost their attractiveness by simplifying access to land and premises.

According to the customs survey, despite some modest improvement in customs clearance and border crossings, a major problem is arbitrary implementation by customs officials. There were also some notable regional differences in the implementation of the customs reforms. The demand for bribes has declined, while prices for intermediaries have risen in

The willingness to implement reforms and a clear understanding of the determinants of growth on a regional level matter

Entrepreneurs and innovations crucial for sustainable growth

Government needs to build a better infrastructure and institutional environment to allow a more efficient use of human capital

some regions, suggesting that corruption is being institutionalized.

Stimulating new sources of growth and investment

Stimulating new sources of growth is arguably the most important feature of any growth policy. The importance of entrepreneurs and innovations for sustainable growth is firmly established. However, there has been no clear consensus on the determinants of entrepreneurship in Russia and the type of innovations Russian firms are or ought to be engaged in, making it difficult to devise policies to encourage entrepreneurial development and innovations.

A new survey on entrepreneurship in Russia concludes that the social environment in general and social networks in particular seem to play a very important role in sparking entrepreneurship, whereas cultural differences and values are found to be less important. Why are there not more entrepreneurs? Three main reasons stand out in Russia: insufficient funds, lack of entrepreneurial skills, and risk aversion. Lack of money can be interpreted both as a credit constraint and as a lack of drive to raise funds. Thus it seems that individual characteristics are important determinants in the decision to become an entrepreneur.

It is widely believed that Russian firms do not innovate. This belief is based on the conjecture that Russian firms should conduct R&D

and introduce completely new products with the same intensity as do firms from developed countries. At the same time, "distance to frontier" theory suggests that firms from countries, located far from the technological frontier, can grow quite fast not by introducing new technologies, but by copying technologies and products developed in other countries¹.

When asked why they innovate, most firms mentioned the need to improve their financial situations or to decrease costs. Increase in market share and access to new markets is a part of development strategy for more than 60 percent of innovating firms, although less than 40 percent of them plan to move into international markets. Lack of finance is reported to be the major obstacle to innovations. Retained earnings is the major source of funding for innovations, so it is not surprising that more than 80 percent of firms named shortage of funds as a serious obstacle for innovations. Lack of external funding, be it government support or private funds, is the second most important factor.

Due to Russian technological backwardness, imitating rather than innovating is an efficient growth strategy. However, this does not mean that the government does not have to think about ways to build a better infrastructure and institutional environment, both of which will allow a more efficient use of currently existing human capital capable of making innovations, not only imitations. This task will become more and more urgent as the Russian technological position improves.

¹ Acemoglu et al (2002a) and Acemoglu et al (2002b)

Краткий обзор

Прогресс российских регионов в области привлечения инвестиций и экономического роста остается недостаточным и происходит очень неравномерно, несмотря на значительный потенциал в регионах. Свой вклад в разрыв между имеющимися возможностями и результатами деятельности вносят все основные структуры страны — институциональные, политические, бюджетные и социальные. Хотя в последнее время произошли некоторые улучшения в области дерегулирования экономики, бюджетной реформы и сокращения бедности, тем не менее этот разрыв сохраняется и в некоторых случаях даже возрастает. Настоящий отчет посвящен объяснению причин сложившейся ситуации и способам эффективного выхода из нее.

Какие факторы определяют региональное развитие России?

Недостаточный и неравномерный прогресс в регионах обусловлен не только очевидными факторами — географическим положением, различиями между городом и селом, наличием природных ресурсов, — но также темпом и характером реформ. На региональное развитие влияет проведение ряда структурных реформ, которые, однако, в основном осуществляются из центра.

Выбор реформ

Нынешние реформы в России главным образом направлены на государственные институты. Это глубокий и очень сложный процесс. И хотя российское правительство заявило о важности этих преобразований, оно не продемонстрировало свою способность осуществить их в полном объеме, во всяком случае до выборов в 2007 и 2008 гг. При наиболее благоприятном развитии определение приоритетности и последовательности реформ поможет правительству выделить самые актуальные из них и реализовать уже начатые.

Кроме того, нет уверенности, что все реформы способствуют экономическому росту и инвестициям. Мы пришли к выводу, что некоторые реформы противодействуют другим: например, одновременно реализуемые правительством политические и бюджетные реформы, похоже, работают в противоположных направлениях.

Бюджетная реформа направлена на более четкое распределение полномочий между центром и регионами с целью: а) снизить стимулы и технические возможности регионов оказывать политическое и социальное давление на федеральное правительство при обсуждении вопроса о трансфертах из федеральной казны; б) повысить стимулы региональных администраций к развитию собственной базы налогообложения. Реформа разрабатывалась для политической системы с избираемыми губернаторами, и еще не ясно, как она будет работать при новой системе с назначаемыми губернаторами. Можно предположить, что политическая централизация ослабит некоторые из стимулов, созданных в результате бюджетной децентрализации.

Недостаточность структурных решений

Существует множество структурных проблем, ограничивающих эффективность реформ. Борьба с бедностью, неравенством и безработицей была бы гораздо успешней при их более последовательном решении. Примером тому может служить институциональное развитие рынка труда. Несмотря на принятие нового трудового кодекса, рынок труда все еще недостаточно эффективен из-за остающихся структурных проблем, приводящих к его сегментации и низкому уровню мобильности трудовых ресурсов. Это важно, поскольку трудовая миграция могла бы способствовать частичному устранению различий в реальных доходах, заработной плате и уровне безработицы по регионам. Сегментация приводит к появлению первичного и вторичного рынков труда. При этом наиболее безопасная и лучше оплачиваемая работа сконцентрирована на первичном рынке, а перемещение трудовых ресурсов с него на вторичный рынок очень ограничено. Таким образом, некоторые группы и регионы могут быть вынуждены постоянно довольствоваться лишь низкооплачиваемыми рабочими местами. Существует несколько важных структурных объяснений этим институциональным пробелам.

Во-первых, капитал не перераспределяется в регионы с дешевыми квалифицированными трудовыми ресурсами, потому что в России нет развитых институтов рынка капитала и подвижность капитала очень низка. Во-вторых, миграция может и не окупить связанных с нею затрат.

Несмотря на значительный потенциал, прогресс российских регионов по привлечению инвестиций и экономическому росту недостаточен и неравномерен

Недостаточный прогресс в регионах обуславливается темпом и характером реформ

Эти затраты для мигранта состоят из разницы в плате за жилье, стоимости регистрации в месте пребывания, оплаты проезда и поиска работы. В-третьих, ограниченность в средствах сильно привязывает население к региону проживания, сокращая возможности выбора работы и заработной платы за его пределами. Треть населения России находится в такой ловушке бедности. Недостаточная развитость жилищного и ипотечного рынков еще более снижает мобильность беднейших групп населения. Более того, предприятия, которые унаследовали местный монопольный или олигопсонический контроль над рынком труда, могут препятствовать миграции своих работников посредством различных схем их удержания.

Степень "захвата" реформ

Для нынешних отношений между бизнесом и государством характерны "кумовской" капитализм и коррупция. Крупные и обладающие политическими связями компании влияют на правила игры, создают препятствия на пути появления и развития конкурентоспособных (и часто более производительных) предприятий, изменяют направление и темп экономических реформ. Иными словами, фирмы, обладающие политическим влиянием, захватили контроль над государственными чиновниками, которые извлекают из этого немалую выгоду. Такое положение дел препятствует развитию малого бизнеса и росту фирм, у которых нет политического влияния. При увеличении степени "захвата" государства снижаются эффективность малого бизнеса и объем розничного товарооборота. Кроме того, рост рентабельности, производительности, продаж, занятости и инвестиций фирм и предприятий без политических связей замедляется в среде с высоким уровнем "захвата" государства. А соответствующее снижение налоговых поступлений и рост бюджетной задолженности отрицательно отражаются на региональных бюджетах.

Уровень "захвата" государства зависит от концентрации производства, уровня образования и сознательности избирателей. Политическое влияние компании определяется ее размером как в финансовом плане (возможности подкупа чиновников), так и в плане занятости (социальное значение), а также структурой собственности. Инициативы российского правительства, включая налоговую и административную реформы, должны были привести к существенному снижению уровня "захвата" государства в регионах и сокращению его негатив-

ного влияния на региональную экономику. Однако исследования показывают, что каких-либо существенных изменений в уровне "захвата" государства в регионах не произошло: он постепенно возрастал в период первого срока правления президента Ельцина и остался почти неизменным во время второго срока его пребывания у власти и первого срока президентства Путина.

В период первого срока правления президента Ельцина политическое влияние в первую очередь приобретали предприятия с большим количеством работников, выпуском и капитальными ресурсами, предприятия в добывающих отраслях, а также состоящие в крупных финансово-промышленных группах. С тех пор изменилось немного. В период президентства Путина отмечается концентрация политической власти в центре: предприятия, принадлежащие федеральному правительству, стали при Путине самыми сильными лоббистами, а компании, участвовавшие в залоговых аукционах, и фирмы, принадлежащие региональным администрациям, потеряли свое политическое влияние.

Что могут сделать регионы для ускорения своего развития?

Хотя в основном развитие регионов в России определяется центром, наше исследование показывает, что на региональном уровне также имеют значение готовность осуществлять реформы и ясное понимание, каковы новые источники экономического роста.

Повышение готовности к осуществлению реформ

Практическое проведение необходимых реформ — серьезный вызов для большинства стран с переходной экономикой, и Россия не является исключением. Основываясь на данных по проведению ключевых административной, земельной и таможенной реформ, мы приходим к выводу, что их реализация приносит явные положительные результаты для экономического роста и инвестиций, при этом на региональном уровне пути и степень реализации реформ существенно различаются.

Данные исследования, посвященного административной реформе, свидетельствуют о том, что бремя госрегулирования для малого бизнеса остается высоким и что проблемы коренятся не в федеральном законодательстве, а в региональном и местном его исполнении. Однако ре-

Готовность осуществлять реформы и ясное понимание новых источников экономического роста на региональном уровне имеют большое значение

гионы невозможно классифицировать как "хорошие" или "плохие", поскольку острота каждой из проблем, связанных с административным регулированием, существенно отличается по регионам. Мы выделяем три региональных фактора, способствующих продвижению административной реформы: местные бюджетные стимулы, снижение концентрации производства и высокий предреформенный уровень присутствия малого бизнеса в регионе.

Данные по земельной реформе показывают, что больше всего фирм, имеющих собственные помещения, находится в Московской области и Нижнем Новгороде. Этот фактор вызвал в указанных регионах рост инвестиций и развитие малого бизнеса. Можно сделать вывод, что регионы могут повысить привлекательность для бизнеса, упростив доступ к земле и помещениям.

По результатам исследования таможенной службы, несмотря на некоторые небольшие улучшения в порядке растаможивания грузов и пересечения границы, большой проблемой остается произвол таможенных чиновников. Отмечены также серьезные региональные отклонения в осуществлении таможенной реформы. Вымогательство на таможенных снизилось, но при этом в некоторых регионах выросли цены на услуги посредников, из чего следует, что коррупция начинает приобретать формальный статус.

Стимулирование новых источников экономического роста и инвестиций

Стимулирование новых источников экономического роста, — возможно, наиболее важная часть экономической политики. Не вызывает сомнений большое значение частных предпринимателей и инноваций для устойчивого роста экономики. Однако до сих пор четко не установлены факторы, способствующие развитию предпринимательства, и типы инноваций, которыми должны заниматься российские компании, что затрудняет разработку мер экономической политики в этих областях.

Недавнее исследование предпринимательской деятельности в России приводит к выводу, что социальная среда в целом и сети социальных связей в частности играют очень важную роль в стимулировании предпринимательства, а культурные различия и ценности менее значимы. Почему в России не так много предприни-

мателей? Можно выделить три главные причины: нехватку средств, недостаток предпринимательских навыков и несклонность к риску. Нехватку средств можно толковать и как кредитные ограничения, и как недостаточное стремление получить кредиты. Таким образом, мы приходим к выводу, что индивидуальные особенности человека — важный фактор в решении стать предпринимателем.

Широко распространено мнение, что российские фирмы не склонны к инновациям. Эта точка зрения основана на предположении, что российские фирмы должны проводить НИОКР и создавать совершенно новую продукцию так же часто, как и предприятия в развитых странах. В то же время, согласно экономической теории, фирмы стран, находящихся в своем развитии далеко от границы технологических возможностей, могут расти весьма быстро не разрабатывая новые технологии, а копируя технологии и продукцию, разработанную в других странах¹.

В ответ на вопрос, почему фирмы занимаются инновациями, большинство назвало необходимость улучшить свое финансовое положение или снизить затраты. Стремление увеличить долю на рынке и получить доступ к новым рынкам является частью стратегии развития для более чем 60% фирм, занимающихся инновациями, хотя менее 40% из них планируют выход на международные рынки. Как показывает исследование, недостаток средств является главным препятствием на пути инноваций. Чистая прибыль — главный источник финансирования такой деятельности, поэтому неудивительно, что более 80% фирм назвали нехватку средств серьезным препятствием для внедрения новшеств. Вторым по значению фактором, тормозящим инновации, является недостаточность внешнего финансирования, будь то государственная поддержка или частный капитал.

Из-за технологической отсталости России копирование технологий является для страны в настоящее время более эффективной стратегией экономического роста, чем инновации. Однако это не значит, что правительство не должно думать о путях создания более благоприятной инфраструктуры и институциональной среды, которые позволили бы эффективнее использовать имеющийся человеческий капитал, способный не только к копированию, но и к инновациям. Эта задача будет становиться все более актуальной по мере технологического развития России.

Предпринимательство и инновации имеют большое значение для устойчивого роста экономики

Правительству необходимо создавать более благоприятную инфраструктуру и институциональную среду для эффективного использования имеющегося человеческого капитала

¹ Acemoglu и др. (2002a) и Acemoglu и др. (2002b)

1. Introduction

Russia needs to diversify its economy in order to sustain the high economic growth levels of recent years. Development in the regions throughout Russia and active promotion of small business growth and foreign investment are crucial factors in this regard. Yet, it remains largely unknown why so many regions do not seem to improve the climate for small and foreign firms more ambitiously in order to increase the economic base and thus improve their growth potential. New research findings and data presented in this report will help to explain why this has not happened.

A country's investment climate is often discussed simultaneously with the overall business environment. Most definitions and investment climate studies incorporate both as they deal with government controlled external factors —most often labeled as institutions, regulations and policies — facing the private sector. And there is an important point to discussing the investment climate and business environment simultaneously. Market-friendly and well-functioning institutions, regulations and policies are equally important for large foreign investors and small domestic firms as both groups tend to have relatively little leverage to work around ill-functioning institutions and corrupt bureaucracies. At the same time, these two groups are particularly important for economic development in a country like Russia that needs to diversify its economy.

Large foreign investors and small domestic firms are particularly important for an economy that needs to diversify

Thus, it is even more important to focus on the climate for investment and small business growth. We start from the well-established notion that small firms and entrepreneurs are key drivers of economic reform and growth and that the spillover effects from foreign investors are potentially large in a country like Russia.

This report is divided into four parts. Chapter 2 gives a detailed background of the institutional, political, fiscal, and social situation in Russia. An understanding of these factors, especially about the large differences across Russia, is important for the analysis in the coming chapters, but initiated readers can go directly to chapter 3 or 4. Chapter 3 provides an in-depth description of the current status of investment, growth, small business development, and industrial concentration from a regional perspective. The analysis in chapter 4 sets out to explain the drivers of and obstacles to regional development in Russia by focusing on the relationship between the regions and the federal center on the one hand and between businesses and the state on the other. It also analyzes the government's capacity to implement reforms, which has been the number one obstacle in most transition countries, and the prospects for arguably the most important new sources of growth: new firms and innovations. The last chapter concludes and offers some policy recommendations.

2. Preconditions for realizing the potential

In this chapter we will look at the institutional, political, fiscal and social differences in Russia. Although it is hardly a surprise that a large country like Russia has domestic differences, it is important to understand both the scale and scope of these. Moreover, understanding the differences precisely in these factors is important for the discussion on realizing the growth and investment potential in the Russia's regions.

2.1 Institutional preconditions

The underlying institutional structure is of great importance for any market economy. The

quality of market institutions has accordingly become one of the most important factors for determining a country's investment climate and prospects for growth. Although the concepts of market institutions are quite broad, they are most often referred to as rule of law, control of corruption, voice and accountability, political stability, government effectiveness and regulatory quality.

The institutional development in Russia is, in this regard, a disappointment, and an important obstacle to investment and growth. Although most of the international surveys ranking countries' institutional quality are

rather general, the conclusion that Russia is lagging behind not only the advanced market economies, but also the other transition economies in Central and Eastern Europe, is unavoidable. Moreover, with the one exception of government effectiveness, Russia is scoring worse than its relatively poor income category average, including countries like China and Brazil².

The picture does not look much better when comparing development in Russia over the last eight years. Government effectiveness has improved quite a lot and the rule of law and control of corruption has improved somewhat but from low levels. Voice and accountability, political stability, and regulatory quality have worsened during the period according to these World Bank indicators.

Even if Russia has improved in some important areas during the last decade, the gap between other emerging markets has widened. In some areas, most notably in control of corruption and regulatory quality, the gap has widened substantially since 1996. These are areas where the new EU members have reformed most ambitiously over the last decade, partly as a result of the accession process. It has become evident that Russia lacks an equally strong reform driver or anchor that the prospect of EU membership offered the Central European and Baltic states.

Another World Bank survey looks at regulations and what the costs of doing business are in different countries³. They measure, for instance, the time and costs associated with starting and closing a business, hiring and firing workers, registering property, and getting credit. In general, Russia scores relatively well and has, most importantly, improved lately. For example, in Russia, an entrepreneur has to go through more procedures over a longer period in order to register a firm compared to the average in OECD countries. It costs less though and requires a smaller deposit to register the firm in Russia⁴.

Registering property is somewhat more cumbersome in Russia compared to the OECD average but costs much less. It also requires more procedures and a longer time at a higher cost to enforce contracts in Russia. But it requires less time at a smaller cost to close a business in Russia, although the recovery rate is

smaller. The cost of doing business survey shows that Russia has been making progress in some important areas and is ahead of the CIS average.

However, even in this survey, Russia is losing out to the transition countries in Central Europe. The new and potential EU members are among the fastest reforming countries in the world in this regard and the gap with Russia is actually widening. It should also be noted that the World Bank survey does not necessarily measure the actual costs of doing business as it does not take factors such as corruption and illegal bureaucratic procedures into account. Indeed, there may be a considerable discrepancy between the reform benchmark and its actual implementation. Effective implementation of reforms is necessary if Russia is to sustain economic growth and improve the investment climate. There is a widespread concern that the implementation of current reforms is too slow and that few new reforms will be introduced before the parliamentary and presidential elections in 2007 and 2008.

2.2 Political preconditions

Due to its enormous size, economic, geographic, and ethnic heterogeneity, Russia is destined to have some sort of federal governance structure. However, throughout history, the degree of centralization and decentralization has varied considerably. While on paper Russia had a federal structure during the Soviet period, it was in fact a unitary framework with regions that were formally autonomous but subordinated to central party control. The effective elements of a real federal structure appeared only in 1992, after the collapse of the Soviet Union. The new constitution adopted by a national referendum in 1993 divided Russia into 89 constituent entities (21 republics, 6 territories, 49 regions, 2 federal cities, 1 autonomous region and 10 autonomous districts). Formally all subjects of the Federation have equal standing. Usually regions (oblasts) and territories (krais) are areas in which the Russian population is a majority, although there may be autonomous districts and sub-regions within these subjects where the majority belongs to a titular nationality. Republics are ethnic based and have a slightly higher status, which for example allows them to have their own constitutions.

The problem with Russian federalism is that the country has never had an efficient federal

On institutional quality Russia lags behind not only the advanced market economies but also other transition economies

Government effectiveness, the rule of law and control of corruption have improved somewhat in the past years, while accountability, political stability, and regulatory quality have worsened

² World Bank Institute (2005) www.worldbank.org/wbi/governance. See Appendix 1 and 2 for details

³ World Bank (2005) www.doingbusiness.org

⁴ See Appendix 3 for details.

The problem with Russian federalism is that the country has never had an efficient federal structure

Overall, the political role of the regional authorities has decreased considerably during Putin presidency

structure. Essentially, current relations between Moscow and the regions are grounded in the limited experiences with federal arrangements Russia has had, namely Soviet-era ethno-federalism and the asymmetrical federalism of President Boris Yeltsin's administration. In the early 1990s, the federal center was weak and lacked the resources to breed loyal subjects in all 89 regions of the country. In an attempt to keep the country together, Moscow and the regions reached a compromise in the form of bilateral power-sharing agreements. Thanks to these agreements, the amount of regional autonomy correlated directly with the amount of power in the hands of regional leaders. To a large extent, this was the solution that prevented the breakdown of Russia.

One instrument in this political game was budgetary transfers, used to either appease politically troubling regions or to reward loyal ones⁵. The economic aspects of decentralization as such were considered relatively unimportant, as the focus was on getting political support for liberalization policies that were expected to bring economic growth.

When Vladimir Putin was elected president in March of 2000, he started to reform federal relations by strengthening the central government vis-a-vis the regions and introduced seven federal districts (Central, North-West, Southern, Volga, Ural, Siberia and Far Eastern). After forming the federal districts and appointing presidential representatives for these early on, the federal government initiated the process of unification of regional political structures and legislation.

In addition to creating the federal districts, the federal government initiated the process of merging neighboring regions. First to merge were Permskaya oblast and Komi-Permyatsky autonomous okrug. To date, a merger has been finalized in Krasnoyarsk (with Taimyr and Evenki autonomous okrugs), and Archangelsk (with Nenetsky autonomous okrug). Similar processes are underway in Irkutsk and Tyumen oblasts.

Overall, the political role of the regional authorities has decreased considerably during Putin's presidency. Previously, regional governors and heads of regional legislative bodies constituted the Federation Council — the higher chamber of the federal legislative body.

Nowadays this council consists of regional representatives that are appointed by the regions, but in fact these are much less independent of the federal level.

The most recent political reform related to the federal-regional government relations abolished elections for regional governors, replacing them with presidential appointments. Since the mid-1990s almost all regional governors had been elected by the regional population through direct elections. But on September 13, 2004, Vladimir Putin announced that the governors would be appointed by the regional legislatures at the recommendation of the president. This decision came after the Beslan tragedy. The president cited the fight against terrorism as the main rationale for the abolishment of direct gubernatorial elections. Moscow wanted to regain control over the regions lost during the 1990s and be able to directly monitor decision making in the federation's subjects.

Since September 2004 new gubernatorial appointments were made in 35 regions. In most cases, previously elected governors have kept their position. In some cases, the governors have been appointed for a third or even fourth term, meaning that the new scheme has allowed them to bypass the two-term limit that existed under the previous system. To date, former governors have failed to be reappointed by the president in only eight regions. It is expected that Putin's regime will get rid of the most prominent figures from Yeltsin's time, as the population may view these as competitors to Putin. The new scheme can also be used as a disciplinary device. Putin used that option when firing the governor of Koryaksky okrug, following irregularities in budget funds that were aimed at purchasing and storing energy resources to provide residents with electricity and heat during the winter months.

2.3 Fiscal structures

The need for a system of fiscal federalism in Russia arises from the fact that Russia's regions are very diverse in their income level and industrial structure. Therefore, even partial equalization of public goods provision across regions requires transfers from the rich (donor) regions, to the poor ones. The principal rich regions are Moscow, and some natural resource extracting regions in Siberia. Most of the Southern and Western regions, with the exception of

⁵ Popov (2000)

St Petersburg and Leningrad oblast, are recipients of federal transfers.

If the political reforms described above make regions more closely tied to the center, then the fiscal reform works in the opposite direction. The fiscal federalism reform is aimed at the stricter division of responsibilities between the center and the regions. Moreover, at least on paper it gives the regions more freedom in designing policies within their area of responsibility. There were two lines of thought behind this reform. The center both wanted to decrease the motivation and technical opportunities for the regions to use political and social threats while bargaining for transfers from the central government, in addition to improved incentives for the regional governments to develop their own tax base. The reform was designed for a political system with elected governors, and it is not yet clear how it will work in the new system of appointed governors.

An important characteristic of the old system was the weakness of the local authorities. Their own tax base was almost non-existent, except for in the large cities; more than half of local budgets were transfers from the regional governments⁶. Each additional rouble of tax collection was expropriated to regional budgets. At the same time, regional governments often had to cover for local governments' losses or expenditure arrears. As a result, local governments had almost no incentives to develop their tax base by improving the business climate or to improve public goods provision. In the late 1990s and early 2000s, a fiscal federalism reform was introduced. Due to this reform, the allocation of federal funds to the regional governments is now conducted via 5 special funds⁷.

The Regional Financial Support Fund (RFSF), created in the mid-1990s, remains the major vehicle for channelling federal transfers. Created in 2001, the Compensation Fund (CF) is aimed at granting the regions sources of funding for the realization of federal laws, mainly those that regulate the provision of social support to the population. Three other funds are aimed at stimulating reforms of regional finance and public goods provision. The resources of the Co-Financing of Social Expenditure Fund (CCEF) are channelled into co-financing provisions of public goods, such as education, healthcare, culture, social support and social benefits. The Regional Development

Fund (RDF) is used to co-finance spending on building infrastructure. Finally, financed by a World Bank grant, the Regional Financial Reforms Fund (RERF) provides grants to the regions to cover the expenses of the projects, designed to improve the process of regional budget reforms. The World Bank grant expired in 2004 and in 2005 the federal government envisaged the creation of the new Regional and Municipal Financial Reform Fund (RMFRF).

These five main funds are designed to limit the abilities of the regional governments to bargain for transfers. Research has indeed showed that the role of political factors in distributing the transfers from the center to the regions declined in the period 2001-2003⁸. Even asymmetry between different types of region, i.e. autonomous republics vs. other regions, has been disappearing. However, there has not been a complete abolishment of the previous system. There are additional forms of fund transfer from the federal to the regional governments, which allow the preservation of major features of the previous system. Among such transfers are the central government credits for "cash gaps," and, introduced in 2002, "donations for the stabilization of the revenue base".

The rationale behind credits for cash gaps is the possibility of a mismatch of revenues and expenditures. This may appear due to seasonality, or simply as a result of an accident. An example of such an accident is a temporary decline of tax revenues from a large tax payer, or a temporary increase of expenditure due to unexpectedly cold winter. The important part of the definition is that it is a temporary problem. However, in practice it is usually impossible to tell whether a cash gap is temporary or a sign of more general financial problems in the region. As a result, budget loans aimed at financing a temporary cash gap may be used as a cheap source of financing regional budget deficits. To distinguish temporary cash gaps from a permanent deficit of liquidity, the Russian Budget Code (art. 137) requires that budget loans may not be given for a period exceeding six months. In practice, however, this norm has been frequently violated.

In practice, a budget loan to cover cash gaps was often not given based on some formal criteria but as a result of informal negotiations between the regional authorities and the Ministry of Finance. An examination by CEFIR

If the political reforms make regions more closely tied to the center, the fiscal reform works in the opposite direction

The reform was designed for a political system with elected governors, and it is not yet clear how it will work in the new system of appointed governors

⁶ Enikolopov et al (2002)

⁷ See Appendix 4 for a detailed survey of the funds. Some sub-regional territories, such as "closed" cities and "science" cities receive transferred directly from the Federal budget.

⁸ Jarosinska (2003) and Koidze (2005)

researchers of the data on budget loans to the regions in 2000-2004 reveals that in that period provision of budget loans was to a large extent ungrounded. As a result, the effectiveness of financial aid has been low, and many regions exerted significant efforts on getting budget loans without proper reasons. In their turn, regional budgets appear to face similar problems when dealing with municipalities.

The practice of receiving and using budget loans varies greatly across regions. In the period from 2000 to 2003 only three regions, the Republic of Bashkortostan, St. Petersburg and Nenetsky Autonomous District, did not apply for loans. Samara oblast and the Republic of Tatarstan received loans only in 2003. The examples prove that even those regions that are able to balance their budgets without relying on loans have found it profitable to ask for and receive budget loans.

In the long run, chronic credit extensions create soft budget constraints and worsen budgetary policies in the regions. Possibly for this reason, in 2003 and 2004 the Ministry of Finance exerted greater effort to make regions repay previously issued budget loans.

An interesting question is whether, in a large and diverse country such as Russia, it is possible and desirable to reach a completely politically unmotivated disbursement of transfers. While hard budget constraints are needed to optimize public goods provision, threats of succession may require transfer provision policy to be more flexible. From this point of view, Russia's inability to move to a fully formal base for the provision of transfers is not surprising.

2.4 Social and labor market policies

The most important socio-economic factors in Russia are arguably poverty, inequality, and a number of labor market issues. In this section we will study these factors from a regional perspective in order to determine how social policies can support regional growth and investment.

2.4.1 Poverty and inequality

Almost 30 million Russians had incomes below the subsistence level in 2003. The con-

siderable economic recovery after the 1998 crisis has not been associated with any significant decline in absolute poverty levels. Economic growth is often a precondition for poverty reduction, but it is not a guarantee. Development in Russia illustrates the fact that distribution matters a great deal as well.

Income inequality dynamics may explain the modest decline in poverty over the last five years. Measured by the Gini-coefficient⁹, income inequality increased up to 1999 and then stabilized. At the same time, wage differentials increased considerably throughout the same period. This is likely to be a sign of significant redistribution, both formal (via state transfers) and informal (via support from relatives for example). This becomes even more evident if the high shares of incomes from the informal sector, known for a very uneven distribution, are taken into account¹⁰.

Russia's regions display a significant variation in poverty levels. A head-count index (shares of population with incomes below regional subsistence level) varies from the lowest value of 23 percent in St. Petersburg to the highest of 58 percent in the Rostov region in southern Russia¹¹. In the North-Western regions, except for St. Petersburg, about 40-45 percent of the population live below regional subsistence levels. There seems to be no direct relationship between the level of economic development of the region and the level of poverty, which implies that poverty is linked to regional distributional policies.

That regional wealth distribution is important becomes more evident when studying poverty gap measures, which shows the aggregate poverty deficit of the poor relative to the poverty line¹².

In most regions poverty is not deep. The income deficit of the poor is on average about 10-15 percent of poverty line income and could be lifted out of poverty by targeted transfers. In some regions in the Far East, such as Chita and Primorski krai, the poverty gap is about twice the average. In the North-West, all regions are below 20 percent with the lowest value in St. Petersburg (7 percent) and the highest in Komi Republic (19percent).

Yet another measure, the severity of poverty (the so-called Foster-Greer-Thorbecke P2 meas-

Almost 30 million Russians had incomes below the subsistence level in 2003

Economic recovery after the 1998 crisis has not been associated with any significant decline in poverty levels

⁹ A widely used measure of income inequality, with values varying from 0 (perfect equality, everybody has the same income) to 1 (perfect inequality)

¹⁰ At the same time the overall impact of tax/benefit policy in Russia is found to be regressive, which has reinforced the increased inequality in the labor market.

¹¹ Self-reported household income is used as the basis for calculations. Alternative estimations based on consumption measures in World Bank (2005b) give 3 percent for St Petersburg and 21 percent for Rostov

¹² See Appendixes 5 and 6 for details

ure), which measures income inequality across poor groups in addition to the aggregate poverty deficit, also shows that in the majority of the regions poverty is not very deep.

The average income by gross regional product per capita varied enormously in 2002: from the lows of 8,300 roubles in Ingushetiya to the highs of 192,600 roubles in Moscow and 294,000 roubles in oil-rich Tyumen¹³. Inter-regional inequality in Russia is quite high by international standards. However, it accounts for less than 10 percent of total inequality¹⁴, with the remaining 90 percent explained by inequality within regions. Gini-coefficients of intraregional inequality vary from 0.28 in Ivanovo and Tver regions (in the Central district) to 0.44 in Eastern and Western Siberia¹⁵. The North-West have a less-than-average income inequality, with the exception of Komi republic. There seems to be no strong correlation between intra-regional inequality and the regional level of economic development, though one needs to control for other factors to isolate the relationship.

2.4.2 Regional labor markets

Wage inequality in the labor market may be an important determinant of regional poverty levels. Regional disparities, in terms of average wage and unemployment rates, in the Russian labor market are significant; they exceed inter-regional variations in Europe and inter-state ones in the US.

The average general level of unemployment was at a moderate 8.6 percent in 2003, by the ILO definition, whereas officially registered unemployment stood at just 2.3 percent. Registered unemployment only includes those who have officially registered with unemployment agencies. However, many unemployed lack incentives to officially register with these agencies. Unemployment was highest in the Caucasus and in some regions in eastern Siberia (Tuva, Chita). Both in Moscow and St. Petersburg the general unemployment (ILO-defined) was below the average at 1.3 percent and 4.1 percent, respectively.

Table 1: Number of people with incomes below subsistence level and Gini coefficient, selected years

	1992	1995	1998	2001	2002	2003
People with income below subsistence level, million	49.7	36.3	34.0	39.4	34.6	29.0
% of population	33.5	24.7	23.3	27.3	24.2	20.4
% of previous year	n/a	109.0	112.2	94.0	87.8	83.8
Gini coefficient	0.289	0.387	0.394	0.398	0.398	0.400

Source: *Russia in Figures, Goskomstat (2004)*

In addition, to fully understand interregional variations in unemployment, there is also significant wage variation across and within regions that should be taken into account. Real average wages are in most cases higher in more developed regions with higher GRP, but there is also substantial variation within regions.

Labor migration could potentially eliminate some of the variation in real income, wage and unemployment rates. Interregional labor mobility is important not just for the convergence of regional living standards but also for the overall success of transition. The regional dimension is an important factor for intersectoral reallocation of resources from obsolete sectors to more profitable ones. However, intersectoral mobility is quite low and the intensiveness of intersectoral labor flows is small¹⁶. Given the inherited high concentration of production, low intersectoral mobility could slow down structural changes in production in response to relative changes in prices, as Russia further liberalizes trade.

In contrast to market economies, firms in socialist economies did not locate according to efficiency considerations. Rather, location decisions were guided by perceived or real requirements of the military, and Stalin's commitment to swiftly develop economically backward regions. Many towns and even entire regions rely upon a single industry or, in some cases, a single enterprise because the production in the Soviet economy was organized in such a way as to reap economies of scale.

Because Russia lacks developed capital market institutions and because capital mobility is

There seems to be no strong correlation between intra-regional inequality and poverty, and the regional level of economic development

¹³ Deflated GRP per capita. The estimations are from World Bank (2005b), pp. 166-67

¹⁴ World Bank (2005b), p.37

¹⁵ See Appendix 6 for details.

¹⁶ Akhmedov et al (2003)

very low, capital does not reallocate to regions with cheap qualified labor. If capital does not move to where labor is located, then labor should migrate in order to correct misallocations and to ensure labor supply for new industries with higher productivity.

However, labor reallocation across regions is barely taking place. The overall annual migration rates are rather low by international standards at just 2 percent, by official estimates, of which half is intraregional migration¹⁷. This is two times lower than restricted Soviet mobility.

It is therefore not surprising that skilled workers have become a scarce resource in more prosperous regions, constraining the growth potential of profitable firms. In the past few years a productivity and income gap emerged between Moscow, St. Petersburg, and some of the western regions on the one hand, and the Far North, the southern and eastern periphery (the so-called 'Red Belt') on the other.

Why are workers from, say Ryazan, a town situated two hundred kilometers away from Moscow, not moving to the capital? The most obvious answer is: because migration may not be worth the costs. These consist of differences in rents, the cost of registration at the destination (propiska), the fixed cost of moving, and the cost of job searching. Estimations show

that, provided a worker migrating to Moscow finds a job immediately, he or she would be able to break even within a couple of months¹⁸. However, if the costs associated with searching for a job are taken into account, assuming a six month search period, a painter, for instance, would break even only after one and a half years. Thus it appears that there is scope for migration, but the associated costs must be paid upfront, requiring a substantial amount of cash for migration, which in effect limits the number of people that are able to migrate for work.

The lack of liquidity in the poorest regions is indeed one of the reasons for such low migration rates, as another CEFIR study confirms¹⁹. In these regions the population cannot leave simply because they are unable to finance the cost of moving, and growth in incomes would increase rather than decrease outgoing migration. The financial constraints effectively attach the population to the region, reducing outside options and wages. According to CEFIR estimates, a third of the Russian population is locked in such poverty traps. Undeveloped housing and mortgage markets have made migration even more difficult for the poorest groups²⁰.

Other factors that restrict mobility are distortions accumulated during the Soviet regime: so-called propiska, or residence permits, which restrict mobility from rural areas and small towns to major metropolitan areas. The persistence of propiska in some cities has resulted in significantly faster population growth in cities that do not have such restrictions.

The highly segmented local labor markets inherited from the past have not disappeared. One or two large firms, often in decline, still dominate many local labor markets and the very existence of inherited monopsonistic or oligopsonistic local labor market structures can obstruct workers' ability to migrate. Firms have an incentive to attach their workers, i.e. to restrict their ability to migrate by decreasing outside options and increasing rents. Controlling for personal and regional characteristics, workers' propensity to leave a region decreases with the degree of concentration of the local labor market²¹. The provision of fringe benefits and in-kind payments is not due to the inertia of paternalistic managers, but can rather be explained as an attachment strategy

Table 2: Public service provision by firms

District	Percentage of firms			
	Producing heat	Producing electricity	Owning rail cars	Giving support to road construction
Central	75.4	4.2	10.2	16.8
North West	80.9	10.6	14.9	20.4
South	91.3	0.0	13.0	38.5
Volga	75.4	1.6	29.5	25.0
Urals	71.4	4.8	28.6	36.2
Siberia	62.5	2.5	20.0	23.5
Far East	77.8	0.0	11.1	38.5
Total	75.7	4.5	17.1	24.0

¹⁷ Based on data for 1992-1999. See Andrienko and Guriev (2004)

¹⁸ Friebel and Guriev (2000)

¹⁹ Based on data for 1992-1999. See Andrienko and Guriev (2004)

²⁰ Guriev (2005)

²¹ Friebel and Guriev (2000)

of firms: paying wages in non-monetary forms makes it hard for workers to raise the cash needed for leaving the firm/region. Another study by CEFIR confirms that firms provide part of the compensation package in the form of fringe benefits instead of simple monetary salaries in order to attach workers (Table 2)²².

Such labor market segmentation has several dimensions, formal vs. informal employment, metropolitan areas vs. other areas, and is quite dangerous. The risk in creating a "primary" and a "secondary" labor market is that more secure and well-paid jobs are concentrated in the former and that mobility from the former to the latter is very restricted. Certain groups and/or certain regions may therefore be permanently stuck in a situation with scarce low-paid jobs. Indeed, a study of the Voronezh region confirms that the structure of the local labor market matters for unemployment duration: those living in municipalities with a highly concentrated labor market stay unemployed longer²³.

Increased labor mobility along with the development of small businesses could reduce monopsonistic power and stimulate competition in the regional labor markets. It should be noted that although overall migration is rather low, its intensity depends on economic factors. People move from poorer and job scarce regions with poor public goods provisions to richer ones that are prospering both in terms of employment prospects and public goods provision. So, competition between regions already exists, albeit on a small scale, and regional policies and fiscal federalism play an important role. Regional policies that improve living standards, create jobs, and improve public goods provision, attract migrants. This effect is substantial relative to the average migration rate.

2.4.3 WTO and the labor market

Contrary to popular fear of a large negative impact, the consequences of the expected WTO accession for the Russian economy²⁴, and specifically for the labor market, are not expected to be dramatic. This is provided the

size of the shock is comparable to that of the increased trade openness during the 1990s. Hypothetically an output shock of 1 percent could result in approximately 0.2 percent change in employment, or less if the real wage adjustment mechanism is taken into account.

Future trade liberalization would not have a significant effect on wages either. Tariff reduction and trade liberalization would likely lead to only a slight increase in the wage differentials between skilled and unskilled labor. The highest wage premiums are found to be in fuel, energy, and metal industries, and the lowest in agriculture. Therefore, the claim that "workers in more protected industries earn relatively more" has no significant support. Imports have a significantly negative effect on wage premiums, while export orientation has a positive effect.

Regional variation in adjustment costs may arise from regional differences in industrial structure, including the degree of industry concentration, and/or differences in the elasticity of the final demand for products. The difference is driven by a significantly larger share of industries exposed to trade shocks (e.g. fuel, metallurgy, petrochemical, and timber industries), and hence, regions with more volatile labor markets. Also, in the least concentrated markets, i.e. markets with a higher number of potential employers, the employees have more outside opportunities which, firstly, makes firms behave more as wage-takers (as opposed to wage-setters as it is in more concentrated and more monopolized markets), and secondly, restricts firms from destroying jobs in response to temporary shocks in expectation of competition for employees. The first tendency would imply that in less concentrated markets, adjustments to shocks, including trade shocks, is done mainly through employment rather than wages, while the second tendency would counteract this and put a restriction on adjustment through employment.

We find higher volatility in employment in north-eastern parts of Russia (including the Northern region) known for higher concentration, and hence, labor markets with a significant degree of monopsony.

Competition between regions already exists, albeit on a small scale

Contrary to popular belief, the consequences of the WTO accession for the Russian economy and the labor market are not likely to be dramatic

²² Haaparanta et al (2003)

²³ Denisova (2002)

²⁴ Akhmedov et al (2003)

3. Status quo

The existing levels of investment, growth, small business development and output concentration varies considerably across Russia's regions. A clear understanding of the reasons behind the fact that these differences exist and seem to persist and may even increase is crucially important for future development in the regions.

3.1 Investments

Given the low level of institutional development in Russia, it is no surprise that the investment climate in Russia as a whole is relatively poor. But there are important regional differences. The conventional wisdom is that the most favorable investment climate in Russia is found in the North-West and Central federal districts and that the climate is worsening the further south and east one goes. This view is not necessarily correct but it is difficult to assess a region's attractiveness by studying the existing flows of foreign direct investments. This is partly because the flows have been so limited and focused on the energy sector. The largest cities and the energy rich regions have so far attracted the bulk of the foreign investments flowing into Russia even though some other

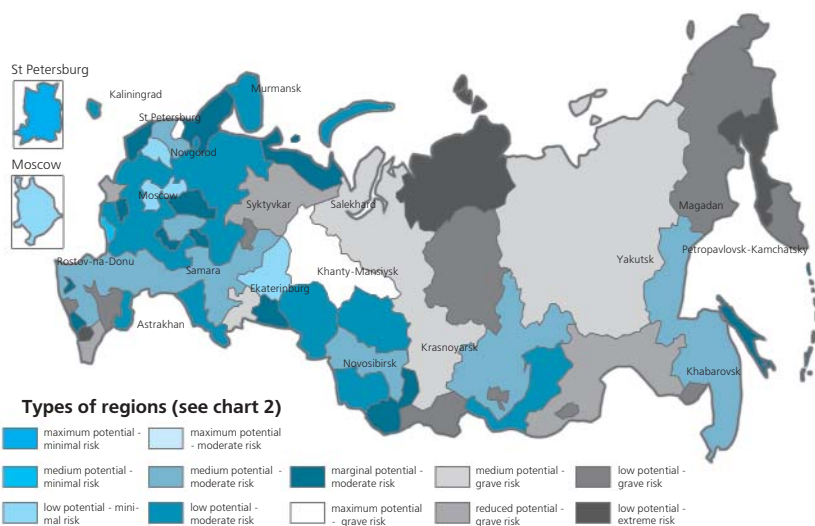
regions have improved their investment climate lately and have also started to attract more FDI.

The rating agency Expert RA has been rating the investment climate in Russia's regions since the late 1990s according to their investment potential and risk²⁵. The potential index focuses mainly on macroeconomic factors whereas the risk index estimates the likelihood of losing from an investment. The ten regions with most potential, according to Expert, are Moscow, St Petersburg, Moscow oblast, Khanty Mansiysky, Yekaterinburg, Samara, Nizhny Novgorod, Krasnoyarsk, Krasnodar and Tatarstan. The regions with least risk are Yaroslavl, St Petersburg, Belgorod, Novgorod, Tatarstan, Moscow, Nizhny Novgorod, Moscow oblast, Vologda, and Krasnodar.

In the combined ranking, it is only St Petersburg that gets the top score of maximum potential with minimal risk. Belgorod is ranked second as a medium potential with minimal risk region. Novgorod and Yaroslavl are ranked relatively high as low potential with minimal risk whereas Moscow, Moscow oblast, and Sverdlovsk are ranked as high potential with moderate risk regions. Fifteen regions are then ranked as medium potential with moderate risk and 27 regions as reduced potential with moderate risk. The bottom half of the list is dominated by high risk regions in the south, but there are also regions from the North-West, such as Karelia, Pskov and Komi.

The largest cities and the energy rich regions have so far attracted the bulk of foreign investments

Map 1: Investment rating of the regions, 2002–2003



Source: Expert RA

3.1.1 FDI flows

According to UNCTAD, Russia was ranked 97th out of 140 economies in 2003 in terms of inward FDI performance and 27th in terms of inward FDI potential²⁶. Russia undoubtedly has a lot of potential for foreign investors but the FDI inflow has been well below potential and a source of disappointment even though investment seemed to pick up last year. In 2004, the inflow of FDI to Russia was almost US\$12 billion, which can be compared to US\$60 billion to China and the US\$6 billion to Poland. The accumulated investment stock in these countries in 2004 was US\$98 billion in Russia (or 17 percent of GDP in 2004), US\$245 billion in China (15 percent of GDP) and US\$61 billion in Poland (25 percent of GDP). One major dif-

²⁵ Expert RA (2005) www.gateway2russia.com

²⁶ UNCTAD (2005)

ference between Russia and most other emerging markets is the amount of FDI flowing out of the country. In 2002 and 2003, outward FDI was larger than inward FDI in Russia. By 2004, more than US\$82 billion in FDI stock had flown out of Russia (83 percent of inward stock). The corresponding figures for China and Poland are almost US\$39 billion (16 percent of inward stock), and less than US\$3 billion (4 percent of inward stock) respectively²⁷. Consequently, UNCTAD rates Russia (24th out of 132 economies) much higher in terms of outflows of FDI compared to other emerging markets, such as Poland (62) and China (72)²⁸.

Most of all investors want stability and predictability and the first years of Putin's presidency have been promising in this regard. The Gref economic reform program was matched with increased stability and some larger investors, most notably BP, started to invest or make plans to invest in Russia. The attack on Yukos does not seem to have stopped that positive trend despite increased uncertainty and growing concerns about the Russian investment climate and rule of law. The Russian private sector does not seem to have lost too much faith in the Russian market as capital outflows, which resumed in the wake of the Yukos affair, have decreased considerably lately. During the first three quarters of 2004, the net capital outflow from the private sector totaled US\$17.4 billion but was reduced to US\$2.8 billion for the same period in 2005²⁹. Indeed, the World Bank argues that "improvements in the expectations of investors" is one of the key factors behind the strong growth in Russia in 2005, which is a result of a series of measures introduced to reduce the uncertainty in the investment climate in general and in the strategic sectors in particular³⁰.

Just as the Russian economy as a whole is dominated by Moscow and the energy-rich regions, so are the foreign investments (Table 3). To date, Moscow has attracted about one third of all the FDI flowing into Russia. The figure is even larger when including the FDI destined for the Moscow market that has spilled over into the surrounding oblast. Also St Petersburg and the surrounding Leningrad oblast have attracted sizable FDI. A number of energy rich regions (such as Sakhalin and Tyumen) and regions with strategic locations (Krasnodar, Arkhangelsk, Sakhalin, Leningrad oblast, all with ports on the Black, North,

Table 3: FDI Top Ten Regions (USD Mln, 2001–2002)

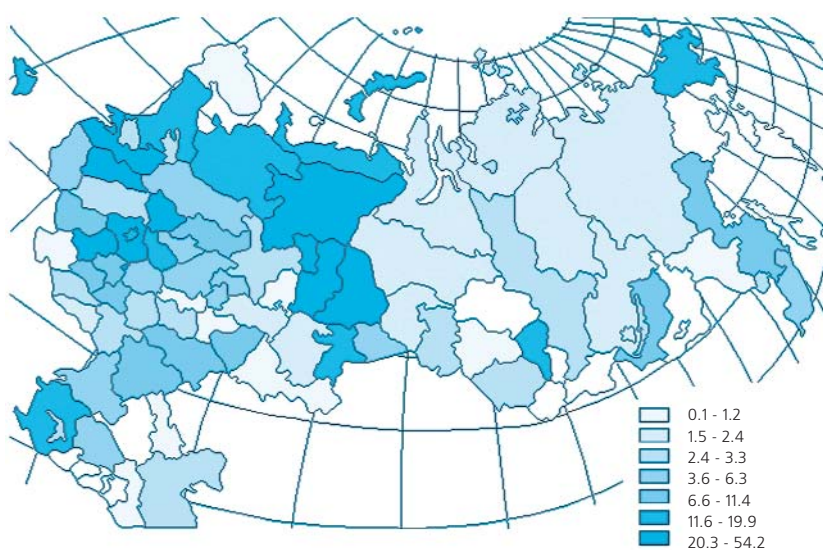
Region	Amount	Region	Amount
1. Moscow City	2835	6. Leningrad oblast	354
2. Sakhalin	1054	7. Tyumen	257
3. Moscow oblast	902	8. Samara	215
4. Krasnodar	549	9. Sverdlovsk	201
5. Arkhangelsk	385	10. St Petersburg City	198

Source: Aton Capital

Pacific or Baltic seas) have also managed to attract relatively large amounts of FDI. Apart from these obviously attractive regions, there are a few regions that stand out in terms of attracting FDI. Sverdlovsk and Samara seem to have attracted significant foreign investment based on their well developed industry. Sverdlovsk has steel, chemicals and machinery production and Samara is a hub for the automotive industry.

These regions have attracted the vast majority of the foreign investments in Russia. The top five regions alone have attracted some 70 percent of the FDI stock. There is clearly potential for other regions to attract foreign investors, not the least in industries such as forestry, but

Map 2: Share of firms with substantial (>10%) foreign ownership in regional industrial output (excluding offshore owners) in 2003



²⁷ UNCTAD (2005)

²⁸ Ibid.

²⁹ World Bank (2005a)

³⁰ Ibid

FDI in the North-Western regions are not necessarily driven by the Baltic Rim integration

Central Russia and Siberia are more attractive for Baltic Rim investors than the North-West

that requires an improved investment climate and improved infrastructure.

3.1.2 Foreign owned firms

The low level of FDI in Russia is not only revealed by FDI flows but also by data on foreign owned firms' share in total production in Russia³¹.

Map 2 shows the regional distribution of foreign firms' share in production of total industrial output. It is constructed using firm-level balance-sheet data. As a denominator, we use regional industrial production as reported by the Russian statistical agency. We should note that the foreign owned firms' share of output reported here can differ from the share of output of foreign firms reported by the Russian statistical agency. The difference is the part of output share that is produced by off-shore firms. The average share of foreign firms in industrial output is 18.9 percent but without offshore it becomes 10.3 percent. Similarly, in employment it stands at 9.0 percent and 5.4 percent respectively.

As a comparison, in the early 2000s the average share of foreign employment in Bulgaria and Croatia was 16 percent, Poland

20 percent, Czech Republic 32 percent, and Estonia 41 percent. The North-Western regions have the highest share of foreign firm production in industrial output. Six out of 11 regions have a share of foreign company output of more than 20 percent.

One would expect that the North-Western regions of Russia have such a high share of foreign company output because they are closely integrated with some of the Baltic Rim countries. Table 4 shows that this is not necessarily true. In some regions, mainly Karelia and Komi, Baltic Rim FDI overwhelmingly dominates FDI from other sources. However, in other regions, notably Kaliningrad, Leningrad oblast, and Murmansk oblast, Baltic Rim FDI contributes only to a modest share of the overall FDI despite these regions' common border with the Baltic Rim countries.

Map 3 provides further evidence against the hypothesis of closer integration between North-West Russia and the Baltic Rim countries than between Russia as a whole and the Baltic Rim. The map shows the distribution of the share of output of firms owned by companies or individuals from the Baltic Rim countries in the overall output of foreign owned firms. It turns out that some of the Central Russian and Siberian regions are even more attractive than North-Western ones for Baltic Rim investors.

The biggest difference between foreign owned firms with and without owners registered offshore is in the metal sector. The highest share of production by foreign-owned companies is found in the food and wood industries. Usually, firms in these industries are relatively small and many were created after the beginning of transition. Such an industrial structure may be one of the factors explaining why these two industries have been leaders in the share of foreign company production throughout the 1990s.

For political reasons, the share of foreign-owned firms in the fuel industry was almost negligible until 2003. Since then one of the large oil companies, TNK, formed a joint venture with BP, and a stake in LUKOIL was sold to Conoco-Phillips in 2004. However, this change has not produced dramatic differences in the calculations and the overall share of foreign firms in production in this sector remains the lowest among all industries.

Table 4: Share of foreign ownership in North West Russia

Region	FDI firms share in total output	Baltic Rim FDI share of FDI
Karelia republic	20.0%	97%
Komi republic	21.5%	98%
Arkhangelsk oblast	18.7%	19%
Vologda oblast	3.6%	1.3%
Kaliningrad oblast	11.9%	32%
Leningrad oblast	54.2%	21%
Murmansk oblast	0.5%	2.8%
Novgorod oblast	29.4%	68%
Pskov oblast	5.6%	11%
St. Petersburg City	30.5%	57%

³¹ Data for 2003. We consider all firms with foreign ownership share of more than 20% as foreign owned. Applying this traditional definition to Russian firms is problematic, however. Because of lack of the rule of law, many Russian businesses use off-shore registered companies as intermediate owners. As a result, many 'foreign owned' firms included in the statistics are in fact Russian owned. To the extent that some foreign companies may own Russian assets via off-shore companies, our measure under-reports the true measure, however, the error is not very large.

Many economists and policymakers believe that one of the major benefits of attracting FDI to the regions is that there can be technological spillovers between domestic and foreign firms. Our research has shown that foreign firms are much more productive than Russian ones³². Foreign firms are also more capital intensive and less labor intensive than Russian firms. As far as productivity spillover is concerned, so far in the 2000s a positive effect can be observed only from export oriented FDI or in the case of sectors with more than 50 percent FDI presence. The first effect may be explained by the fact that export oriented FDI usually brings to the host country more up-to-date technologies than the home market oriented FDI³³.

In addition to productivity spillovers, there seems to be a spillover effect on production function. Domestic firms in industries with a relatively high share of foreign firms become relatively more labor intensive, and relatively less capital intensive. Possibly, these results reflect a market segmentation effect, where domestic firms, facing stronger foreign competition, move into more labor intensive and cheaper sectors of production. Additionally, vertical spillovers in Russia can work in the same way. According to anecdotal evidence, foreign firms outsource only the production of technologically simple and labor intensive components to Russian firms. It is also interesting to note that in countries with better institutions, such as Poland, exactly the opposite effect is observed: domestic firms, which face tight foreign competition, become more capital intensive, and less labor intensive³⁴.

In its investment ranking, Expert rating agency reaches one general and quite basic but important conclusion: "it is impossible to significantly improve the investment climate without developing a strategy for social and investment development in Russia's regions and municipalities."³⁵ Further to this, Expert points out the paradoxical fact that only about 25 percent of the regions have such a strategy.

General investment rankings and investment flows give an indication about the investment climate in a region but often stop short of explaining why some regions have succeeded or failed to improve their attractiveness. Moreover, the usefulness of analyzing foreign investment flows to Russia is reduced by the relatively small overall levels and the heavy

dominance of oil and gas. Unfortunately, relatively little is known about the structure and characteristics of the regions and the incentives behind regional development.

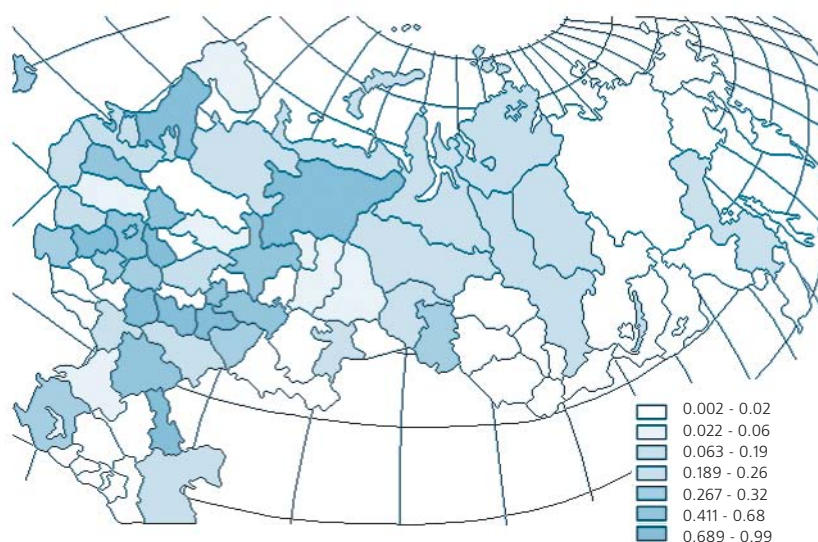
3.2 Regional growth patterns

Existing studies on regional growth mainly focus on actual distribution and common features among regions. This forms our information base, and more specifically we use material in a report carried out by Aton Securities. They use data from the State Statistics Committee and explore whether poor regions are participating in national economic growth currently taking place, in addition to how inequalities across regions are developing.³⁶

Aton uses four measures to evaluate regional growth patterns; real GRP growth, real income per capita growth, real wage growth, and growth in car ownership (per 1000 people). Examining data for 1999-2002 shows some regions with high real GRP growth but lower results for the other indicators. Two examples are Moscow City and St Petersburg, which both are historically concentrated business areas. They start from a high base and therefore rank relatively poorly in the other indicators besides growth. On the other hand, some regions start from a very low base, and hence show very strong growth rates, for example Dagestan and Astrakhan.

Foreign firms are more productive and capital intensive and less labor intensive than Russian firms

Map 3: Share of firms with substantial (>10%) foreign ownership from Baltic Rim countries in the total output of foreign owned firms



³² Bessonova et al (2003), and Dolinskaya and Yudaeva (2005)

³³ Moran (2005)

³⁴ This part is based on Dolinskaya and Yudaeva (2005)

³⁵ Expert RA Agency

³⁶ Westin (2004). See Appendix 7 and 8 for details

The highest level of GRP per capita is found in regions with a high degree of industrial production and many companies in the service sector

There are also regions with "quality growth," i.e. strong growth from a high base. A few examples are Krasnodar Krai, Tomsk, Rostov, Novosibirsk, and Perm. Regions that have managed this quality growth share the following characteristics: the presence of natural resources, a large urban population and/or a large service sector. Aton presents no specific reasons for growth in poorer regions, but states that it could be due to increased investments in the service and natural resource sectors, increased employment or increased productivity.

Geographical location and availability of natural resources are found to determine relative wealth, which is measured in terms of income and wage growth. The highest level of GRP per capita is found in regions with a high degree of industrial production and many companies in the service sector. With the exception of Moscow City, the regions with highest GRP per capita are located in the Far Eastern Federal District (Sakhalin, Magadan, Dakha and Chukotka), which is probably an effect of the low population density in the eastern regions. Other regions that perform well are Tyumen, Krasnoyarsk, and Samara, which host some of

Russia's largest companies. Five of the ten poorest regions are dominated by agriculture and forestry sectors, and are located in the Southern Federal District. (Ingushetsia, Dagestan, Adygeya, North Ossetia and Karachayevo-Cherkessia)

The Aton report found inconclusive results for inequalities, as income per capita and nominal wages showed a slight decline between regions, but GRP and GRP per capita showed an increase in inequality. Few regions have moved significantly up or down in the ranking, but there are some notable exceptions, such as Bashkortostan, Volgograd, Nizhny Novgorod, and Buryatia that moved at least 10 places upwards, and Adygeya, North Ossetia, Ulyanovsk, Kaliningrad, Voronezh, Amur, and Oryol that moved down significantly.

3.3 The regional distribution of SMEs

As stated in the introduction, development of the SME sector is crucial in order to diversify the Russian economy and sustain economic growth. The Russian SME Resource Center has conducted an analysis of the role and place of small and medium-sized enterprises in Russia, and came to the following conclusions³⁷. At the federal level, individual entrepreneurs are most common, followed by medium-sized enterprises and farms. In principal, this also holds at the regional level. In 2003, SMEs represented 48.8 percent of total employment, up from 45.1 percent in 2002. SMEs are non-uniformly distributed over Russia, and in 2003 the number of enterprises per 1000 economically active people varied from 44 in the Republic of Buryatia to 450 in the Republic of Altai³⁸.

When limiting the focus to the small business sector, output grew more than 30 percent each year during 2000-2003 but this is probably mainly due to the formal legalization of business, i.e. small businesses moved out of the shadow economy following improved regulations. Small business output growth exceeded GDP growth and hence this sector's relative share in total GDP has increased.

Table 5: Regional SME growth

2002: fastest growers	2003: fastest growers	Regions with unusually large share of small business employment
Voronezh (11%),	Kaliningrad, 6.3%	Moscow oblast, 35.6%
Nizhny Novgorod(7.7%),	Stravropol, 4.8%	St Petersburg City, 31.8%
Volgograd(6.7%),	Bashkortostan, 4.1%	Kaliningrad, 22.5%
Ryazan (7.5%),	Moscow City, 3.6%	Leningrad, 22%
Tomsk(6.5%),	Novosibirsk, 3.4%	Samara, 19,6%
Samara (6.2%),	Samara, 2.3%	Voronezh, 18%
Stravropol(6%),	Komi, 3%	Tomsk, 17.5%
Krasnodar (5.9%),		Ryazan, 17.4%
St Petersburg City (5.4%),		Stravropol, 17.1%
Amur (5.2%).		Moscow City, 16.8%
Moscow oblast (29%)		Kaluga, 16.8%

³⁷ SMEs include small enterprises, individual entrepreneurs, farms, and medium-sized enterprises that have up to 250 employees (according to the EU definition)

³⁸ See Appendix 9 for details

The fastest growth of the small business sector took place in 2002, when most de-bureaucratizing reforms were implemented (see the section on administrative reforms). Growth is unevenly distributed across regions and the best performers are presented in the Table 5.

3.4 Concentration of output

The heavy influence of a number of large financial industrial groups (FIGs) or oligarchs is a well known factor in the Russian economy. The actual extent of these groups' control of the economy is less well known³⁹.

Previous literature on the oligarchs displays varying opinions about their impact on economic and political developments, and mainly debates whether it is a positive or negative effect. Some argue that oligarchs are a counterweight to the Russian bureaucracy and that they are both willing and able to lobby for the development of institutions and reforms. In addition they are said to be the only ones that can afford and be willing to invest in Russian industries. Others state that the oligarchs have weakened Russia's economy by stripping assets from firms and sending the money abroad. The oligarchs are also said to have weakened democratic development by forming enormous inequalities and by capturing the state for their own interests.

The definition of an oligarch is not clear cut, but it commonly refers to a businessman who has sufficient resources to influence national politics. Oligarchs are often assumed to have built their fortunes during the privatization process in the mid-1990s and more specifically through the loans-for-shares scheme. In this scheme the government appointed commercial bankers to run auctions allocating controlling shares over large amounts of natural resources, in exchange for loans to the federal government. Not surprisingly the auctioneer awarded the stake to himself at a very low bid. The scheme was set up to consolidate support from the bankers for Yeltsin. However, not all 22 oligarchs surveyed in the study by Guriev and Rachinsky were part of the loans-for-share

scheme but it does fit the stories of Abramovich, Khodorkovsky and Potanin, among many others.

Among the 22 oligarchs covered in the paper, nine are in their 30s and 13 are in their 40s. The older oligarchs typically come from the soviet-era nomenclature and during privatization they converted their control of enterprises to ownership. The younger group built up their wealth during Gorbachev's partial reforms when the co-existence of regulated and quasi-market prices created huge opportunities for arbitrage. When privatization began these businessmen owned trading companies, banks and/or investment funds and hence had the financial funds to buy the privatized firms.

The 22 financial industrial groups surveyed represent about 40 percent of sales and employment in the sample, which is more than regional and federal government together and more than all other private owners put together. The highest concentration of sales is found in the ferrous, non-ferrous metals and aluminum sectors (78, 92 and 80 percent respectively). In the pulp and paper industry the oligarchs' share in sales is 30 percent, which is lower than most of the other large sectors. The four largest owners in the pulp and paper industry control 41 percent of the sales.

After Putin came to power in 2000, the oligarchs have gradually been pushed out of politics. Instead, they have used the Russian Union of Industry and Entrepreneurs (RSPP) as their main lobby mechanism. The oligarchs control the work of the RSPP and meet with the president on a regular basis. According to Guriev and Rachinsky, the issues RSPP have lobbied for are to a great extent in line with the necessary reform of the Russian economy, but argue that "the intensity and therefore outcomes of RSPP's efforts vary widely across specific activities." Most notably, the RSPP's stand on banking reform, competition policy and WTO accession has been less than clear. What is clear, however, is the enormous control these oligarchs have over both employment and sales in industry.

The highest concentration of sales is found in the ferrous, non-ferrous metals and aluminum sectors

After Putin came to power in 2000, the oligarchs have gradually been pushed out of politics

³⁹ Guriev and Rachinsky (2004)

4. Drivers for regional growth and investment

Two common features for regions with good growth levels in Russia today are geographical location and the availability of natural resources. However, these obvious findings are not very helpful when considering what regional and federal authorities can do to promote investments and growth, as these characteristics cannot be changed. We take the discussion on growth and investment one step further. In the next four sections we present and discuss factors that affect growth and investments which policy-makers can do something about.

First, the relationship between regional and federal authorities is analyzed, followed by the relationship between the state and the business sector. Next the regional ability and willingness to implement reforms is examined and finally we discuss the potential for new sources of growth.

4.1 Relationship between region and center

The potential development of Russia's regions is affected both by federal and regional initiatives. In this section, we examine the relationship between these two administrative layers in general and the political and fiscal incentives of the latter to implement reforms and improve the investment climate.

4.1.1 Political incentives

It is not self-evident that regional and federal authorities are driven by the same motives, and mutual dependence is important for how successful promotion of growth and investments will be. The federal government has explicitly stated that they want to diversify the economy and promote the development of small businesses and foreign investments, as these are essential for a sustainable growth in Russia.

Until recently, the main incentive for governors to support the Kremlin was the threat of federal intervention in the regional elections. The result was that the less the political weight of the incumbent and the richer the region⁴⁰, then the more eager the governor was to please

the Kremlin. At the same time, the most powerful regional leaders were able to not play by the Kremlin rules. In 2004, the Kremlin's decision to abolish regional elections was largely motivated by the desire to improve its own bargaining position.

One of the incumbent's instruments in this game is his local administrative resources. Governors can exert pressure on local electoral committees, municipal level officials, and local media. There is a mass of evidence that such pressure has taken place, especially on local media. Governors could also "buy" regional voters by increasing budget expenditure before the elections.

This phenomenon is called the political business cycle. A CEFIR study by Akhmedov and Zhuravskaya (2004) shows that political cycles took place in Russia's regions in the period 1996-2003. The cycles were very short, and the main changes usually took place a month or two before and after governor elections. The cycles were characterized by higher budgetary expenditures in the pre-election period (the cumulative increase in budget spending during the year prior to elections amounts to 18percent) and contraction after the elections. The most sizable cycles were observed in social spending and paying off wage arrears to state employees: social expenditures grew by 24percent in the pre-electoral month and reached the level of 31percent over the norm; the stock of wage arrears dropped by 32percent over a three month period directly prior to elections. Budget revenues also grew on the eve of elections, but not as much as expenditures did, and governors used additional sources to finance the expansion. Pre-electoral expansion in the regions may be financed by either a shift in spending timetabling and running a deficit on the eve of elections, or by borrowing from the private sector, or with the help of increased federal transfers. The latter grew by 15percent in the pre-electoral month⁴¹. Usually a mix of all three ways of financing was used.

It is hard to make an ultimate conclusion about the causes of these political cycles. Two explanations are equally possible. The first one is that opportunistic cycles were caused by voters' irrationality, and were therefore an instru-

The Kremlin's decision to abolish regional elections in 2004 was largely motivated by the desire to improve its bargaining position vis-a-vis regions

⁴⁰ These two things usually go together

⁴¹ The effect is estimated for the regions that are net recipients of transfers.

ment of influencing voters' choices. The second one is that the cycles serve as signals to inform the voters about the unobserved competence of the incumbent governors⁴². Akhmedov and Zhuravskaya (2004) show that cycles get weaker when both the transparency of the government and the awareness of the voter increases, and when democratic institutions become more developed and efficient. Until this happens, political cycles are rational for the incumbents because it increases their chances of re-election. However bad the problem with political cycles was, its existence demonstrated that regional governors' elections were a source of governor accountability to the electorate. The simple fact that the governors did not fully rely on "administrative resources" to manipulate the election results allows us to make such a conclusion.

Although political business cycles do not have a substantial effect on economic growth, the distortions they cause bring about noticeable social costs. For example, the accumulation of wage arrears during the incumbent's term and rescheduling of social transfers hardens consumption smoothing⁴³. The presence of well-shaped cycles indirectly shows that the population lacks objective and independent information about local power. The absence of such information clearly was the factor which reduced the effectiveness of elections as a tool of selection of the best possible governors for the regions, and as a source of governor accountability. Moreover, the possibility of fruitfully using administrative resources reduced the incentives of governors to implement growth-promoting economic policies.

Instead of trying to solve this information problem and thereby improve the quality of elections as an accountability device, the federal government in September of 2004 decided to abolish elections altogether, and to replace them with the appointment of regional governors by the Regional Federal Councils. If we put aside the fight against terrorism, which was the given official motivation for this reform, and which seems to have little relation to the content of the reform, there are two rationales for this reform. The first one is to improve the accountability of the regional governors before the federal center in order to improve their incentives to improve the welfare of residents in their regions. The second reason is to increase control of the center over the regions, and use this control for political purposes, such as guaran-

teeing the results of parliamentary and presidential elections. Under the previous system the center had a lot of power in the regions, but it still had to negotiate with the governor at least to some extent. The governors' bargaining power has decreased tremendously under the new system.

While the usefulness of this reform for the Kremlin to manipulate elections is not in doubt, its overall effect on welfare is uncertain. Using cross-country data, Enikolopov and Zhuravskaya show that in the case of fiscal decentralization, political centralization can improve public goods provision. As we will show below, Russia is formally moving toward more fiscal decentralization, although in practice the Kremlin wants to take full control over regional policies. In a large federal country such as Russia, having both fiscal and political centralization will almost definitely not improve public goods provision. In any case, political centralization is most efficient in countries with strong national parties. Such parties provide checks and balances on the regional governors. The possibilities to make a career within the party can work as an incentive device for the governors. The absence of strong regional parties in Russia is one of the reasons why political centralization will almost surely fail to improve public goods provision.

4.1.2 Fiscal incentives

As mentioned above, two reforms that affect the regional-federal relationship have been introduced in Russia recently. The political reform giving the president the power to appoint governors was described previously. The second reform is the division of financial responsibilities between the federal and regional governments. During the 1990s, it was common for the federal government to introduce a policy that was to be implemented in the same way in all regions and financed from regional budgets without taking into account the sources of finance for such policies. Many responsibilities were inherited from the soviet system, and as a result it was common for regions to delay outstanding payments or not to provide such benefits at all. The new reform aims at specifying the division of responsibilities, prohibiting unfunded federal mandates, and reforming the system of social benefits. Therefore, the exact content of policies can differ substantially from region to region. This is particularly common in the area

The presence of electoral cycles shows that the population lacks objective and independent information about local authorities

The absence of strong regional parties is one of the reasons why political centralization will almost surely fail to improve public goods provision

⁴² See Rogoff and Sibert (1988) and Rogoff (1990)

⁴³ A large share of Russian citizens have such low savings as to ignore this effect.

During the 1990s, local governments had no incentives to increase the tax base and to provide public goods

The new scheme may result in a selection process where the best governors will not be reappointed or will not have incentives to exert the fullest efforts

of social policies, but also in policies aimed at attracting investments.

One of the most important questions concerning the effectiveness of these reforms is how they will affect the incentives of the governors to improve the business climate and to conduct policies aimed at improving the welfare of the population of their regions. During the 1990s, the structure of fiscal relationships between local and regional governments was such that local governments had no incentives to increase the tax base and to provide public goods.⁴⁴ Any increase in revenue was almost entirely offset by changes in shared revenues. As a result, governments tended to over-regulate businesses. The reform of fiscal relationships and the deregulation that were introduced during Putin's first term helped to improve the situation. The reform of fiscal relationships was aimed at improving fiscal incentives. The deregulation reform limited the abilities of local governments to intervene in the functioning of small business.

The change in the political format for the selection of governors may work in the opposite direction though. Although the center now has more power to fire governors in the case of a deep crisis, the governors might not have strong incentives to care about the well-being of the population and only care about making the right impression on the president. Some of the governors, who were known to be success-

ful during the 1990s, were not reappointed or are not expected to be reappointed under the new system. In the future, the best governors may not be reappointed either, as they will appear too powerful in comparison to the federal authorities. Hence, the new scheme may result in a selection process where the best candidates will not be reappointed, or candidates will not have incentives to exert their fullest effort. One of the problems of the previous scheme was that career prospects for successful governors were not well defined. In other countries, successful governors can get a good position in the federal authorities, and, eventually, become the head of state. In Russia such a scenario does not look very possible thus further distorting the incentives of the governors.

4.2 Relationship between business and state

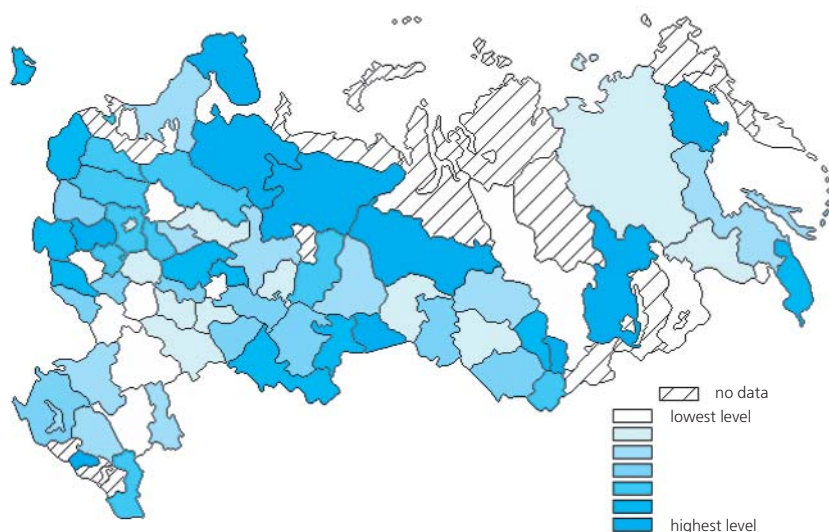
The Russian economy is characterized by a close relationship between big business and state institutions (crony capitalism) and high levels of corruption. One result of this relationship is high levels of state capture; a phenomenon whereby politically powerful firms influence the rules of the game and create obstacles to the emergence and development of competitive businesses, as well as changing the direction and speed of economic reforms. Hence they "capture" the state for their own interests.

When the Soviet Union was dismantled, the state had little accountability and overall institutions were weak, which made governments susceptible to capture. Large-scale privatization led to income inequalities with the rich oligarchs getting strong economic and political powers. In this section we give an account of the evolution of state capture during Yeltsin's and Putin's terms as president.

Decentralization gave the regions greater autonomy, thus their economic policies and susceptibility to capture varied significantly. The level of capture depends on industrial concentration, level of education, and voter awareness. In the CEFIR study the measure of state capture in the Russian regions is based on Russian legislation in 1992-2000, and using this measure the effects of capture is evaluated.

A firm's political power is determined by its size, both in terms of cash (ability to bribe) and employment (social significance), as well as

Map 4: State Capture 1994-1998



⁴⁴ Zhuravskaya (2000)

ownership structure. Not only private but also state-owned firms are engaged in state capture. In addition, firms belonging to foreign or regional private owners were more likely to be captors, and firms owned by federal private oligarchs were less likely. Enterprises that were members of larger financial-industrial groups or members of groups that had engaged in loans-for-share schemes were more effective captors during Yeltsin's term. As for industrial structure, a World Bank study (2000) shows that enterprises that operate in the natural resource sectors extract more rents and are more likely to be captors.

Politically powerful firms benefit greatly from their influence. Compared to firms without political influence, powerful firms' sales and employment grew faster, they invested more and received more profits, and besides, their performance picked up with the growth of capture.

Although there is no evidence that capture had a significant impact on aggregate economic growth, the study shows that the rest of the economy was suffering from state capture by powerful elites. With an increase in capture, firms without political influence stagnated, their productivity, sales, and investments declined. Regional small business share of employment shrank and retail turnover went down. Regional budgets were negatively affected as tax collection decreased and budget arrears increased.

It is widely accepted that there has been a big shift in the relationship between the state and businesses during President Putin's terms in power. A number of the richest and most famous Russian businessmen found themselves behind bars or in exile. Also, a centralization process, which can eventually reduce local capture, has been initiated. Do these factors lead to a decrease of capture and redistribution of power to new winners?

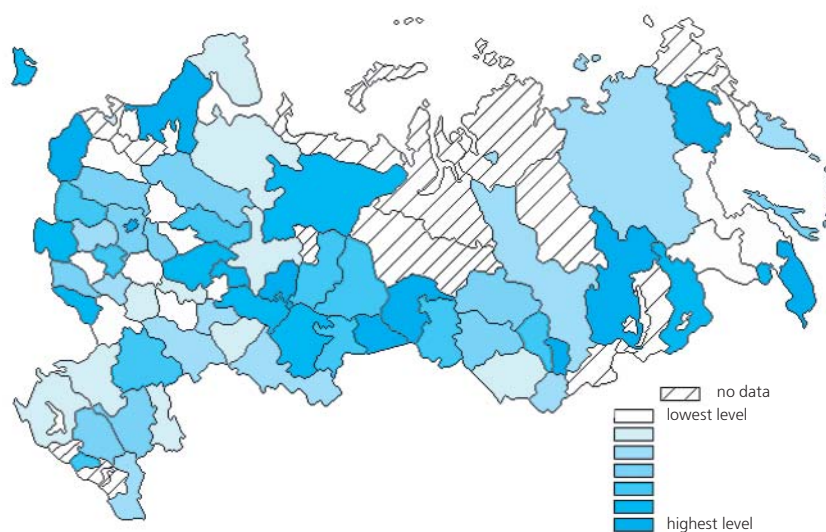
Yakovlev and Zhuravskaya use data on regional preferential treatments for firms that were among the five largest in terms of sales, in 72 regions for the period from 2001 to 2003.⁴⁵ Preferential treatments include tax breaks, investment credits, subsidies, subsidized loans, loans with a regional budget guarantee, official delays in tax payments, subsidized licensing, free grants of state property, and special "open economic zone" status.

State capture is measured as the concentration of preferential treatments in the region and a firm's political influence is measured as the firm's share of total number of preferential treatments in the region.⁴⁶

In contrast to Yeltsin, whose political term was notorious for strengthening oligarchs, Putin began his first term in the office by fighting the most famous of them: Berezovsky, Khodorkovsky, Gusinsky, and Lebedev; this was also on the agenda during his second election campaign. In addition, Putin pursued the centralization process described above, which restricted the autonomy of regional political elites and moved political and economic power from the regions to the federal center.⁴⁷ A new tax law, which restricted the use of individual tax breaks, was adopted, as well as a number of laws, aimed at easing the burden of business regulation.⁴⁸ A new anti-corruption campaign was launched and some governors, who were considered most corrupt, such as Rutsyoy in Kursk region and Nazdratenko in Primorsky region, were not permitted to run for re-election.

Considering the initiatives described above, one could expect a significant decrease in the level of capture in the regions and a reduction of the negative effects on the regional economy. However, various polls and even President Putin himself have drawn attention to the blooming corruption in various government bodies.⁴⁹ The CEFIR study also shows no sig-

Map 5: State Capture 1999–2003



⁴⁵ Yakovlev and Zhuravskaya (2004)

⁴⁶ See Appendix 10 for a comparison of the levels of state capture in Russian regions during President Yeltsin's and Putin's terms.

⁴⁷ Seven large federal districts were created taking away some regional autonomy.

⁴⁸ Akhmedov (2003b)

⁴⁹ According to ROMIR polling agency (www.romir.ru), people put unsuccessful anti-corruption measures as the second biggest failure of President Putin.

The level of state capture grew gradually during Yeltsin's first term and remained almost unchanged during Yeltsin's second term and Putin's first term

nificant change in the level of capture in the regions: the level of state capture grew gradually during Yeltsin's first term and remained almost unchanged during Yeltsin's second term and Putin's first term.

State capture has continued to have a negative effect on small business development, and on the growth of firms without political power. Small business output and retail turnover decline as state capture increase. Growth in the profitability, productivity, sales, employment and investment of firms without political connections slow down in environments with high capture.⁵⁰

At the end of 1999, a tax law restricting individual tax breaks was enacted. Tax breaks were the most popular type of preferential treatments constituting one-third of the total number of preferential treatments. Nevertheless, the law has not resulted in any considerable change in either the number or concentration of preferential treatments provided by the regions to firms. The law has only led to a change of the type of preferential treatments; the share of tax breaks has significantly decreased, whereas the share of subsidies, subsidized budget loans, budget guarantees of credits, and subsidized energy prices has significantly increased.

The question is whether Putin's attempts have led to a real redistribution of political power. In theory the concentration of political power should be in the hands of the biggest and the richest enterprises. These firms' bargaining position is strengthened by the fact that they are important employers and have considerable rents that they can use to bribe politicians.

During Yeltsin's terms, firms with bigger employment, larger output and capital, firms in extract industries, and firms that belong to bigger financial-industrial groups were more likely to have political influence. Things have not changed dramatically under Putin. In the regions, firms with bigger output and employment relative to other firms received more preferential treatments, and firms that belong to bigger financial-industrial group were also more likely to be successful captors. Finally, the average political influence of firms in extract industries is greater than the influence of firms from all other industries, except machine-building and electricity industries.

During Putin's administration, a concentration of political power to the center can be seen: enterprises that belong to federal government became the most effective lobbyists during Putin's governance, whereas firms that engaged in loans-for-shares schemes and firms that belong to regional government lost their political power.

To summarize, the study shows that there have been no significant changes in the overall level of capture. The only changes observed are in the structure of the most powerful industrial groups: firms that belong to the federal government have become the most politically powerful.

State capture does seem to have a direct effect on regional growth. One explanation could be that the firms who are capturing the state represent a large share of the regional economy and as they are benefiting from this system, short-term growth is generated. However, this is not sustainable growth and the need for the diversification of the economy calls for regional and federal administrations to change this development. At the federal level, the administration can affect the situation by improving the fiscal incentives for the regional administration.

Still, one can note that the regions that are on the top-20 list for least state capture are the very same regions that occupy the top-20 list for growth and a high share of small business activity. St. Petersburg, Rostov and Krasnodar are top performers regarding GRP and low state capture. The following regions from the top-20 for least state capture are also in the top-20 for high shares of small business and individual entrepreneurs: St. Petersburg, Samara, and Ryazan are among the top-20 for employment share, and St. Petersburg, Samara, Voronezh are among the top-20 for share of economic entities.

4.3 Government capacity to implement reforms

There have been several economic and structural reform programs in Russia over the last few years aimed at improving the business climate and regulatory environment that firms face. However, the reforms will not have any substantial effect until implemented. In this sec-

⁵⁰ See Appendix 11 for details

tion we present the results from surveys monitoring the administrative, land, and customs reform in order to increase the understanding of the drivers for implementation of reforms and, ultimately, growth and investment.

4.3.1 Administrative reforms

Small business output growth in Russia has been unevenly distributed among regions. One cause for this regional variation might be the difference in administrative burden faced by firms, as the strongest growth in small business output took place during the same time as several regulatory reforms were implemented in 2002. Red tape is one, if not the most, serious problem faced by companies in Russia.⁵¹ CEFIR has been monitoring the small business sector's administrative burden since the spring of 2002. The fifth and most recent round of monitoring was conducted in the spring of 2005.

Two instruments are used in the survey, one for older firms measuring the administrative burden for existing firms, and one for younger firms measuring the regulatory costs of entry. The former covers inspections by government agencies, licensing and certification regulations, and tax administration, in addition to the firm's general perception of the business climate. The second instrument covers the registration procedures, and licensing and certification for new firms.⁵²

Based on the results from the five rounds, reforms seem to initially have had a significant positive effect, but the speed of progress declined over time. The individual reforms perform somewhat differently. The number of inspections and license applications decreased as did the cost and time associated with these activities. Registration became simpler and faster but at an increased cost. After each round the general conclusion has been that the regulatory burden for small business remains high and that the problems stem from regional and local enforcement, rather than federal legislation.

There are large variations in regional performances, but one cannot simply rank regions as "good" or "bad," since there are significant differences in how severe each problem is within one region. In the first round, Smolensk Region was ranked the best region in terms of the number of fire safety inspections but the

worst region in terms of the time it took to get a certificate. In the last round, Sakhalin was the worst performing region in terms of cost for licensing, but the best region in terms of fire, sanitary, and administrative-technical inspections. Thus, a situation with internal regional variations has prevailed and evaluations of the progress in reform implementation at the regional level have to be done on an individual basis.

Overall, three main determinants for reform progress have been established: local fiscal incentives, less concentration of output, and a high pre-reform presence of small business in a region. A high concentration of output slows reform in licensing but speeds up the reform in inspection. This can also be described in terms of when there are many large firms, the burdens for existing firms are removed faster, and entry barriers are removed slower. Finally, the pre-reform level of small business accelerates the reform in licensing, certification, and the time spent on inspections. Together with the second determinant, this points to the importance of the small business lobby for implementing deregulations.

The findings in the monitoring survey suggest that, to a certain extent, the regional level of development for small and medium-sized enterprises seems to be in the hands of the regional administration. These results indicate that there is still much to do regionally and locally in order to improve the situation.

4.3.2 Land reform

In order for firms to operate they need access to premises, and potentially also to land, in order to invest in production facilities. In the last rounds of CEFIR's monitoring a section on the conditions for purchase and leasing of premises and land was added.

In 2003, a federal law allowing authorities to sell land was introduced even though some regions, like Samara and Saratov, already had regional laws that allowed this. The possibility for firms to buy land is very politically sensitive, as some people still believe that land should be the property of the government, which was the case during soviet times.

The survey identified renting from a private party to be the fastest way of acquiring prem-

Reforms seem to initially have a significant positive effect, but the speed of progress has declined over time

There are variations in regional performance, but regions cannot generally be ranked as good or bad

⁵¹ See for instance OECD (2004)

⁵² A summary of the main findings of each round are presented in Appendix 12

Table 6: Legal right to premises and land

Legal right to premises	Average	Legal right to land	Average
Own	26%	Own	5 %
Rent from government	23%	Rent from government	25 %
Rent from private party	45%	Rent from private party	8 %
Other	6%	No relation to land	58 %
		Other	3 %

es, and buying from a private party as the lengthiest process. The costs of acquiring premises include various administrative costs (intermediaries, registrations etc.) on top of the actual price. The largest share of firms feeling pressure to give bribes is found among those buying premises from the government. Given the numbers presented in Table 6, it is not surprising that firms perceived the procedures of renting from a private party as the most transparent.

Older firms (more than three years) are more likely to own their premises compared to younger firms, among which it is more common to rent from a private party than from the government. As renting from a private party is considered the most transparent, it is not surprising that newer firms prefer this solution. Half of the firms who own their own building say that it is too expensive or too difficult to buy land.

In some regions renting is predominant, while in others owning premises is. In addition, the share of firms renting from the government and renting from private parties differs, and a general explanation could be that this depends on how developed the secondary market for land is. If land is expensive, firms might only be buying land for their own use rather than investing money in land in order to collect rents.

When shifting to the regional perspective, Moscow oblast stands out with the largest share of firms owning their premises and the smallest share of firms renting premises from a private party. Moscow oblast also has the largest percentage of firms claiming to own their own land (17 percent), and the largest

share renting land from the government (51 percent), and this probably goes hand in hand with the ownership of premises.

The fact that Moscow oblast stands out reflects the region's extensive efforts in attracting firms from Moscow City, by reducing costs and simplifying procedures. The number of SMEs has in fact increased in Moscow oblast and decreased in Moscow City lately. In regional comparisons, Moscow City usually stands out, but in this case Moscow region has also upped its performance due to the competition from Moscow City. The low levels of firms renting from private parties in Moscow oblast could be an effect of the high prices and few investor effects described above.

The region with the second largest share of firms owning premises is Nizhny Novgorod. This is not surprising as Nizhny Novgorod is one of the most liberalized regions. The second largest share of land-owners is found in Rostov. Renting premises from the government is most common in Khabarovsk and this combined with low levels of firms owning their own premises indicates that local authorities have strong control over the local premises. The governor of Khabarovsk is known to be among the most authoritarian; hence this is most likely a consequence of strong rule.

Samara and St Petersburg are among the regions with the smallest percentage of firms owning their own premises. Almost 60 percent of firms in Samara and St Petersburg rent from a private party, which is the largest share among all regions. Both these cities are among the most expensive in Russia; St Petersburg is the second largest city and Samara has a population with high income due to a automobile factory located there, and the high price level could explain why firms prefer to rent, rather than buy their premises. This reasoning also holds for Novosibirsk (fourth largest city) but not Nizhny Novgorod, despite the fact that it is the third largest city. The reverse situation in Nizhny Novgorod illustrates the difference in institutional environment in terms of access to credit and the authorities' treatment of SMEs. The fact that a large percentage of firms rent from a private party is probably the effect of sub-letting, and most premises are most likely to actually be in the hands of the authorities. An alternative explanation could be that this is due to corruption; that authorities rent premises to

Regions can attract investments and promote SME growth by simplifying access to land and premises

middlemen at prices below market value, who then sub-let it to the firms, but this needs to be further investigated.

The experiences of Moscow oblast and Nizhny Novgorod indicate clearly that regions can attract investments and promote SME growth by simplifying access to land and premises.

4.3.3 Customs reform

The poor design and enforcement of customs procedures are believed to affect trade and investments negatively. Importers and exporters, domestic as well as foreign, are faced with high transaction costs that hamper investment incentives. When discussing the costs of customs procedures it is not only a matter of actual expenses for firms as the customer also bears the costs through higher prices and potentially also access to lower import volumes.

Customs is one of the main obstacles for doing business in Russia. In a business climate survey presented by OECD about 80 percent of the respondents consider "delays at border crossing due to inefficient customs procedures" to be a medium, serious, or very serious problem.⁵³

However, as a step in the process of improving and simplifying trade transactions in Russia a new Customs Code was introduced on January 1, 2004. The aim of the new legislation was to simplify customs procedures, reduce arbitrary implementation by customs officials, and limit the number of required documents. Moreover, local amendments are no longer permitted, and the maximum time for customs clearance has been set at three days, compared to the previous maximum of ten days. It also stipulates that physical inspections should be based on risk assessment. Prior to the new law, customs clearance had to be conducted where a company is registered, but now importers are free to choose their route of delivery.

CEFIR has been monitoring the effects of the reform. At the beginning of fall 2004, we measured the perceived changes between the second half of 2003 and the first half of 2004. The general results from the survey were that time for customs clearance and border crossing have decreased, with a larger decrease in time for customs clearance. However, the majority of

firms report no change in time. The limit of a maximum of three days for customs clearance is not fully respected, and customs still often demand unexpected documents. The majority of goods are inspected, which indicates that the risk assessment procedure is not yet in place. About half of all firms, both importers and exporters, use intermediaries, and the reasons for doing so are rather evenly distributed among the following four explanations: a lack of qualified personnel, to save time, to optimize customs duties, or that the intermediary has documents that are hard to obtain.

There are no major obvious differences among the surveyed regions, but one can still comment on the relative performances and some regional variations. The use of intermediaries is most common in St Petersburg and Moscow City for both exporters and importers. Intermediaries were least commonly used in Karelia. The problem of demanding unexpected documents is most widespread in Kaluga, where about half of all importers state that this happens always or often. The least problematic situation is found in Moscow oblast where approximately 3 out of 4 importers report that this rarely or never happens to them. There are also regions where demand for bribes has gone down at the same time as prices for intermediaries have increased, which indicates that corruption is being institutionalized. Anecdotal evidence suggests that some customs officers only accept declarations from a customs broker, and firms are thereby forced to pay the fee for these services, hence illegal bribes are substituted with legal fees.

When measuring the time effects of the customs reform, the results are presented in terms of time for border crossing, time for customs clearance and how often the total time for customs clearance exceeds the maximum three days. Kaluga reports the best results for all three categories, and Leningrad oblast also performs well regarding customs clearance and respecting the maximum time limit. St Petersburg has the best results for time in border crossing, but the worst results in the frequency of exceeding the maximum time limit of three days for clearance. Kaliningrad has the largest share of exporting firms experiencing an increase in time for border crossing and customs clearance. Finally, importers in Karelia report the worst results for all three categories, with the largest share reporting an

Controversial and unpredictable laws and their arbitrary implementation remain very problematic

There are indications of customs corruption being institutionalized

After a new Customs Code was introduced in 2004, time for customs clearance and border crossing have decreased

⁵³ OECD (2004)

Trade facilitation could certainly be a part of a regional strategy for increasing trade and investment

increase in time, and the largest share of firms that often or always experience an exceeded time limit.

This survey only covers a few regions and it will not be clear until the next round of research if there are regional differences regarding the implementation of the customs reform. Still there is much to be done in order to simplify customs handling, and trade facilitation could certainly be a part of a regional strategy for increasing trade and investment. There has already been an initiative for e-declaration at some customs terminals, and implementing this would certainly simplify companies' customs handling.

4.4 New sources of growth

Active promotion of innovation and entrepreneurial activity in the regions are crucial factors for unleashing the potential in the Russian economy. Yet, the understanding of the driving forces behind an improved climate for new market entrants and innovators has been largely unknown, until now.

4.4.1 Entrepreneurs

It is increasingly recognized that entrepreneurship plays a crucial role for successful economic development. When studying the determinants of entrepreneurship, social scientists emphasize three sets of variables: institutions, social networks, and personal characteristics. An institutional perspective focuses on the role of economic, political, and legal institutions in fostering entrepreneurship. Particularly relevant are credit markets and the protection of property rights. Credit constraints make it impossible for the relatively poor to borrow funds to start up a business, and insufficiently strong property rights may not provide entrepreneurs with the necessary incentives. The second perspective emphasizes sociological variables, such as social norms, values, and social networks, including relatives, friends, and social groups. The third perspective emphasizes the individual characteristics of entrepreneurs, such as a personal need for achievement, self-confidence, self-reliance, and attitudes toward risk.

There remains no clear consensus on the determinants of entrepreneurship, which makes it difficult to devise policies to encourage entre-

preneurial development. For example, relaxing credit constraints may not be of much help if the main obstacle to entrepreneurship lies in the insecurity of property rights. Similarly, financial and legal reforms may not achieve much if the roots of entrepreneurial potential lie in cultural factors and personal traits.⁵⁴

A new international project studies entrepreneurship in a number of large emerging markets from all three perspectives introduced above.⁵⁵ The pilot study was carried out in Russia during 2003-2004 and 1200 interviews were conducted in seven cities (including Moscow) in four different regions. An entrepreneur was defined as an owner or a co-owner of a business with five or more employees. The sample included both entrepreneurs and non-entrepreneurs in order to understand how these groups differ in terms of individual characteristics. Non-entrepreneurs mirrored the sample of entrepreneurs with respect to age, gender and educational attainment. In addition, 150 non-entrepreneurs were surveyed without regard to demographic characteristics.

A random sample determined the rough proportion of entrepreneurs across cities, and considerable variation was found: the lowest proportions of self-employed and entrepreneurs were found in Nizhny Novgorod (6 percent) and Moscow (8 percent) and the highest in Taganrog (18 percent).

Controlling for age, gender, education, and location, entrepreneurs are found to be wealthier, are more likely to own a home, a car, and a computer; they also spend a smaller proportion of income on food, compared to non-entrepreneurs. Only 5 percent do not own either a car or a computer, compared to 48 percent among non-entrepreneurs. Entrepreneurs are also more mobile, both professionally and geographically.

Having a father and mother who have completed higher education and the presence of a businessperson among close relatives and friends from adolescence are factors that increase the probability of becoming an entrepreneur. Individual perceptions of the business climate matter for career choice: lower perceived levels of corruption and a more benign public attitude towards entrepreneurship increase the probability that an individual will become an entrepreneur.

⁵⁴ Djankov et al (2004)

⁵⁵ Ibid.

Entrepreneurship plays a crucial role for successful economic development

The social environment in general and social networks in particular seems to play an even bigger role. However, only 5 percent of the entrepreneurs in the sample inherited a family business, so family effects played a role through other, less direct channels. Beyond the family, one's social circle in general, for example, friends from childhood and adolescence, seem to affect the decision to become an entrepreneur. More than a quarter of entrepreneurs in the sample claim that friends who became entrepreneurs influenced their own career decisions.

Cultural differences and values are found to play less of a role than expected. Entrepreneurs attach more value to work, intellectual achievement, power and politics than non-entrepreneurs. In regards to family, friends, leisure, religion, service to others, financial security, health, and freedom, they tend to share the values of non-entrepreneurs.

The study determines two major categories of entrepreneurs: "entrepreneurs by opportunity" and "entrepreneurs by necessity." The first group became business owners because they seized an opportunity, the second category because they lost a job or the industry they worked in declined. Family networks have a positive effect only on the probability of becoming an "opportunity entrepreneur" and have a negative effect on "entrepreneurs by necessity." Government officials' perceived favorable attitude toward entrepreneurs increases the chances that an individual will exploit a business opportunity, while reducing the chances that he or she will start a business out of necessity.

Why do more people not become entrepreneurs? The three main reasons given by non-entrepreneurs were: insufficient funds, a lack of entrepreneurial skills, and risk aversion. The latter two are individual characteristics. Lack of money can be interpreted both as a credit constraint and as a lack of drive to raise funds. Thus it seems that individual characteristics play an important role in the decision to become an entrepreneur. Confidence in starting one's own business is boosted by having entrepreneurs in one's family and among one's friends.

The results suggest that the social network, that is having entrepreneurs among family members and friends, is the most important variable affecting the decision to become an

entrepreneur. Certain personal characteristics, such as academic success, cognitive ability, self-confidence, greed, and risk-taking are also important determinants of entrepreneurship, echoing the claims of Schumpeter. Weak institutions play some role in discouraging people from starting or expanding an enterprise, but not a crucial one. Cultural differences do not seem to be of great importance in Russia.

4.4.2 Innovate or imitate?⁵⁶

It is widely believed that Russian firms do not innovate. This belief is based on the conjecture that Russian firms should conduct R&D and introduce absolutely new products with the same intensity as do firms from developed countries. At the same time, "distance to frontier" theory suggests that firms from countries, located far from the technological frontier, can grow quite fast not by introducing absolutely new technologies, but by copying technologies and products developed in other countries.⁵⁷ In many cases this "development by imitation" strategy can produce faster growth rates than attempts to grow by innovating.

The Russian State Statistics Committee (Goskomstat), which uses a definition of innovations close to the above-mentioned one, reports that only about 9 percent of Russian firms innovate. A 2004 study by CEFIR and the Institute for the Economy in Transition in Moscow survey uses a definition, which includes imitations. It suggests that the true number is much higher: at least 40 percent.

Table 7 provides a breakdown of innovations by type as reported both in Goskomstat statistics and in the CEFIR-IET survey. According to both sources, more than 60 percent of innovations are the introduction of new equipment or products. About 30 percent of innovating firms report doing R&D.

In the CEFIR-IET survey, firms were asked to classify products and technological innovations as either imitations, or as introductions of absolutely new products and technologies. Among 727 firms, which replied to the questionnaire, 226 firms either did not make innovations, or did not specify their type, 196 firms only conducted imitations, 148 firms introduced only absolutely new products or technologies, and the remaining 157 firms had innovations of both types.

Having entrepreneurs among family members and friends affects the decision to become an entrepreneur

At least 40 percent Russian firms innovate, according to a study

⁵⁶ This text was first published in *BOFIT Russia Review* 5, 2005. It is based on Kozlov and Yudaeva (2005)

⁵⁷ Acemoglu et al (2002a) and Acemoglu et al (2002b)

Table 7: Percentage of firms, involved in innovative activities, breakdown by activity

	Goskomstat	CEFIR-IET
Purchase of new technologies	16%	
Introduction of new technologies		36%
Of which: patents, licenses, prototypes	8%	7%
Purchase of modern equipment	62%	64%
Research aimed at development of new products and technologies	33%	
In-house R&D		33%
Outsourced R&D		16%
Purchase of IT products	27%	
Development and preparation for production of new products	37%	
Introduction of new products		61%
Marketing studies	19%	31%
Training of personnel	24%	45%

When asked why they innovate, most of the firms mentioned the need to improve their financial situation or to decrease costs. Increasing market share and access to new markets is a part of development strategy for more than 60 percent of innovating firms, although less than 40 percent of them think of getting access to international markets.

Lack of finance is reported to be the major obstacle to innovations. Retained earnings is the major source of funding for innovations, so it is not surprising that more than 80 percent of firms named shortage of funds as a serious obstacle for innovations. Lack of external funding, be it government support or private funds, is the second most important factor. Shortage of qualified personnel and management was named as a significant barrier by less than 25 percent of firms. Lastly, infrastructure was named as a significant barrier by only 16 percent of respondents.

Regression analysis on both datasets confirmed the hypothesis that credit constraints is an important obstacle to innovations. Profit turned out to be a positive and significant determinant of the probability of innovation. As recent theory suggests, competition has an inverted U-shape effect on innovations: increase in competitive pressure from a small level increases the probability of innovation, but after a while additional competitive pressure results in decline in profitability to a level detrimental to innovations.

Comparing imitators and innovators revealed interesting differences. While the effect on competition is similar in both cases, innovators seem to be less dependent on profitability than imitators. This finding is even more surprising given that theory usually assumes the opposite: since imitations are less risky, it should be easier for imitators to get access to external funds. We can provide two different explanations for this finding. Getting non-government external funding is in a sense an "innovation" for Russian firms. They did not have to do this in soviet times. So innovators may be more proficient in this activity than imitators. In the same regression specification, we also find that better corporate governance is positively associated with the probability of innovation, but not with the probability of imitation. Since improvement in corporate governance is an important step in improving access to external funding, this result can be interpreted as an indirect confirmation of our hypothesis. The second interpretation of the fact that profitability is not related to the probability of innovation is that the group of innovators may be heterogeneous. In addition to "true" innovators, it can include "survivors," that is non-profitable firms, struggling to survive by introducing new products. These new products may in fact be of an imitation type, but due to a lack of technological knowledge firms may consider them innovations.

There are two other differences between imitators and innovators. The probability of imitation is positively associated with the probability of having a foreign educated manager or a manager who took some courses or training abroad. Thus imitators follow "westernization" strategy: they copy both foreign products and managerial techniques. At the same time imitators allow themselves to do less marketing studies than do innovators. Probably they

believe that imitations of foreign products will be in high demand anyway.

At the beginning of 2005, a new round of CEFIR-IET innovation surveys was conducted. The results of the survey show that the innovation rate is increasing: more than 60 percent of almost 800 firms, which responded to the questionnaire, said that they introduced new products in the last three years.

The increase in the innovation rate has happened to a large extent due to an increase in imitations. Moreover, not only did firms that had not innovated before start to report that they had introduced imitations of existing products or technologies, but also other firms, which in the previous survey had classified themselves as innovators, now started to consider themselves as imitators. We do not know whether these firms realized that their new products or technologies are in fact imitations of the existing ones, or if they just decided that at this stage of the development of the Russian industry imi-

tating existing products is a more profitable strategy than innovating.

Although aggregate statistics may be silent about it, Russian industrial firms are going through a process of massive restructuring both from the technological and organizational point of view. As predicted by the "distance to frontier" theory this restructuring is mainly of an imitation type. More and more firms introduce products and technologies, which are close substitutes to the existing ones. Only a small proportion of firms introduce original products.

Due to Russian technological backwardness this is an efficient growth strategy. However, this does not mean that the government does not have to think about creating the infrastructure and institutional environment, which would allow a more efficient use of currently existing human capital, capable of innovating, and not only imitating. This task will become more and more urgent as the Russian technological position improves.

Imitating is an efficient growth strategy at the moment, but conditions need to be created to foster true innovations

5. Conclusions

Providing local fiscal incentives, promoting small businesses, ensuring less concentrated output and transparent and effective regulation, and stimulating the emergence of new sources of growth will positively affect regional growth and investments

The discrepancy between the investment and growth potential and the relatively limited and highly uneven progress in Russia's regions is to a great extent based on the institutional, political, fiscal and social structures of Russia. Postponement of vital reforms and the poor implementation of reforms in combination with directly contradictory reforms are the main challenges to bridging the gap.

There are substantial differences in terms of growth and investment and, subsequently in unemployment, income, and poverty levels, across and within Russia's regions. There are some important preconditions — such as the existence of natural resources and large urban populations — and structural barriers to regional growth and investment strategies. However, there are also a number of important factors that affect growth and investments that regional and local government can do something about, despite the poor institutional climate and the overall relationship between the center and the regions.

Crony capitalism, state capture, and corruption have become symbols of the Russian market economy. Capture has not been reduced during the last seven years of high growth. But it has changed. During Putin's presidency, the ability to capture the state has generally been transferred from private sector oligarchs to political sector oligarchs. Corruption and

bribery have increased dramatically during the same period. Capture and corruption are effective barriers to small business development and the fight against poverty. While capture creates obstacles to the emergence and development of competitive (and often more productive) businesses, corruption works as a regressive tax on poor people. Capture and corruption have regional and local faces and the degree depends on industrial concentration, level of education, and voter awareness.

The implementation of reforms has clearly positive results for growth and investment but there are substantial regional variations in implementation. Surveys of the administrative, land, and customs reforms show that although it is difficult to rank regions overall as "good" or "bad" there are a number of determinants for reform progress: local fiscal incentives, less concentration of output, and a high-level of small businesses, all seems to matter for implementing reforms. Apart from improving the implementation of current reforms and regulating current business activities in a more transparent and effective way, regional governments can also stimulate the emergence of new sources of growth. The regional institutional environment matters for foreign companies, entrepreneurs, and innovations. This is arguably a troika that Russia's regions, regardless of current status, need much more of.

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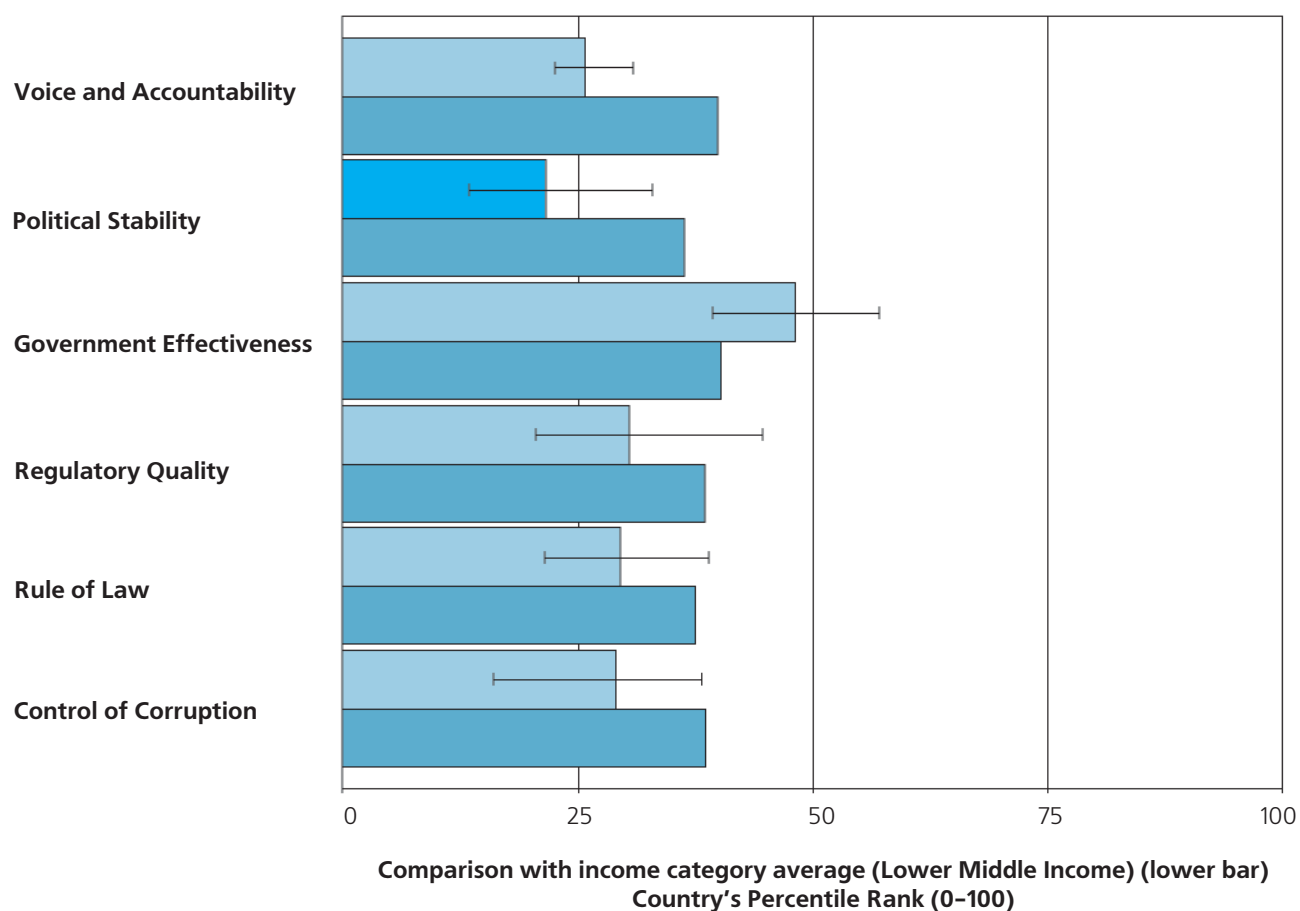
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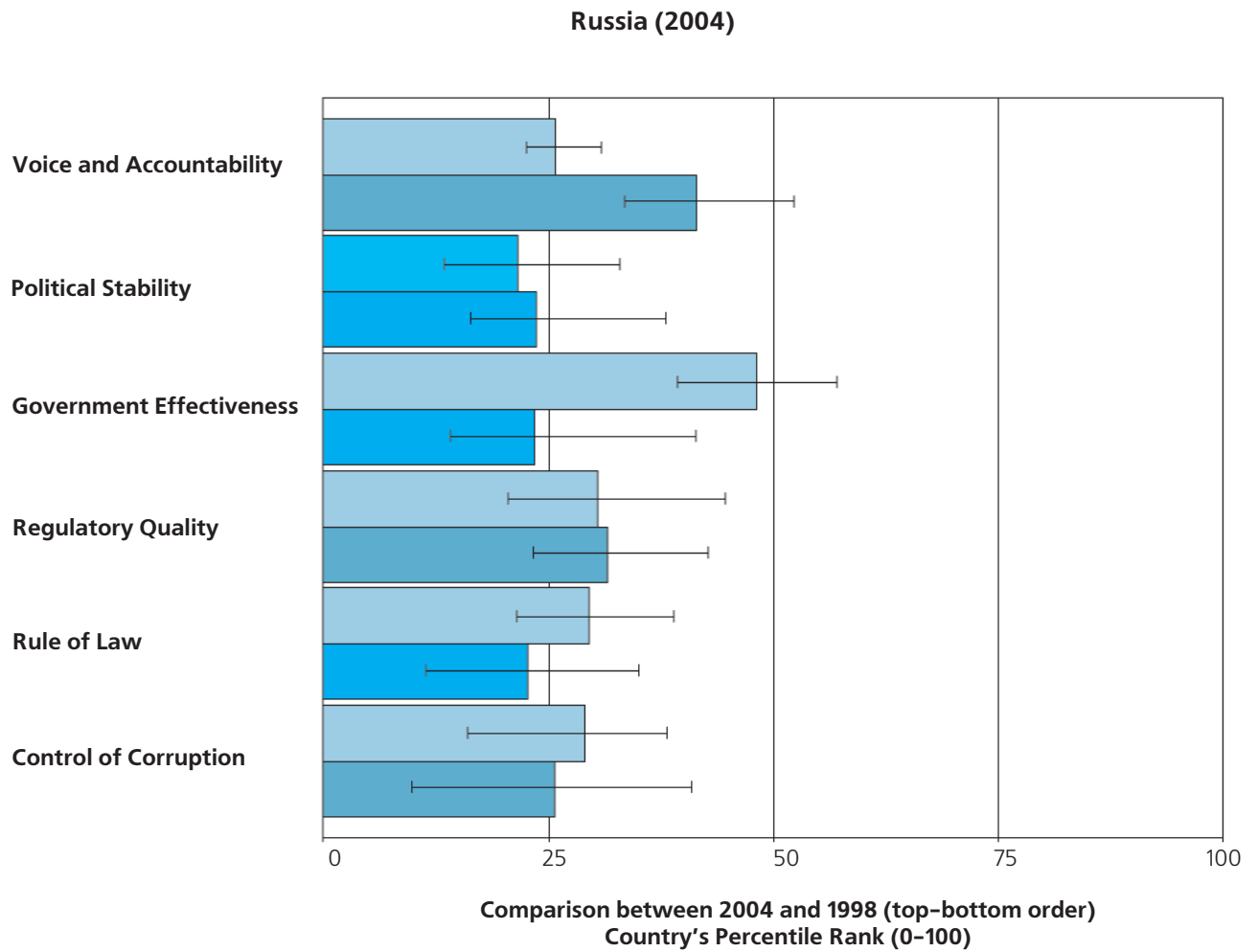
Appendix 1: Russian Governance Indicators, Comparison with Income Category

Russia (2004)



Source: D. Kaufmann, A. Kraay, and M. Mastruzzi, 2005: *Governance Matters IV: Governance Indicators for 1996-2004*
<http://www.worldbank.org/wbi/governance/pubs/govmatters4.html>

Appendix 2: Russian Governance Indicators, Comparison 2004 with 1998



Source: D. Kaufmann, A. Kraay, and M. Mastruzzi, 2005: *Governance Matters IV: Governance Indicators for 1996-2004*
<http://www.worldbank.org/wbi/governance/pubs/govmatters4.html>

Appendix 3: Cost of Doing Business

Starting a Business (31)	Russia	Region	OECD	Protecting Investors (73)	Russia	Region	OECD
Procedures (number)	8	9	6	Disclosure Index	7	4.5	6.0
Time (days)	33	36	19	Director Liability Index	3	4.2	5.3
Cost (% of income per capita)	5.0	13.5	6.5	Shareholder Suits Index	5	5.6	6.7
Min. capital (% of income per capita)	4.4	49.1	28.9	Investor Protection Index	5.0	4.8	6.0
Dealing with Licenses (143)	Russia	Region	OECD	Paying Taxes (52)	Russia	Region	OECD
Procedures (number)	22	21	14	Payments (number)	27	46	16
Time (days)	528	251	150	Time (hours)	256	431	192
Cost (% of income per capita)	353.7	668.9	68.0	Total tax payable (% gross profit)	40.8	50.2	46.1
Hiring/Firing Workers (57)	Russia	Region	OECD	Trading Across Borders (67)	Russia	Region	OECD
Difficulty of Hiring Index	0	34.5	29.5	Documents for export (number)	8	7	5
Rigidity of Hours Index	60	56.9	50.0	Signatures for export (number)	8	10	3
Difficulty of Firing Index	30	41.5	27.3	Time for export (days)	29	31	12
Rigidity of Employment Index	30	44.3	35.7	Documents for import (number)	8	11	6
Hiring cost (% of salary)	35.8	29.6	20.8	Signatures for import (number)	10	15	3
Firing costs (weeks of wages)	16.6	32.8	32.6	Time for import (days)	35	42	14
Registering Property (35)	Russia	Region	OECD	Enforcing Contracts (62)	Russia	Region	OECD
Procedures (number)	6	6	4	Procedures (number)	29	29	19
Time (days)	52	127	33	Time (days)	330	393	232
Cost (% of property value)	0.4	3.0	4.7	Cost (% of debt)	20.3	17.4	10.9
Getting Credit (148)	Russia	Region	OECD	Closing a Business (71)	Russia	Region	OECD
Legal Rights Index	3	5.6	6.3	Time (years)	3.8	3.5	1.5
Credit Information Index	0	2.5	5.0	Cost (% of estate)	9	14.0	7.6
Public registry coverage	0	1.4	7.8	Recovery rate (cents on the dollar)	27.6	29.8	73.5
Private bureau coverage	0	6.6	58.0				

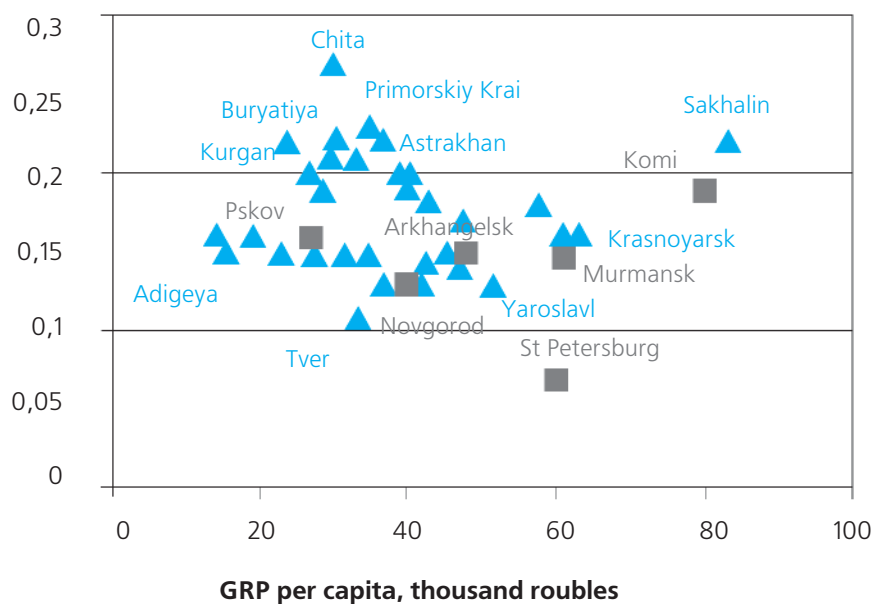
Source: World Bank, *Doing Business in 2006*
www.doingbusiness.org

Appendix 4: Major Channels of Financial Support Provision to the Regions

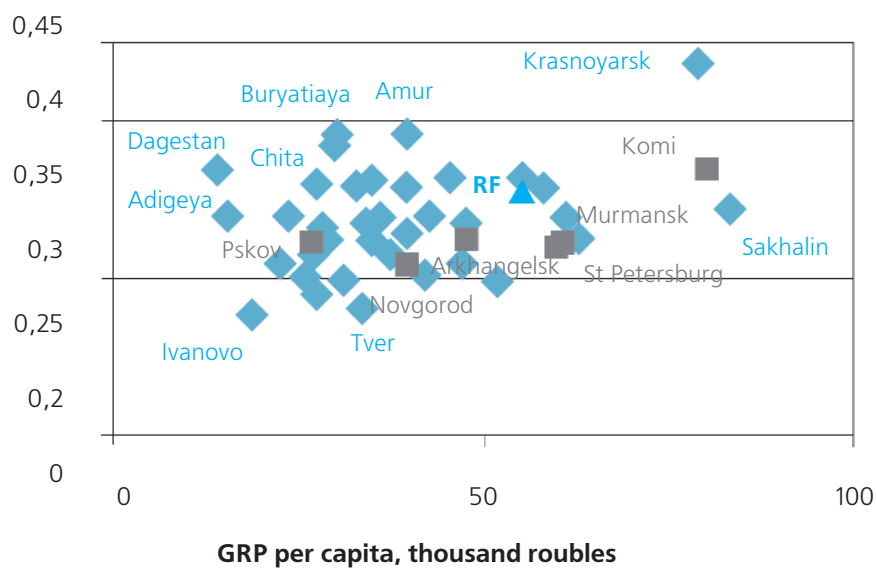
	RFSF	FC	CCEF	RDF	RERF, RMRFR
Goal	Equalization of funding sources of major budget expenditures	Financing of expenditures, regulated by federal laws (mainly social expenditure)	Co-financing of "important" social expenditures, and support of social reform programs	Support of regional infrastructure development	Support of budgeting process reforms
Rules of provision of funds	Formula, which calculates tax potential and "normal" level of expenditure	Formula, based on the number of social support recipients	Formula, based on expenditure standards, and pace of reform estimate	Competition among investment projects	Competition among reform programs
Type of financial assistance	Subsidies, with special rules of provision and usage	Grants for financing special federal laws provisions	Co-subsidy for specified expenditure items	Subsidy (usually requires co-finance) for financing investment projects	Subsidy or grant for financing special expenditure items
Conditions	Federal Treasury transfer to the regions - transfer recipients	Funds for financing special programs	To support the expenditure size at the level of federal standard, alt. program performance	Co-financing	Fulfillment of reform program
Allocation rules	To financial bodies of the regional government	To final recipients (citizens, organizations, enterprises) via Federal Treasury.	To financial bodies of the regional governments after confirmation of expenditures for the corresponding expenditure items	To firms and organizations via Federal Treasury	To regional financial bodies after confirmation of expenditures on budgeting reforms and improvement of regional government finances
Time of creation	Since 1994	Since 2001	Since 2003 - 2004	Since 2000, change of rules in 2002-2003	Duration of the WB grant: 2001 - 2004
Size in 2005 (Law)	190 bln Roubles (US\$6.8 bln)	33.4 bln Roubles (US\$1.2 bln)	23 bln Roubles (US\$0.8 bln)	2.5 bln Roubles (US\$89 mln)	0.6 bn Roubles (US\$21 mln)

Source: CEFIR

Appendix 5: Poverty Gaps, Intra-Regional Inequality



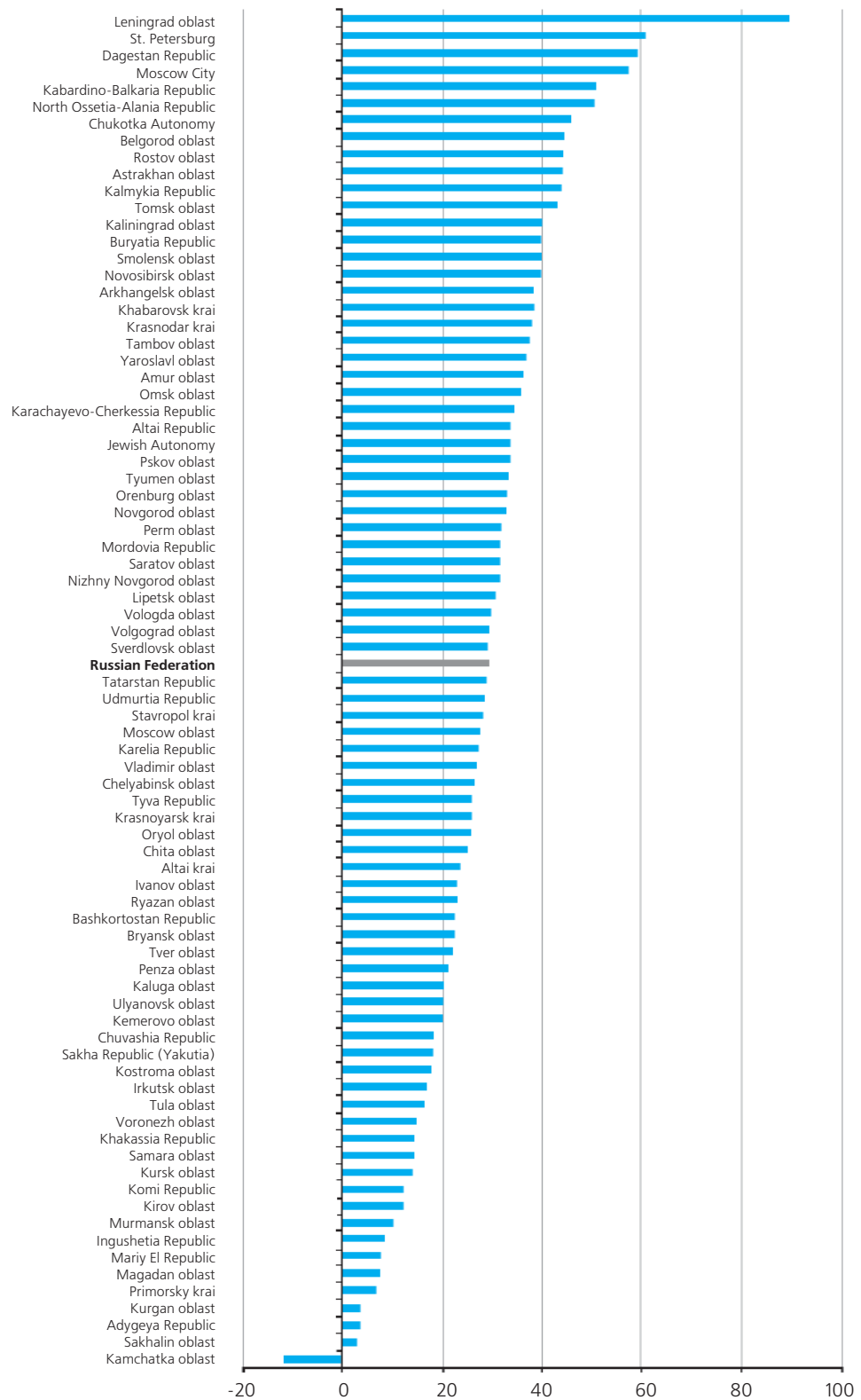
Appendix 6: Intra-Regional Inequality, Gini-coefficient



Note: Moscow, Tyumen and Sakha-Yakutia have high GRP per capita values and are not shown on this graph

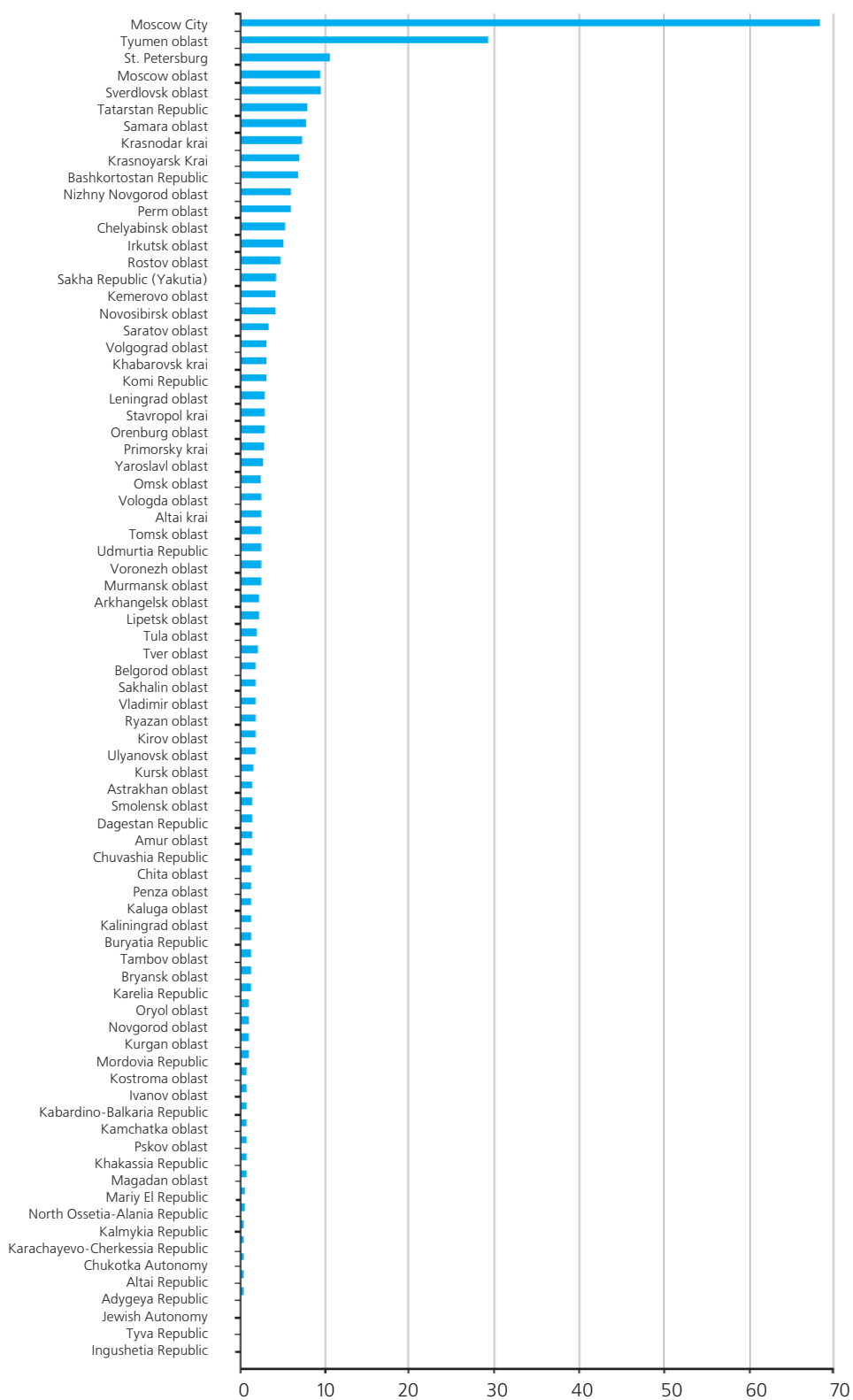
Source: CEFIR calculations based on NOBUS database

Appendix 7: Gross Regional Product Growth, in %, 1999–2002



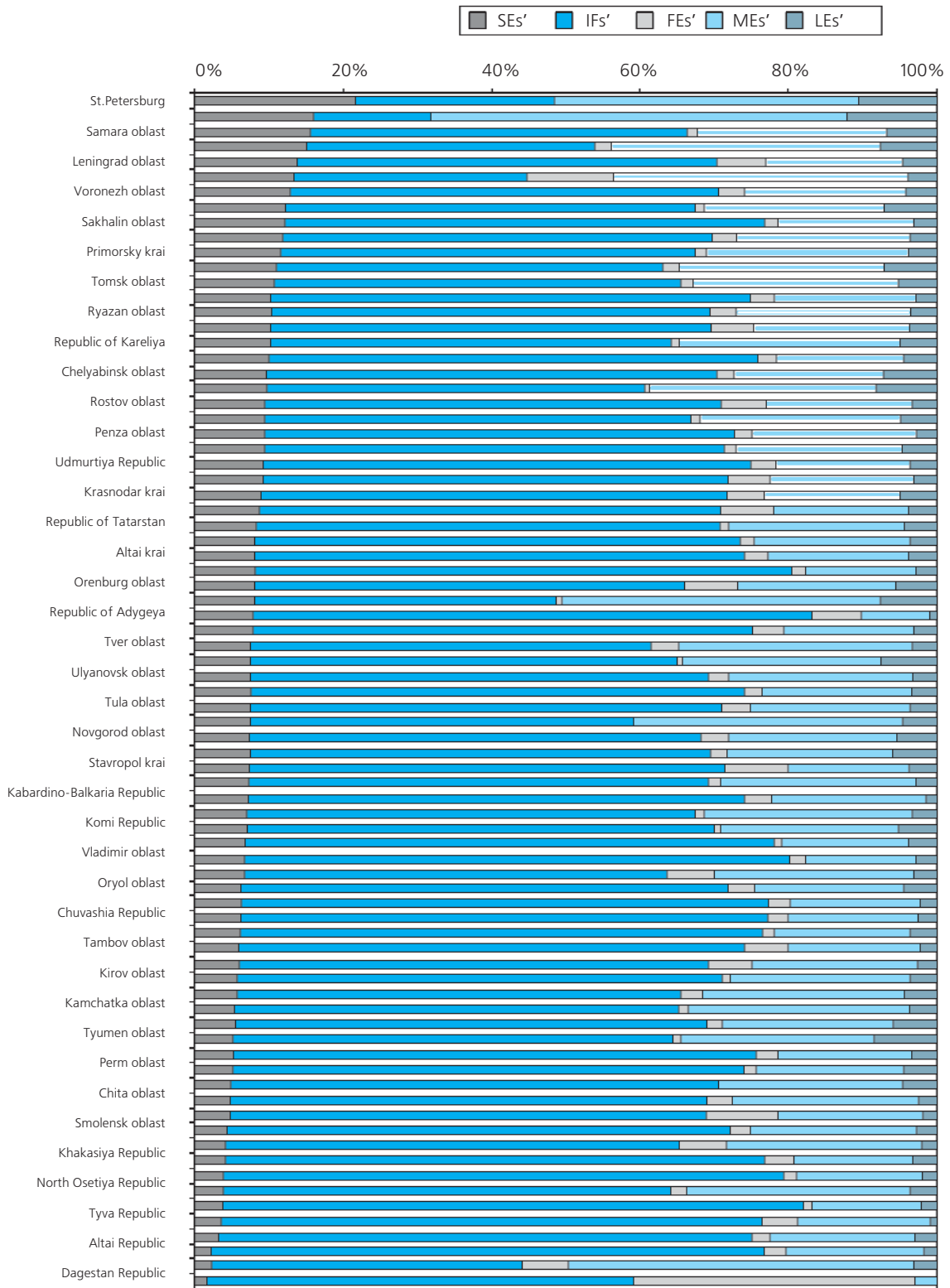
Source: Aton

Appendix 8: Gross Regional Product



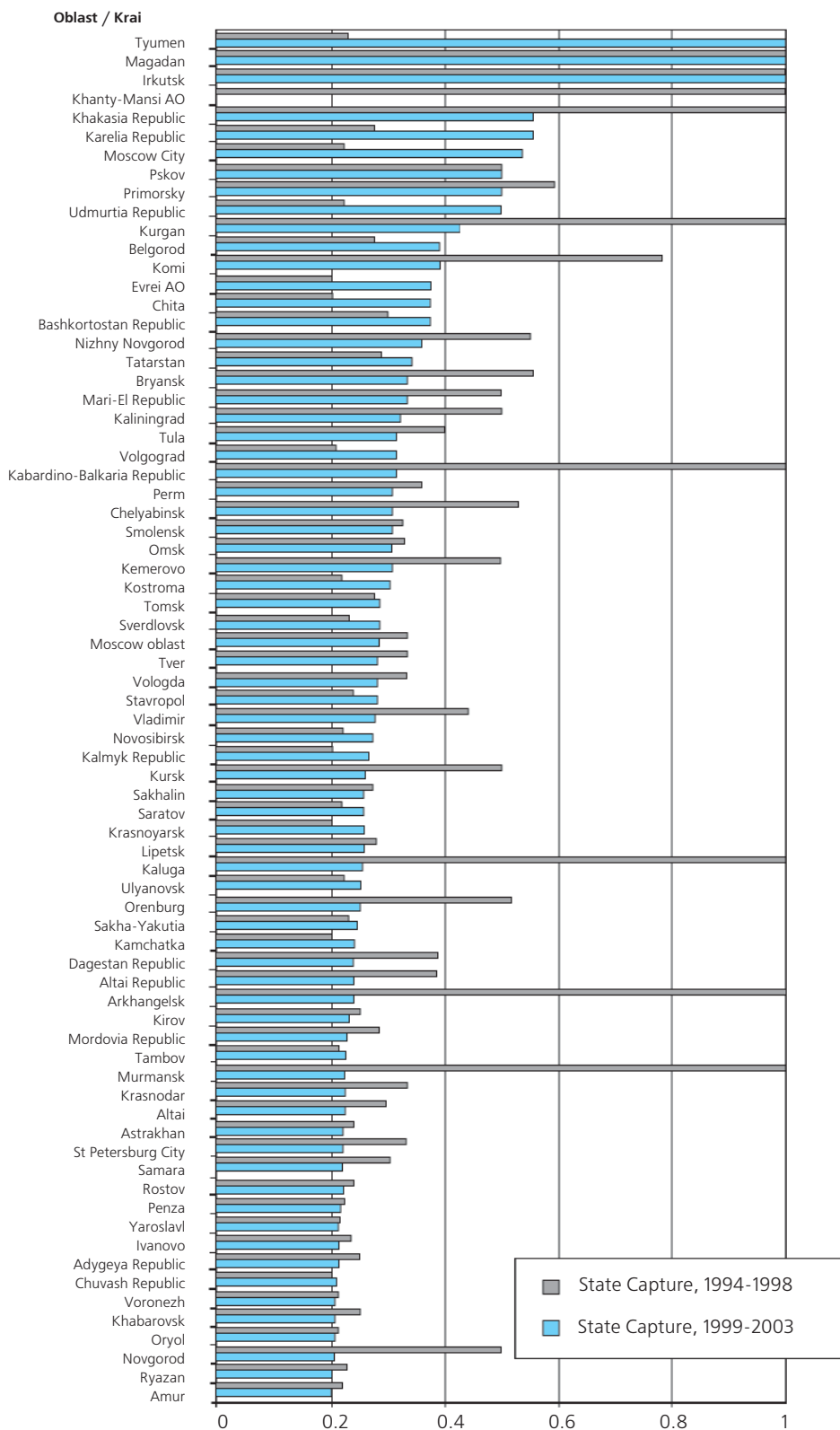
Source: Aton

Appendix 9: SME Distribution Across Regions



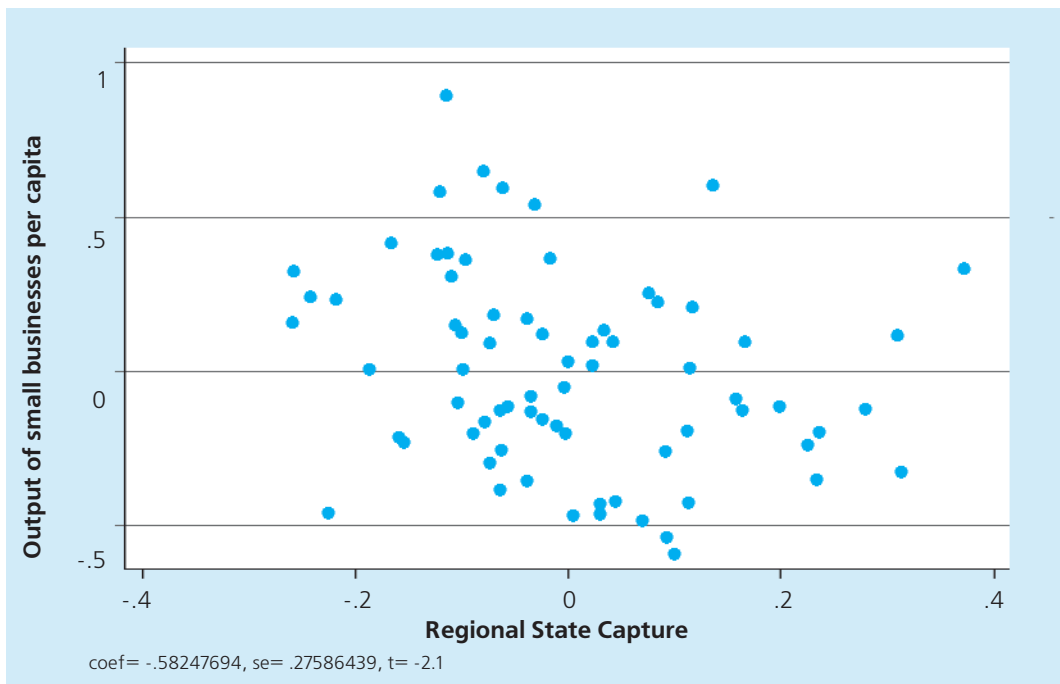
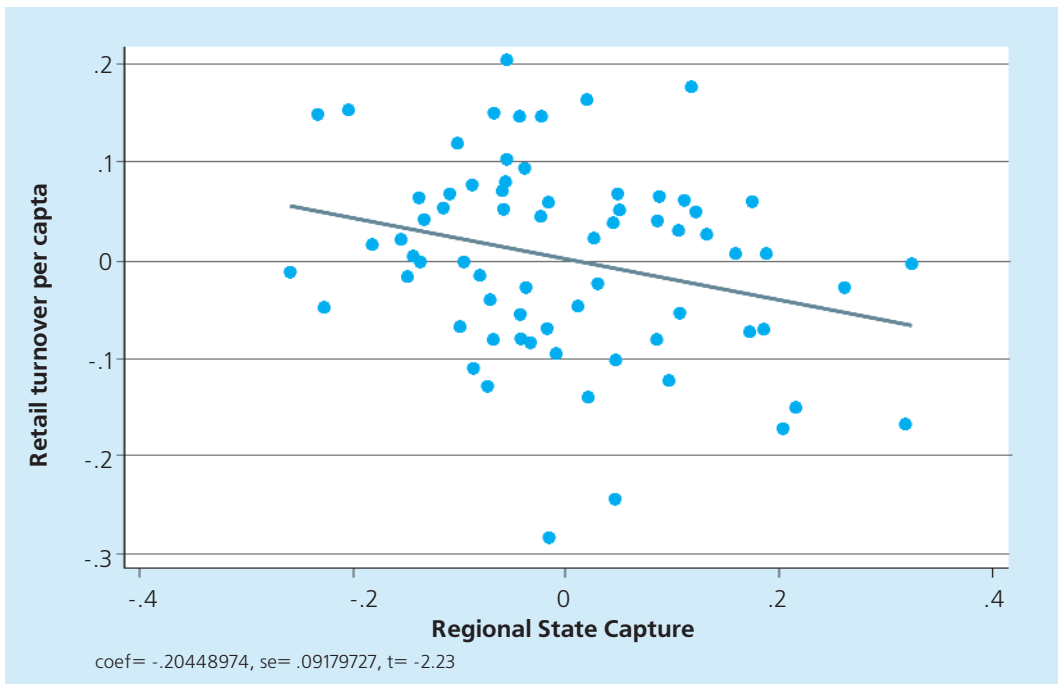
Source: Russian SME Resources Center

Appendix 10: State Capture Yeltsin vs. Putin



Source: Yakovlev and Zhuravskaya (2004)

Appendix 11: State Capture and Small Business Growth



Source: Yakovlev and Zhuravskaya (2004)

Appendix 12: Monitoring Administrative Reforms

Time Period	Reform	Findings
1st and 2nd half of 2001	None	Baseline information was gathered. Practices in all areas were very far from the benchmarks.
2nd half of 2001 and 1st half of 2002	Inspection (Aug 2001)	The number of inspections fell by a third. The time and costs spent on inspections fell. Abuse of power was still present.
	Licensing (Feb 2002)	The number of firms applying for licenses fell by a third. The time and costs to obtain a license reduced. Costs were still twice the target level, and almost half of the issued licenses had validity shorter than prescribed. Tax administration appears to have worsened, especially for firms that did not use the simplified tax system (introduced in 1997). Only 29% of eligible firms used the system and they paid on average 7 taxes instead of 9.
1st and 2nd half of 2002	Registration (July 2002)	Registration procedures became simpler and faster, but more expensive. The objective of introducing a one-stop-shop was met by local administration, as firms no longer visited them, but firms still had to visit 4 agencies (down from 5) in order to register.
	Tax reform (Jan 2003)	The new system simplified tax administration, and 48% of eligible firms used the new system. On average, the number of paid taxes for these firms went down to 5.72 from 9.56 before. For all firms the average number was 7.68. Poor information was a reason why some eligible firms did not switch to the new system. The average number of inspections declined, but the abuse of power intensified. There was no change in the percentage of firms applying for licenses. Competition is perceived by firms as a more serious problem than government regulations and tax administration.
1st and 2nd half of 2003	None	The number of agencies to be visited, as well as monetary costs and time for registration, decreased. The number of applications for licenses fell, and so did the frequency of inspections by the most actively inspecting agencies. The number of firms using the new tax system increased to 59%. In a subjective perception survey, fair competition and tax level were perceived by firms as the most serious problems.

Source: Akhmedov et al (2003b)

Notes