OECD Reviews of Regulatory Reform

RUSSIA

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Foreword

The OECD Review of Regulatory Reform in Russia *is one of a series of country reports carried out under the OECD's Regulatory Reform Programme, in response to the 1997 mandate by OECD Ministers.*

Since then, the OECD has assessed regulatory policies in 21 member countries. The reviews aim at assisting governments to improve regulatory quality – that is, to reform regulations to foster competition, innovation, economic growth and important social objectives. It draws on two important instruments: the 1995 Recommendation of the Council of the OECD on Improving the Quality of Government Regulation and the 1997 OECD Report on Regulatory Reform.

The country reviews follow a multi-disciplinary approach and focus on the government's capacity to manage regulatory reform, on competition policy and enforcement, on market openness, and on the regulatory framework of specific sectors against the backdrop of the medium-term macroeconomic situation.

Taken as a whole, the reviews demonstrate that a well-structured and implemented programme of regulatory reform can make a significant contribution to better economic performance and enhanced social welfare. Economic growth, job creation, innovation, investment and new industries are boosted by effective regulatory reform, which also helps to bring lower prices and more choices for consumers. Comprehensive regulatory reforms produce results more quickly than piece-meal approaches; and they help countries to adjust more quickly and easily to changing circumstances and external shocks. At the same time, a balanced reform programme must take into account the social concerns. Adjustments in some sectors have been painful, but experience shows that the costs can be reduced if reform is accompanied by support measures, including active labour market policies.

While reducing and reforming regulations are key elements of a broad programme of regulatory reform, experience also shows that in a more competitive and efficient market, new regulations and institutions may be necessary to ensure compatibility of public and private objectives, especially in the areas of health, environment and consumer protection. Sustained and consistent political leadership is another essential element of successful reform, and a transparent and informed public dialogue on the benefits and costs of reform is necessary for building and maintaining broad public support.

The policy options presented in the reviews may pose challenges for each country. However, the in-depth nature of the reviews and the efforts made to consult with a wide range of stakeholders reflect the emphasis placed by the OECD on ensuring that the policy options presented are relevant and attainable within the specific context and policy priorities of the country.

Each review consists of two parts. Part I presents an overall assessment, set within the macroeconomic context, of regulatory achievements and challenges across a broad range of policy areas: the quality of the public sector, competition policy, market openness and key sectors such as electricity and railways. Part II summarises the detailed and comprehensive background reviews

prepared for each of these policy areas, and concludes with policy options for consideration which seek to identify areas for further work and policy development in the countries under review. The background reviews for Russia have been posted on the OECD Web site: www.oecd.org/regreform/backgroundreports.

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The principle authors of this review are William Tompson and Rudiger Ahrend – Chapter 1: Performance and Appraisal; Nick Malyshev – Chapter 2: Regulatory Governance; Sarah Reynolds – Chapter 3: Competition Law and Policy; Blanka Kalinova – Chapter 4: Enhancing Market Openness through Regulatory Reform; Stephen Perkins – Chapter 5: Railways; and Doug Cooke and Isabel Murray – Chapter 6: Russian Electricity Reform: Emerging Challenges and Opportunities.

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Table of Contents

List of boxes

List of tables

List of figures

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OECD Reviews of Regulatory Reform: Russia
Building Rules for the Market

Executive Summary

Since the break-up of the command and control system in 1992, regulatory reform in Russia has been both an instrument and a product of change. In the Soviet era, government involvement in economic activity was pervasive. State action substituted for market mechanisms. Regulation as it is practiced in developed market economies did not exist – it was not needed in a centrally-planned economy. In the context of Russia's transition, the freeing of prices, the creation of competitive markets, the privatisation of state assets and the liberalisation of foreign trade are all "regulatory reforms" as understood in this review. The transformation of the Russian economy has redefined the economic role of the Russian state. It has obliged the authorities to create regulatory institutions and procedures to meet the needs of a market economy.

Regulatory reform in Russia consists not so much in reducing the state's role as in transforming it. On the whole, broad-based regulatory reforms have been pursued vigorously. The liberalisation of prices and the establishment of free trade were accomplished quickly in the early 1990s, albeit with some significant exceptions. Although privatisation was very controversial, it has had a positive impact on business performance. It has proven much more difficult to reform the public administration, to create new regulatory institutions and to implement new, market-oriented forms of regulation. The adoption of effective competition policy and the reform of infrastructure industries have proved even more daunting challenges. Difficulties also surround the creation of a judicial system on which economic agents can rely for timely and effective enforcement of contracts and protection of property rights. The success or failure of reform in such areas will largely determine whether Russia can continue its current robust growth over the long term.

The Russian economy has undergone profound, and often painful, structural change since 1991

The last thirteen years have witnessed a dramatic transformation of Russia's economy, away from Soviet central planning and toward a free market. An economy based on state ownership and control and a high degree of autarky is giving way to a system based on private ownership, market forces and growing participation in world trade. The market economy is now well established in many sectors. After dropping precipitously in the 1990s, both GDP and living standards are rising.

Russia's current expansion is due, in large part, to painful reforms undertaken over the previous decade. The economy has, of course, benefited from the 1998 rouble devaluation and from highly favourable shifts in its terms of trade. But it was the structural changes of the 1990s that allowed the country to exploit the favourable circumstances of the past five years. Russia's economy is still characterised by distortions and flaws inherited from the Soviet past. Much of today's reform agenda consists of the "unfinished business of transition," including the creation of secure property rights and efficient markets. It is

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important, nonetheless, to recognise the changes made in the 1990s and their contribution to the economic growth of the last half-decade.

Significant changes have occurred in the structure of the Russian economy. The services sector, which was neglected during the Soviet period, has grown dramatically. Industry's contribution to overall GDP has fallen from about 54% to about 41%. The share of raw-materials-producing sectors in industrial output and exports has risen sharply, while that of processing industries has contracted.

The structure of ownership has changed even more radically. The private sector, which barely existed in 1991, now accounts for more than 70% of Russia's GDP. Since 1999, ownership in industry has been consolidated at a very rapid pace. Following the privatisations of the 1990s and the secondary reallocation of assets that followed, a small number of industrial groups have come to dominate the industrial landscape. It is estimated that the ten largest industrial groups, together with the state-controlled natural gas and electricity companies, account for roughly half of the country's industrial output. The concentration of ownership has benefited the economy in several ways. But it may pose serious problems for regulatory reform, especially in the field of competition policy.

The fundamental reforms of the 1990s have begun to bear fruit in recent years…

Three major reforms laid the groundwork for the transformation of the Russian economy: price liberalisation, the liberalisation of foreign economic activity and privatisation. The manner in which each of these reforms was executed was widely criticised, both by those who thought the government went too far too fast and by those who argued for even more thoroughgoing reforms sooner. Indeed, debate continues about the manner and timing of these reforms, but some of their benefits are already clear:

- Price **liberalisation** was an essential step toward eliminating the chronic shortages of the Soviet period. It has enabled prices to perform their normal function in a market economy – that of providing information on the real state of supply and demand. Over time, the reform has created new incentives for production and investment.
- The **liberalisation** of foreign trade and foreign investment is somewhat harder to assess. Foreign investment in Russia has been disappointing overall, although it has had a significant positive impact in a few sectors, notably tobacco and brewing. Measuring the impact of trade reform is particularly difficult. It is likely, however, that increased foreign trade and investment will improve domestic economic performance, if only because both enhance competition and favour the transfer of technologies. Recent experience in Russia seems to bear out this expectation. Domestic firms exposed to foreign competition are restructuring themselves faster than other companies.
- **Privatisation** was by far the most controversial feature of reform. And there was much to criticise in the way in which privatisation unfolded in Russia. Nevertheless, the available evidence strongly supports the view that privatisation has improved company performance. Productivity is higher, and is growing faster, in privatised enterprises than in others. The same is true for efficiency, and sales growth. Privatised companies tend to shed excess labour faster than do state-owned firms. They are also quicker to change product lines, to invest in new equipment and to adopt pay incentives linked to productivity.

Several other reforms are now having a visible impact:

- **Competition policy** has made positive contributions in a number of areas. It has helped reduce barriers to the movement of goods and services. It has advanced the cause of consumer protection and it is a force favouring the reform of Russia's infrastructure monopolies. The newly-created Federal Monopoly Service will need to deal efficiently with the most serious competition issues and to perform its enforcement functions in recently deregulated sectors of the economy.
- **Legal and judicial reforms** have created a set of procedural codes and a body of commercial law of generally high quality. Business surveys show that entrepreneurs and investors recognise and appreciate the improvements. But legal institutions are another matter entirely. Improved legislation needs to be matched by improved institutions to resolve legal disputes and enforce the law.
- Recent efforts to **reduce bureaucratic interference** in the affairs of private businesses, particularly small businesses, have had a palpable positive impact. But they, too, have been implemented incompletely and often inconsistently.
- So far, the benefits of **financial liberalisation** have been modest. The banking system and the financial markets remain underdeveloped. They are only just beginning to perform the central function of financial intermediation. Much the same is true of insurance companies and other financial services. Many such firms prospered simply by serving as vehicles for exploiting tax loopholes. The various segments of the financial sector will start performing their true roles only if a set of regulatory reforms now in the works is adopted and vigorously implemented.

Improving the quality of state institutions is an urgent priority

By the year 2000, the Russian authorities had come to regard the reform of the state institutions themselves as the most important reform remaining to be accomplished. Weaknesses in the state institutions have hindered the development, adoption and implementation of effective regulatory policies. Many citizens worry about what is euphemistically referred to as the "relative autonomy" of the state. Government bodies are sometimes heavily influenced by particular private interests – or even "captured" by such interests. The state bureaucracy, which is large and interspersed with corruption, is often deaf to the wishes of the public, or even to those of its political masters. Doubts persist about the independence, competence and probity of the courts, the prosecutors and the police.

The reform of state institutions in Russia has a number of distinct strands:

- The general notion of administrative reform includes both the reorganisation of federal executive bodies that began in early 2004 and the reform of the civil service (or of the "state service" in Russian parlance).
- The government *apparat* (the staff of the prime minister's office) will have to be reformed in a way that increasingly focuses its efforts on government-wide strategic planning, policy evaluation and monitoring the implementation of the overall government programme.
- A major reform of the judiciary was undertaken in 2001. That was an important step forward, but judicial reform still has a long way to go. Entrepreneurs and ordinary

citizens have little faith in the impartiality and effectiveness of the courts, especially in cases pitting private parties against state bodies. The judiciary needs to be isolated from external pressures, from both the private sector and other state bodies.

- A redefinition of the relationships among national, regional and local governments began in 2000, and is ongoing.
- The transparency and predictability of the policy process need much improvement.
- Strengthening the institutions of civil society is vital in order to allow citizens to participate actively in policy formulation and evaluation.

The scope of state ownership and the management of state-owned entities need further attention

The Russian state remains an extremely important player in the economy, both through the provision of public goods and services and through its ownership of substantial productive assets. Continuing state ownership of the means of production creates obvious conflicts of interest for the authorities, particularly in situations where the state acts both as regulator and owner. State ownership can also distort competition. It is no coincidence that many of the cases brought by the anti-monopoly authority have been directed at state authorities and state-owned companies. Such companies are generally less efficient than their privately-owned rivals.

In the light of these considerations Russia's regulatory reformers are concentrating on the further privatisation, on improving the management of state-owned companies and on policies to ensure fair competition between private and state-owned companies.

There is scope for further refining the state's regulatory role

Further reforms should be seen in the context of a larger effort to define the appropriate role of the state in the economy. This effort involves a number of distinct but related lines of policy:

- The concept of regulatory quality needs to be integrated into the central policy-making machinery of government. Overall regulatory oversight should remain at the centre of government. Individual ministries should adhere to regulatory quality principles in their areas of competence. Regulatory impact analyses should be undertaken to ensure that government regulations contribute to the country's economic and social development.
- There is room for further progress on the "de-bureaucratisation" drive that was launched in 2001. Business surveys indicate that the measures adopted in that year had a positive impact initially, but progress appears to have slowed over time.
- More needs to be done to eliminate unnecessary restrictions, both formal and informal, on foreign trade and foreign investment. The competition offered by foreign companies will be a major force in safeguarding competition.
- Strong anti-trust legislation is needed, along with a strong institution to implement it. The anti-trust approach could help the government to protect competition without intervening directly to prevent ownership concentration. The competition authority needs

to be strengthened, and stiffer penalties should be imposed for anti-competitive behaviour. Competition policy will be particularly important in the non-tradables sectors, where the discipline of competition from foreign imports is, by definition, absent.

The Russian authorities have committed themselves to carrying out a wide range of reforms in these and related areas. Promised actions include more privatisations, stronger competition policy and further measures to reduce bureaucratic interference in private business. But there have been signs of late that the state aims to extend its holdings in some key sectors, rather than reduce them.

Competition policy should play an even stronger role

Competition policy will be vital to the Russian economy given the high concentration of ownership in many sectors. In the competitive sectors, this concentration need not be a major problem, provided the economy remains open to international competition. But Russian markets are often less open than they appear to be, particularly in terms of inter-regional trade. Even in relatively open sectors, powerful domestic companies can exercise significant market power, particularly in regional markets. Building a framework that will protect competition without artificially intervening to prevent ownership concentration will require sound legislation and a strong institution to implement it. The competition authority should be strengthened, and stiffer penalties should be set for anti-competitive behaviour.

More needs to be done to reduce regulatory barriers to foreign economic activity

Reducing unnecessary restrictions on foreign trade remains a major challenge. Since the state monopoly on foreign trade was broken up, there has been a shift from regulation through non-tariff measures to tariffs as the main instrument for regulating foreign trade. This has made regulation more transparent and less likely to distort markets and has eliminated many opportunities for official corruption. In recent years, Russia has also accelerated the harmonisation of its trade regulations with international norms. But the general trend toward trade liberalisation continues to meet stiff resistance from some parts of the state administration and from sectoral interest groups. While the legal and regulatory framework has undergone a massive overhaul, major reforms are still needed in the administration of customs duties and trade regulations.

Reforms are needed in some sectors dominated by state-controlled monopolies

Natural gas, electricity, rail transport and banking are four areas in which structural reforms are of tremendous importance (this review contains detailed studies of the electricity and railway sectors, but not of gas or banking). Railway reform is the most advanced at present. There has been virtually no attempt to reform the gas industry. The

four sectors differ in many important respects, and there is certainly no single model of reform applicable to all, but there are a few common elements:

- In each case, one of the major aims of reform is to make resource allocation more efficient. In the rail, power and gas sectors, this will mean putting an end to the subsidies and cross-subsidies made possible by charging some customers less than the cost of production. Such subsidies are value-destroying, they distort resource allocation and they discourage investment. In the banking sector, this will mean fostering the development of efficient financial intermediation.
- All four sectors will require some re-regulation. This makes the competence and probity of state institutions particularly important. Equally important will be the state's ability to create strong, independent regulators and produce high-quality regulation.
- The state is deeply involved in all four sectors, not only as a regulator but also as the owner of the monopolies that dominate them. In all four cases, state authorities are torn between the desire to make the monopolies more efficient and the inclination to meet the heavy "social obligations" that the monopolies have traditionally fulfilled. Such obligations include, for example, cheap train tickets or cheap gas for disadvantaged citizens. "Compensation" for providing such social services often takes the form of tax breaks or other favours to the monopoly companies. The tension between business requirements and social obligations would be eased by a clearer separation between the state's regulatory function and its ownership role. Defining that separation has been a major issue in railway reform, but the overlap between the two functions continues to be particularly marked in the gas sector. Eventually, the goal should be a reduction in the state's ownership of rail, energy and banking assets.
- In each of the sectors, the state-controlled monopolies sometimes act in ways that distort or simply suppress competition. Attempts to challenge such behaviour have generally gotten nowhere. The weakness of the competition authority is partly to blame. So is the still inadequate framework of competition law and policy in Russia.
- One argument for reducing the state's ownership role in these sectors stems from evidence that managers in the major state monopolies have pilfered cash from them. So widespread is the practice that it has spawned a universally-known euphemism: "informal profit-seeking."
- The issue of transparency is central to the monopoly-reform process. In recent years, some progress has been made toward reducing the opacity of the monopoly firms – Sberbank, Gazprom, RAO UES (electricity) and RZhD (railway). But there is much more that can and should be done to enhance their transparency – as well as that of the policy-making and regulatory processes.

The reform of Russia's state-controlled monopolies will not be easy to bring off. But if reform does succeed in these four key areas, it will produce large spill-over effects. The state will have proven itself capable of taking up the toughest of regulatory challenges. And precedents will have been set that could serve for decades to come.

The main aim of reform should be to shore up the fundamental institutions of the market economy

This review addresses a wide range of often rather technical issues, but the analysis returns again and again to a small number of fundamental points. The first key idea is that

reforms should be pursued across a broad front, in order to realise the complementarities that exist among them. This is critical. While most international observers stress policy coherence, an idea that often implies a degree of political constraint, this review stresses the notion of policy complementarity, which points to the additional benefits that may stem from pursuing different strands of reform together.

The second theme that runs through this review is the need to continue building sound basic institutions and conditions for the market economy. The revision of formal laws and regulations will not do much to foster economic growth and development in the absence of a major improvement in the way the Russian state functions. Such basic issues as strengthening the rule of law and securing property rights, increasing the transparency and accountability of state institutions and combating corruption all remain major reform challenges. The Russian government will have to rely more on quality regulation and less on direct intervention in the economy. It must create a public administration that is able – and willing – to perform the role required of it in a functioning market economy.

Consideration of these two themes helps clarify a final, crucial question facing the Russian authorities: the relative priority of different reforms. As is clear from the analysis contained in this report, there is enormous work to be done on regulatory reform. It would be both unrealistic and unfair to believe that any government could do it all at once. However, an emphasis on reform complementarities and on shoring up the basic institutions of the market economy suggests two lines of policy that might be considered the top priorities:

- "State reform" in a broad sense, encapsulating both administrative and judicial reform. The knock-on effects generated by even a moderately successful reform of the public administration and civil service and by real steps to strengthen the independence and probity of the judiciary would be tremendous. Prospects for the successful implementation of virtually every other major structural reform would be improved, while the reduction in official corruption and rent-seeking would of itself represent a major improvement in the business climate.
- Further reductions in barriers to entrepreneurship. This second priority is very closely related to the first, since many of the barriers in question stem not from formal regulation of new businesses but from informal – and often corrupt – practices on the part of officials. The potential complementarities between the two reforms are clear: further reductions in licensing and other regulatory burdens would *ipso facto* reduce bureaucrats' opportunities to intervene in the affairs of private businesses, while judicial and civil service reforms would improve the fairness, transparency and efficiency with which the remaining regulations were administered.

To judge from public statements, the Russian authorities understand and are committed to reform. But the actions of government bodies often contradict their stated reform goals. There has been evidence recently of a drift towards more interventionist, less rule-governed state behaviour. Russia's long-term growth depends in no small measure on checking such tendencies and reinvigorating reforms that aim to create not merely a strong state, but one which is law-based, accountable and efficient.

PART I

Regulatory Reform in Russia

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Building Rules for the Market

PART I

Chapter 1

Performance and Appraisal

Introduction

The Russian Federation has enjoyed five years of robust growth since the 1998 financial crisis. This current expansion is due in large part to the painful reforms undertaken over the previous dozen years. Nevertheless, concerns remain about Russia's capacity to sustain high growth over the longer term, especially in view of its heavy dependence on export-oriented industries, particularly hydrocarbons.[1] Russia is the world's second-largest producer and exporter of crude oil and its largest producer and exporter of natural gas. These endowments, together with the legacies of Soviet central planning, mean that Russia's industrial structure is skewed towards resource extraction and heavy industry.[2] Many of the long-term policy challenges facing Russia today stem from this industrial structure. Since GDP growth will continue to depend heavily on natural-resource sectors for many years to come, Russia must pursue the further development of these sectors, but it must do so in ways that mitigate the well-known risks attendant upon resource-dependent growth. Good macroeconomic management will be critical to success. Russia will also need to nurture an environment conducive to investment in non-resource sectors. Only in this way can the country diversify its economy over the longer term and reduce its dependence on resource extraction. Regulatory reform will play a crucial role in facilitating such structural change.

The past thirteen years have seen a dramatic transformation of Russia's economy. An economy based on state ownership, central planning and a high degree of autarky has given way to one based primarily on private ownership, market forces and integration into the world economy. The private sector, which barely existed in 1991, now accounts for roughly 70% of GDP.[3] The services sector, which was generally neglected by central planners and was thus seriously underdeveloped by the end of the Soviet period, has grown strongly. It now accounts for about 46% of GDP, up from an estimated 36% in 1990, with privately-provided services accounting for most of the growth. At the same time, the share of industry has fallen from around 54% to about 41%. The share of sectors that produce raw materials has risen sharply in output and exports, while that of processing industries has contracted. The structure of employment has also changed, with employment in industry falling from 42.3% in 1990 to just over 30% in 2002. Employment in market services rose from 16.7% to 26.6% over the same period. (There was also a somewhat worrying rise in the share of those employed in *non-market services*, from 25.4 to 29.3%, even as the output of such services fell both in absolute terms and as a share of GDP.)

The market economy is now well established in most sectors. Output and living standards have been rising strongly since 1999, when Russia began to emerge from the financial collapse of August 1998. Real GDP growth between 1999 and 2004 averaged slightly above 6.6% a year. Russia did, of course, benefit from the 1998 rouble devaluation and from subsequent highly favourable shifts in the terms of trade, but Russia had enjoyed favourable external circumstances before, and they did not trigger rapid growth. The economy's response after August 1998 was due in no small measure to the structural

changes wrought during the early 1990s. To be sure, the economic legacies of the communist past are still evident throughout Russia, and many of the key reforms still to be effected reflect the "unfinished business of transition". Nevertheless, it is important to recognise both the extent of the changes that occurred in the 1990s and the degree to which those changes made possible the robust economic growth of the last five years.

Regulatory reform has been both an instrument of economic transformation and a product of that transformation. The freeing of prices, the creation of truly competitive markets and the liberalisation of foreign trade were all "regulatory reforms" within the general definition of the term.[4] At the same time, the transformation of the economy has led to a fundamental redefinition of the economic role of the state, and this in turn has obliged the Russian authorities to create new regulatory institutions and instruments to meet the needs of a market economy. Bureaucratic involvement in the economy was, of course, pervasive under the Soviet system, but little of that activity bore any resemblance to economic regulation in a market economy. Economic regulation as it is practised in developed market economies did not exist – and was not needed – under Soviet central planning. This distinction between regulatory reform as instrument and product of transformation is important, because, as Russia's economic transformation has unfolded, it has become increasingly clear that many of the toughest regulatory-reform challenges are a direct result of the transformation itself.

The toughest reform challenges tend to involve not the *reduction* of the state's role but its *transformation*. Measures that require the state to refrain from regulation have been fairly easy to implement. The liberalisation of prices and trade was achieved quite smoothly during the early 1990s. Far more serious problems have cropped up in the implementation of reforms that entail the creation of new regulatory institutions and new market-oriented forms of regulation – that is, regulatory issues that have themselves arisen as a result of market reforms. Reforming competition policy and restructuring industries like electricity and the railways has proved especially daunting. Competition policy is, of course, brand new; there was no need for any such thing under communism. Difficult issues also surround the creation of a judicial system on which economic agents can rely for timely and effective enforcement of contracts and protection of property rights. The success or failure of reform in such areas will largely determine whether Russia can continue its current robust growth over the long term. Recent empirical work on "growth accelerations" suggests that while economic growth may pick up markedly for a period of years in the absence of economic reform, sustaining faster growth over the longer term (15 years or more) tends to depend on reforms having been put in place.[5]

Regulatory reform in Russia is inextricably bound up with questions about the economic role of the state. The Russian state remains an extremely important player in the economy, not only because it provides public goods and services but also through its continuing ownership of substantial productive assets. In many cases, state ownership creates conflicts of interest for the authorities and also distorts competition. State-owned companies are generally less well-run than private firms, and insiders in state firms still manage to enrich themselves at public expense.[6] Russia's ongoing regulatory-reform agenda must include further privatisation, improvements in the corporate governance of state-owned companies and more vigorous measures to prevent anti-competitive behaviour. The government has committed itself to a wide range of reforms in this area, including substantial further privatisation and an ambitious restructuring of the electricity sector. It has also expressed its intention to level the competitive playing field in sectors

Box 1.1. **What is regulation and regulatory reform?**

There is no generally accepted definition of regulation applicable to the very different regulatory systems in OECD countries. In OECD work, regulation refers to the diverse set of instruments by which governments set requirements for enterprises and citizens. Regulations include laws, formal and informal orders and subordinate rules issued by all levels of government, and rules issued by non-governmental or self-regulatory bodies to which governments have delegated regulatory powers. Regulations fall into three categories:

- Economic regulations intervene directly in market decisions such as pricing, competition, market entry, or exit. Reform aims to increase economic efficiency by reducing barriers to competition and innovation, often through deregulation and the use of efficiency-promoting regulation, and by improving regulatory frameworks for market functioning and prudential oversight.
- Social regulations protect public interests such as health, safety, the environment, and social cohesion. The economic effects of social regulations may be secondary concerns or even unexpected, but can be substantial. Reform aims to verify that regulation is needed, and to design regulatory and other instruments, such as market incentives and goal-based approaches, that are more flexible, simpler, and more effective at lower cost.
- Administrative regulations are paperwork and administrative formalities through which governments collect information and intervene in individual economic decisions. They can have substantial impacts on private sector performance. Reform aims at eliminating those that are no longer needed, streamlining and simplifying those that are needed, and improving the transparency of application.

Regulatory reform is used in the OECD work to refer to changes that improve regulatory quality, that is, enhance the performance, cost-effectiveness, or legal quality of regulations and related government formalities. Reform can mean revision of a single regulation, the scrapping and rebuilding of an entire regulatory regime and its institutions, or improving processes for making regulations and managing reform. Deregulation is a subset of regulatory reform and refers to complete or partial elimination of regulation in a sector to improve economic performance.

Source: OECD (1997), *OECD Report on Regulatory Reform*.

such as natural gas, where state-owned concerns will continue to play a dominant role.[7] However, actual progress has been slow in recent years, and there have recently been indications that the government now intends to *extend* its holdings in some key sectors, rather than reduce them. What is certain is that the government is now intervening more directly in industrial sectors that it regards as "strategic".

Part I is structured as follows. It begins with an overview of the development and performance of the Russian economy since the onset of the market transformation, with special emphasis on those characteristics of the economy that are of particular relevance to regulatory reform. It then considers the contribution that regulatory reform has made to recent performance, before turning to the question of where further regulatory reform might facilitate improved economic performance and the achievement of the Russian authorities' policy goals. It ends by highlighting two major conclusions that emerge from this analysis. The first is that the pursuit of reforms across a broad front could enable Russia to benefit from the complementarities that exist among various strands of reform.

The second is simply that, while much has already been achieved, there is still a great deal to be done to strengthen the basic institutions and framework conditions for the market economy. Establishing the rule of law and the security of property rights, increasing the transparency and accountability of state institutions, and combating corruption all remain critical priorities.

The macroeconomic context and the legacy of incomplete reform

In January 1992, when Russia embarked on its transition to a market economy, it had just emerged as an independent country. The new Russia inherited many of the structures of the defunct Soviet state, but it still lacked many of the usual attributes of statehood. It did not have its own currency. It could not control its borders or collect taxes. Regional and local governments openly defied the centre, and the central bureaucracies were in turmoil. Many of the institutions Russia inherited from the Soviet Union were singularly ill-suited to the needs of democracy or the market economy. As a result, the many reforms carried out over the last thirteen years have been as much about reconstructing the Russian state as about building free markets.

Box 1.2. **Regulatory reform and economic transformation**

The transformation of a centrally planned economy into a market economy can be considered under four broad headings: *liberalisation,* including price and market reform; *stabilisation*, or the restoration of macroeconomic balance*; private-sector development,* including both privatisations and policies to promote new private businesses*;* and *the redefinition of the role of the state*.* Regulatory reform has a direct bearing on all four areas. It is of particular importance in the redefinition of the role of the state. Re-equipping the state to play its proper role in a market economy is fraught with challenges, most of which were neglected in the initial stages of transformation. Basic institutions have to be created to carry out indirect macroeconomic management, as opposed to management by administrative *fiat*. These include a tax system appropriate to a private-enterprise economy, a central bank endowed with the instruments of monetary policy and an effective budgetary system. The law needs to be reformed to define and secure property rights, and courts must be set up to govern transactions. This process is far more complex and difficult than simply producing new laws and legal codes. Laws can be promulgated overnight, but establishing the rule of law will take time. Suitable regulatory frameworks are also needed to deal with particular aspects of economic life, such as monopolies and competition. Finally, the state's approach to social welfare must be redefined. A social safety net must be created (including unemployment insurance, which was non-existent under central planning). The health, pensions and housing systems need to be reformed.

* This is the schema set out by Gray and Gelb (1991).

The transition began in the midst of a severe economic crisis…

The terminal crisis of the Soviet system had its roots in a long-term decline in growth rates from the 1950s onwards, but the final breakdown of the Soviet economy was precipitated by a combination of external shocks,[8] ill-conceived reforms and political unrest. The half-hearted economic reforms of the late 1980s sought to introduce some

Table 1.1. **Basic economic indicators**

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Real GDP growth	–14.5	–8.7	–12.7	–4.1	–3.6	1.4	–5.3	6.3	10.0	5.1	4.7	7.3
Industrial production growth	–18.0	–14.0	–21.0	–3.0	–4.5	2.0	–5.2	11.0	11.9	4.9	3.7	7.0
Gross fixed capital formation growth	–41.5	–25.8	–26.0	–7.5	–21.2	–8.0	–12.4	6.3	18.1	10.3	3.0	12.9
CPI inflation (Dec./Dec.)	2 509	840	215	132	21.8	11.0	84.5	36.6	20.1	18.8	15.1	12.0
Exchange rate (Rouble/USD, average)[1]	0.2	1.0	2.2	4.6	5.0	5.8	9.7	24.6	28.1	29.2	31.4	30.7
Unemployment (ILO-type measure, end year, percentage of labour force)	4.8	5.7	7.8	8.9	10.0	11.2	13.2	12.4	9.9	8.7	8.8	8.6
Exports of goods (USD billion)	53.2	59.7	67.4	82.4	89.7	86.9	74.4	75.6	105.0	101.9	107.3	135.9
Imports of goods (USD billion)	43.0	44.3	50.5	62.6	68.1	72.0	58.0	39.5	44.9	53.8	61.0	75.4
Current account (USD billion)		12.8	7.8	7.0	10.8	–0.1	0.2	24.6	46.8	33.9	29.1	35.8
as a per cent of GDP		7.4	2.8	2.2	2.7	0.0	0.1	12.6	18.0	11.1	8.4	8.3
Budget balance (general government, per cent of GDP)			–9.7	–6.0	–10.1	–8.7	–5.3	–0.5	3.5	3.1	0.3	1.2
Federal budget balance (per cent of GDP)[2]	–5.3	–5.8	–10.6	–5.3	–8.9	–7.4	–5.0	–1.1	1.4	3.0	1.7	1.7
Consolidated budget balance (per cent of GDP)[3]	–3.4	–4.6	–10.1	–5.7	–9.4	–7.8	–4.9	–0.1	2.6	3.8	2.2	2.2
CBR gross foreign exchange reserves (USD billion, end of period)		8.9	6.5	17.2	15.3	17.8	12.2	12.5	28.0	36.6	47.8	76.9

1. Preliminary data.
2. Figures are not comparable before 1994.
3. Prior to the start of 1998, 1 rouble = 1 000 old roubles.

Source: Goskomstat, Central Bank of Russia, Ministry of Finance, Economic Expert Group, IMF, OECD calculations.

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market efficiencies into the Soviet system, but they only made matters worse. They undermined many of the traditional structures and disciplines of the command economy without putting anything better in their place.

By 1991, the policy was fragmenting and the economy was in free-fall. Real GDP that year dropped by somewhere between 8% and 17%. Snowballing subsidies, plummeting production and non-payment of taxes pushed the Soviet budget deficit above 16% of GDP.[9] The government tried to finance the deficit by printing money. The money supply ballooned and what remained of a price-control system collapsed. In 1991, wholesale price inflation reached 138%, retail prices rose by 90% and food prices jumped 112%, despite the fact that the authorities continued to shy away from price liberalisation. Inflation thus coexisted with the shortages inevitably produced by continuing price controls.[10] The external picture was equally dismal. Exports fell by 40% in dollar terms and imports by 80%. The Soviet external debt reached USD 67 bn – roughly 566% of the country's GDP at the market exchange rate. Foreign exchange reserves fell to USD 60 m, enough to cover about 10 *hours* of imports.

... which led to a "big bang" approach to reforms

Faced with an acute crisis, the Russian authorities concluded at the end of 1991 that they must act decisively and without delay. They opted for a "big bang" approach to economic transformation, with rapid price and trade liberalisation and large-scale privatisation. Some critics have argued that it would have been wiser to take a more gradual approach. They contend that the traditional instruments of the old system, like administered price rises and rationing, could have been used to stabilise the situation before proceeding with reforms. However, it is not at all clear that such an approach was feasible, let alone desirable. The system of fixed prices had collapsed. It is doubtful that even the most determined action could have re-imposed wide-ranging price controls and assured an adequate supply of goods at official prices. On 2 January 1992, therefore, some 90% of retail prices and 80% of producer prices were freed. The main exceptions were energy, some raw materials and a few basic foodstuffs. At the same time, the government moved quickly towards external liberalisation. The state monopoly of foreign trade was abolished, and quantitative controls on imports were scrapped in January. A flat 5% import tariff was adopted in July.

These measures were accompanied by drastic cuts in federal spending, particularly on such previously sacrosanct items as defence procurement. Tight monetary policies were put in place to ensure that prices would stabilise at their new levels. Soon after prices were freed, the government undertook the privatisation of state property, initially through a voucher scheme, which was meant to enable virtually all citizens to become asset owners on at least a small scale. It was hoped that this would create a broad class of shareowners who would support further reforms. The sell-off was also meant to free the state budget from the burden of supporting loss-making public enterprises. Privatisation was expected to spawn a population of sink-or-swim firms whose managers would be motivated to use their resources efficiently. When the voucher phase ended in mid-1994, the state's average holding in industrial firms had fallen to 38% (including those not privatised at all before mid-1994). Its average stake in privatised enterprises was down to just 15%. According to official data 57.9% of the workforce, including 76% of the industrial workforce, was employed in privatised or in newly-formed private firms. Over 70% of small-scale enterprises had been transferred to private ownership.

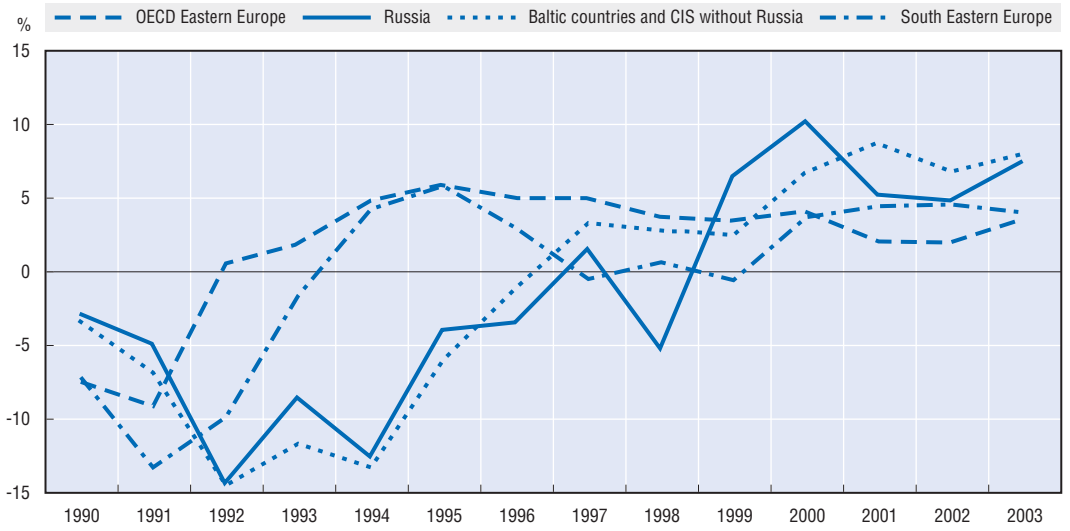
Political realities imposed limits on the government's early reform efforts. After the initial shock of the January 1992 package, price liberalisation proceeded rather slowly. Many regional authorities feared the popular reaction to the rapid elimination of price controls on basic necessities, and the federal government feared the impact on industry of freeing energy prices. Trade liberalisation was also far from complete. Exports of many commodities, notably oil, were subjected to quotas or to very high export duties in order to hold down domestic prices. Numerous controls on exports remained in place, and imports of some necessities were still subsidised. These continuing controls appeased certain domestic constituencies. They also created lucrative opportunities for those administering them. The legislation on voucher privatisation was amended to grant special privileges to enterprise insiders (managers and labour collectives). Most large enterprises emerged from the process with a diffuse yet insider-oriented ownership structure.

Initial reforms were followed by high inflation and falling output

The immediate results of the initial reform package were a spike in inflation and a large drop in GDP. The fall in output had been expected, but it lasted far longer than anticipated. Except for a weak pick-up in 1997, the economy continued to contract until 1999. Inflation fell sharply after the initial shock, but the authorities loosened their policies in mid-1992 and it surged again. The reform package of 1992 might have produced better results sooner had it been followed quickly by the other structural reforms needed to create a market economy. That this did not occur was due above all to the government's failure to bring inflation down quickly. The reformers had believed that tight fiscal and monetary policies would bring about macroeconomic stability by late 1992, setting the stage for economic recovery. In the event, it took four years to reduce inflation to double digits. Structural reform stalled as the government concentrated its energies on stabilisation. In any case, many needed structural measures were opposed by powerful vested interests.[11] Moreover, because the state institutions were so weak, the federal authorities simply lacked the *administrative capacity* to implement many reforms.

The jump in the general price level that followed the 1992 liberalisation was expected. It was chiefly a product of the monetary overhang that had developed in the late Soviet period, when money wages had risen much faster than productivity.[12] At the end of 1991, households and firms held more roubles than they wished, simply because there was nothing to buy with them.[13] When prices were freed, this mass of excess roubles drove them up rapidly. Monthly inflation reached 245% in January 1992. This was a one-off adjustment, however, and monthly inflation declined rapidly to around 10% in the summer. However, the decline proved to be short-lived. The monetisation of budget deficits and the large-scale financing of business through an expanding money supply continued. Inflation rose sharply in the second half of 1992 and stayed very high throughout 1993. The problem was greatly complicated by the maintenance of the rouble zone. The rouble remained the national currency of most former Soviet states, but no satisfactory arrangements for managing it were ever agreed.[14] Instead, central banks abused the right to create quasi-money to finance ailing enterprises in their respective countries. Each member state thus reaped the benefits of the additional quasi-money it created, while the ensuing inflation was shared across the zone.[15] The Central Bank of Russia (CBR) lacked any effective mechanism to prevent such behaviour and was itself heavily engaged in extending soft credits to Russian businesses. The rouble zone broke up

Figure 1.1. **Real GDP growth**
Annual percentage change



Source: UNECE, World Bank, Eurostat, IMF, Interstate statistical committee of the CIS, Goskomstat and national sources.

and the CBR focused on limiting the growth of monetary aggregates. Inflation started to decline in the last quarter of 1993.

According to official data, Russia's real GDP fell by about 32% from 1992 to 1994, continuing the sharp contraction of the previous two years (Figure 1.1). Officially recorded output continued to fall through 1996. The initial drop in output was largely the result of the country's headlong rush to transform a command economy into a market economy. Unsurprisingly, 1992 saw the largest drop in GDP – 15%. A large part of that decline was due to a sharp fall in private consumption, which in turn reflected the uncertainties created by the reforms and diminishing real purchasing power. Another major cause of the contraction was the attempt to impose hard budget constraints on enterprises. The continuing downturn in 1993 and 1994 was also partly a result of the unavoidable shock brought on by the transition, but there were also other factors at work. High and volatile inflation had a significant negative impact throughout 1993 and 1994, while the break-up of the rouble zone contributed to a further contraction in trade among the former Soviet republics.

While output fell across the economy, there were nonetheless some significant differences among sectors. The resource-based industrial sectors responded to collapsing domestic demand by increasing their exports and held up relatively well. So did the service sector. Processing industries, by contrast, fared particularly badly. The low level of international competitiveness of these sectors meant that they could not export their output to compensate for shrinking domestic demand.

Inflation was reduced, but at a very high cost

After the roller-coaster stabilisation efforts of 1992 to 1994, the authorities opted in 1995 for an exchange rate-based strategy that brought inflation down rapidly. This approach led to a very rapid appreciation of the exchange rate. The rouble roughly doubled

Box 1.3. **Reported GDP declines and socio-economic realities**

While there is no doubt that the initial transition recession was traumatic for Russia, the fall in output was almost certainly smaller than it appeared in the official data.* Under the Soviet system, enterprises had strong incentives to over-report their production. Moreover, in the period before 1992, prices had little meaning. Relative prices in the manufacturing and consumer-good sectors were generally far too high, compared to prices for natural resources and basic commodities, so the share of the former in aggregate output was significantly overstated. Just as the size of those sectors that were to suffer the sharpest decline was overstated at the outset, so was the extent of their collapse. Even so, Gavrilenkov and Koen (1994) estimate that real output fell by almost a third between 1989 and 1994. Much of the lost output consisted of goods that were of questionable value and for which there was little, if any, demand. Roughly 15% of the country's output in 1991 proved impossible to sell, even in an environment characterised by widespread shortages and a monetary overhang. Since much of this "lost" output would have contributed little to the welfare of the population in any case, the fall in living standards during the transition – while substantial – was still smaller than the decline in production. This is reflected in both the official statistics (which, critics argue, tend in any case to underestimate incomes and consumption) and surveys of household consumption. Working on the basis of the official data, Gavrilenkov and Yasin (2005) find that private consumption never fell below 90% of its pre-reform (1991) level and that it has exceeded that level since 2000. Nevertheless, the transition *has* been extremely hard on most households. Living standards for most Russians fell in the 1990s, and poverty increased dramatically (though it has been falling in recent years). Indicators of basic human welfare, such as life expectancy, began falling during the Soviet period and have continued to deteriorate. The incidence of tuberculosis and other poverty-related diseases has risen dramatically. While there has been a marked rise in incomes and consumption since 1999, with the largest increases in consumption coming among the least well-off, health and mortality indicators have yet to improve much.

* See OECD (1995), pp. 8-13, for a detailed discussion of the issue.

in value over the course of the year, a development that took a heavy toll on the competitiveness of Russian businesses and explains to a large degree why output continued to fall in 1995 and 1996, rather than beginning to recover as it did in other countries.[16] The other major obstacle to recovery was fiscal. The exchange rate-based stabilisation of this period was not accompanied by the fiscal adjustment needed to make it sustainable. The government deficit was about 6% of GDP in 1995 and rose to 10% in 1996. Indeed, the success of the exchange-rate strategy actually allowed the government to postpone fiscal adjustment, since it could finance its deficits on financial markets and so avoid deficit-financing *via* the printing press.[17] The rapid growth of short-term domestic debt became increasingly burdensome, and rising debt-service obligations further increased the deficits. The stock of rouble-denominated government debt rose from 4.5% of GDP at the end of 1995 to around 18% of GDP at the end of April 1998. There were doubts from the beginning about the sustainability of the exchange rate-based stabilisation. Such doubts helped to prolong the contraction of output and to keep interest rates higher than they would otherwise have been, thereby aggravating the government's debt problems.

In political terms, fiscal stabilisation would in any case have been extremely difficult, if not impossible, in the circumstances. The rapid appreciation of the real exchange rate in 1995 had sharply increased the costs of labour and energy in dollar terms. As the competitiveness of Russian industry deteriorated, the number of enterprises in "good" or "normal" financial condition fell from 35% in early 1995 to just 15% at the end of that year. Yet there were few outright bankruptcies. A large part of Russian industry was kept afloat with subsidies. This reflected both the power of industrial managers as a lobby and the government's fear of the social consequences of structural change. Since direct budget subsidies and soft credits from the central bank had been largely eliminated by the mid-1990s, subsidisation increasingly took the form of unpenalised arrears to the state-controlled gas and electricity monopolies. Enterprises also "borrowed" from their workers, from the state and from their suppliers by simply not paying the money they owed.[18] Tax increases merely generated increased tax arrears. Imposing real financial discipline on the behemoths of former Soviet industry would have been politically impossible. A serious crackdown on non-payments would have risked shutting down a large part of industry overnight.

The rapid real appreciation of the rouble tended to mask the debt problem by keeping the total debt-to-GDP ratio constant from 1995 to 1997.[19] It was only as inflation fell and the real exchange rate began to stabilise in 1997 and 1998 that the underlying debt dynamics became apparent. The re-election of the president in 1996 significantly reduced political uncertainty, and a renewed drive for structural reform in early 1997 gave a further boost to confidence. Officially recorded output began to recover in the export-oriented resource sectors. By that time, these sectors were substantially in private hands. The struggle over control of their privatised assets had largely been resolved – partly by loans-for-shares auctions – and the new private owners were beginning to increase the efficiency of their newly-won holdings. Investor confidence improved, briefly producing net capital *inflows* for the first time. The foreign exchange earnings from resource exports fed a consumption boom in a few regions. All this gave rise to the impression that Russia had finally moved from stabilisation to recovery. A financial boom began in Moscow, despite the fact that Russia's industrial heartlands were still in a very dire state.

The "rouble corridor" coincided with the most controversial privatisation sales

While the bulk of Russian industry was privatised at least in part between 1992 and 1994, the state held onto substantial stakes in what were considered to be the most valuable large enterprises. These were supposed to be sold for cash in a second phase of privatisation. It quickly became clear, however, that there was little demand for those assets at the prices at which the authorities proposed to sell them. Potential buyers feared the risks posed by continuing economic and political instability and the prospect of a return to power by the communists, and many enterprises were controlled by insiders who did not wish to see outside investors, foreign *or* domestic, acquire large stakes in them. Between 1995 and 1997, some of the largest enterprises in which the state had retained significant stakes were privatised through highly controversial "loans-for-shares" auctions. In these auctions, some of Russia's most valuable enterprises – including several major oil companies and the non-ferrous metals giant Norilsk Nickel – were transferred to a handful of well-connected financial-industrial groups for a fraction of their real value. In late 1995, these groups extended large loans to the government and accepted shares of state enterprises as collateral on the understanding that the lenders could realise the stakes if the loans were not repaid by 1 September 1996. It was clear all along that the state would

Box 1.4. **GDP decline in Russia and in other transition countries**

The length and severity of Russia's transition recession stand in marked contrast to the experiences of the countries of Central Europe, where output began to recover about two years after the onset of reforms. This difference is partly attributable to the greater political instability in Russia, which made policy less consistent and less credible, as well as to some avoidable policy errors. In particular, Russia suffered greatly from its failure to bring inflation down in a sustainable way during the first few years of the transition. The price Russia ultimately paid for stabilisation in terms of lost output was much higher than it might have been. But another explanation is to be found in the initial conditions for reform in Russia. One study comparing Russia, China, Poland, Hungary and the Czech Republic with respect to three indicators – structural misdevelopment, institutional preparedness for a market economy and macroeconomic disequilibrium – found Russia to be the least prepared on all three counts.[*] While the structural distortions of the Soviet economy were similar in kind to those found in other ex-communist countries, they were more severe. This was largely because so much of the Soviet Union's basic industrialisation took place under central planning. Soviet planners did not merely deform an existing industrial base. To a great extent, they created industries from scratch, and they did so with priorities that were sharply at odds with the needs of an internationally-integrated market economy. The resulting industrial structure was highly inefficient in its use of resources and severely skewed towards defence and heavy industry. Much of the industrial capital stock was thus virtually worthless in any market environment.

* Ernst *et al.* (1995), pp. 7-13.

not repay the loans, and the 1996 state budget contained no provision for repaying them. The subsequent auctions were conducted by the collateral-holders themselves, who saw to it that the bidding was non-competitive and that the stakes were purchased by entities they controlled, at prices only slightly above the value of the loans. To take but one example, a 38% stake in Norilsk Nickel was privatised for about USD 170 million, implying a value of just over USD 447 million for a company generating between USD 1.2 billion and USD 1.5 billion a year in export revenues.

The Asian collapse and falling commodity prices sparked a crisis

By early 1998, the economic situation had become unsustainable. The consumption boom of 1997 had swelled imports. This, together with a sharp drop in oil prices in the wake of the Asian financial crisis, led to a rapid deterioration in Russia's external balance. The structural-reform offensive of early 1997 had quickly stalled, and the fiscal situation remained grave. When the current account turned negative in mid-1997, it became clear that the exchange rate was too high for a large part of Russian industry. Moreover, continuing large-scale capital flight meant that the rate was too high to allow Russia's economy to achieve external balance. A fresh effort to sort out Russia's messy state finances, bolstered by a hefty IMF loan, brought some short-term relief. But the fundamentals remained unchanged, and capital again began to flow out rapidly. The interest rates on the government's short-term debt skyrocketed, reaching triple digits.[20] By August 1998, the government was left with no choice but to devalue the rouble. The devaluation was accompanied by a forced restructuring of short-term domestic debt – in

effect, a default – and a moratorium on the payment of most private, non-sovereign foreign debt. The government had hoped to limit the devaluation. A controlled devaluation might have been possible several months earlier, but by this point the authorities' efforts to stabilise the currency at a moderately devalued rate had no credibility. The rouble soon followed the stock market into free fall. In real terms, it hit bottom against the dollar in January 1999, at about half its pre-crisis value. In nominal terms, it had fallen 75% against the dollar in five months.

In the aftermath of the financial collapse, the Russian economy virtually came to a standstill. The banking sector was hit especially hard by the devaluation and default, and many private banks stopped operating, causing the payments system to seize up for a time. Inflation accelerated sharply, and many shops and restaurants simply closed their doors. The central bank sought to unblock the payments system by injecting liquidity into Sberbank and some other politically well connected banks. The government was paralysed for several weeks, until a new cabinet could be formed. In the months that followed, however, the new government executed a massive fiscal adjustment. This adjustment was, in fact, largely automatic. The government simply refrained from indexing expenditure commitments to inflation, while nominal revenues rose rapidly. This was really the only option available to the government. Large-scale borrowing was impossible following the default, and massive deficit financing *via* the printing press would have led to hyperinflation. Hyperinflation was indeed avoided, but the sharp fall in real wages, combined with a large cut in real social spending, resulted in a substantial drop in real household incomes. Poverty increased significantly. Imports also fell as the prices of imported goods quadrupled in rouble terms. The current account was soon showing a large surplus.

The post-crisis recovery began early and has proved long-lasting

Despite widespread pessimism about Russia's prospects, the economy started to recover fairly rapidly. Industrial production picked up in October 1998.[21] By early spring of 1999, it had already surpassed the pre-crisis levels of 1997. While growth was very broadly based, the recovery was initially strongest in those sectors that had been doing worst before the crisis, the domestically oriented non-resource sectors. This dramatic turnaround resulted mainly from a rapid fall in the cost of labour and energy, which helped much of Russian industry to become competitive and profitable again. At the same time, the sharp rise in the rouble price of imported goods facilitated import substitution on a large scale. The use of barter tailed off. Arrears and non-payments declined as enterprises began to settle transactions with money. The early post-crisis years also saw a wave of ownership consolidation. Entrepreneurs who had weathered the crisis sought to acquire assets cheaply, while exploiting the general confusion in order to default with impunity on their more vulnerable creditors. They squeezed out minority shareholders by diluting their stakes or by juggling assets among related companies. Some of Russia's leading advocates of good corporate governance today were then among the most aggressive in employing such tactics. Russian companies also exploited the weaknesses of the 1998 bankruptcy law to execute hostile corporate takeovers on the cheap. Some practitioners turned this last device into an art form.[22]

While the devaluation plainly kick-started the economy, a reduced exchange rate was not the only reason for the post-crisis recovery. In 1994, a similar combination of factors – a weak rouble, cheap domestic energy prices and relatively high export prices for oil[23] – had failed to prevent a 12% drop in GDP and a fall of more than 20% in industrial production. By 1999,

however, liberalisation and privatisation, incomplete though they were, had facilitated the emergence of private enterprises that could respond to the opportunity provided by the devaluation. It is significant that the economy began to grow strongly *before* oil prices started to recover. Improving terms of trade were undoubtedly helpful later on, but the initial post-crisis recovery was not dependent on, and certainly not driven by, oil-price rises.

The Russian recovery started unusually quickly after the crash, and it has proved unusually durable. The explanation for the speed with which the recovery began is straightforward. Before the crisis, Russian banks were not performing the role of a normal banking system (transforming savings into loans), but were mainly playing the stock markets and investing in government securities. Thus, the collapse of the banks did not lead to a credit crunch in the real economy. Indeed it had remarkably little impact on economic activity. The reasons for the length and strength of the recovery are less clear, but are connected to oil. The temporary boost to economic activity from a very low exchange rate and artificially-low internal energy prices was largely exhausted by 2001. Wages, energy prices and the real exchange rate had all increased substantially by then. It was at that point, however, that the oil sector really emerged as the locomotive of growth. During 2001 through 2003, Russian oil companies accounted directly for more than one-fifth of Russia's GDP growth.[24] Booming oil exports also allowed consumption to rise rapidly without putting the external balance at risk.

High prices and the apparent security of property rights contributed to an oil-sector boom

Recent developments have raised concerns about the security of property rights in Russia. In the post-crisis period, however, the perception that those rights had become *more* secure contributed importantly to the recovery of investment, particularly in the oil sector.[25] In 2000, new investment in the oil industry was led by companies controlled by the state or by oil-industry insiders, rather than by companies owned by major financial groups, whose property rights were perceived as less secure. In 2001, however, the latter group of companies rapidly increased their investments to levels comparable to those of the former group. This new investment led to a sharp increase in oil production and exports in subsequent years. Output growth, however, was uneven. From 1998 to 2003, companies owned by insiders and financial groups increased their output by 45% and 90% respectively, while the output of state-controlled companies rose only marginally (Figure 1.2).

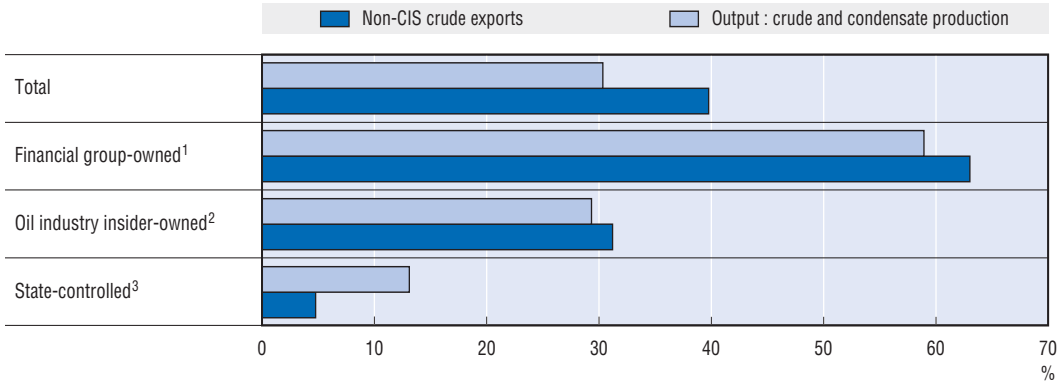
During the period from 2001 through 2003 privately-owned oil companies directly accounted for somewhere between a fifth and a quarter of Russia's GDP growth. (The contribution of state-controlled companies was negligible.) Taking into account the knock-on effects from oil-sector procurement and wages on domestic demand, the contribution of the private oil companies to economic growth was even greater. It is unlikely that Russia could have grown at anything like the rates of recent years had the private oil companies not raised their investment, output and exports very rapidly. It is also unlikely that Russia's private oil companies could have achieved the growth of the last few years if they had remained under state control.

Prudent fiscal policies helped to sustain the recovery…

The government's most important contribution to the expansion after 1998 was the adoption of a prudent fiscal stance – much more prudent than in the pre-crisis period. The

Figure 1.2. **Oil companies: relative performance**

Growth 2001-2003 inclusive



1. Sibneft, TNK, YUKOS.
2. LUKOIL, Surgutneftegaz.
3. Bashneft, Rosneft, Tatneft.

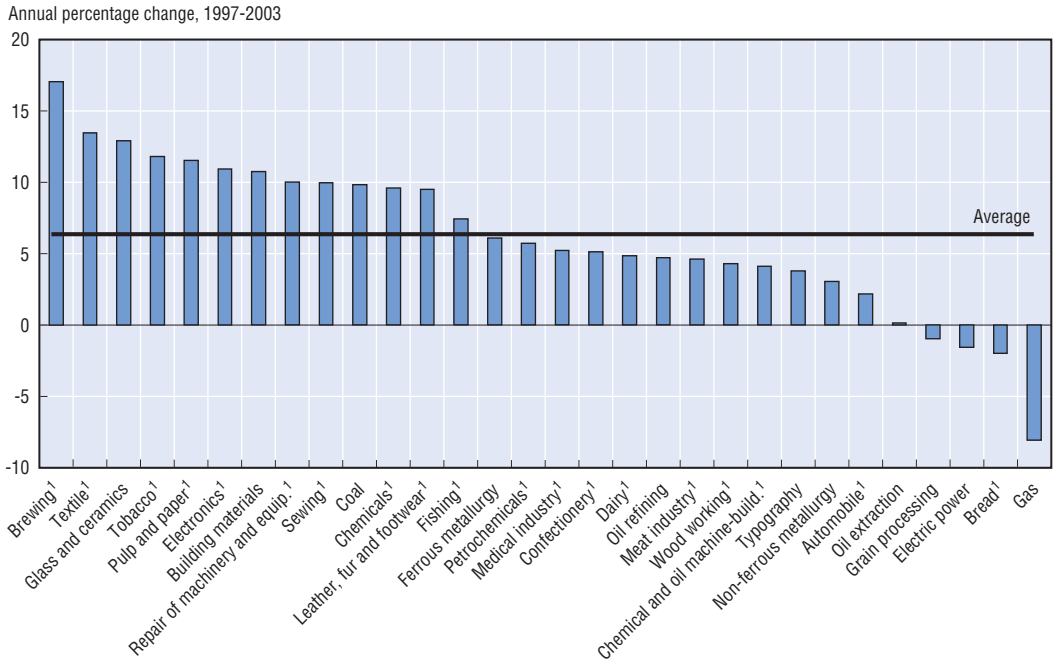
Source: Ministry of Energy, InfoTEK, Rennaissance Capital estimates, RIANTEC, OECD calculations.

fiscal adjustment following the crisis was radical indeed: general government expenditures (including all levels of government and social funds) fell by about 10 percentage points of GDP during 1998-2000, while revenues relative to GDP remained at roughly their pre-crisis levels.[26] The federal budgets for 2000 through 2004 were designed to produce surpluses even if oil prices remained moderate. This approach delivered both sizable surpluses and budgets that would have been balanced even if oil prices had been much lower. To be sure, fiscal adjustment was made easier by strong economic growth and favourable shifts in the terms of trade. Yet the government largely resisted the temptation to spend oil windfalls, using a large part of it to repay debt and accumulate reserves. Seizing the opportunity provided by high oil prices, the government implemented a comprehensive reform of the tax system, which would have been far more difficult to impose under other circumstances. The authorities also adopted a number of institutional reforms, including an overhaul of the budget code and the creation of a federal treasury, which improved the fiscal-policy process and the management of public expenditure.

... While monetary policy struggled to balance concerns about inflation and the exchange rate

Monetary policy in the years after the crisis has been dominated by the pursuit of conflicting policy goals, and has *de facto* been very loose. The Central Bank of Russia (CBR) followed a policy aimed at gradually reducing inflation while limiting the real appreciation of the rouble in order not to endanger the competitiveness of Russian industry. Given large current account surpluses and decreasing net capital outflows, this determination to prevent the rouble from appreciating too rapidly increasingly compelled the CBR to intervene on the foreign exchange markets via large-scale foreign currency purchases. However, in the absence of efficient large-scale sterilisation tools,[27] the accumulation of reserves has led to very strong monetary expansion, which has increasingly conflicted with achieving disinflation.

Figure 1.3. **Labour productivity: changes in the 30 largest industrial sectors**



1. Data on labour productivity for 1997-2002.

Source: Russian Federal Service for State Statistics and OECD calculations.

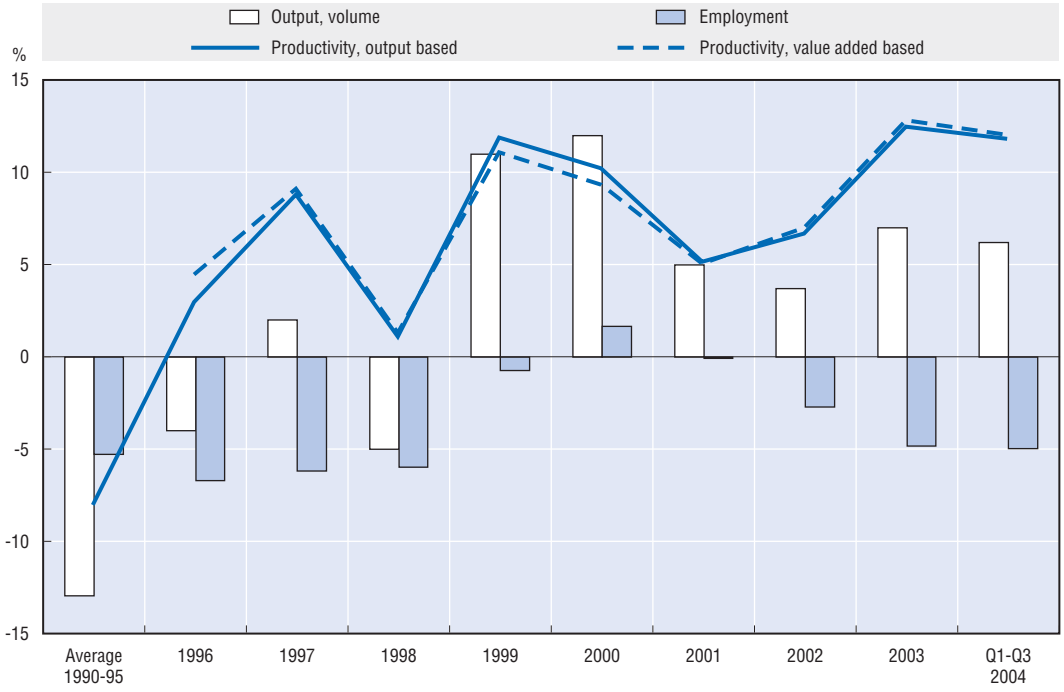
Russian industry has raised productivity

Recent years have seen increasing cost pressure on Russian industry. The rouble's value has appreciated steadily in real terms since early 2000 and wages have risen rapidly, while energy and transport prices, which were frozen for some time after the crisis, have been rising faster than inflation. So far, much of Russian industry has managed to maintain competitiveness despite these pressures. The growth of industrial production slowed in 2001 and 2002, but it recovered to between 6% and 7% in 2003 and 2004. The main reason for this resilience – apart from the dominant role of the oil sector – appears to be rising labour productivity in many sectors (Figure 1.3). Average productivity has been increasing strongly and steadily since 1997 (with the exception of 1998). The average annual increase between 1997 and 2003 was around 8%. The performances of different sectors have varied widely, but there have been improvements in almost all of them. The few inglorious exceptions are sectors in which there is still a lot of direct state control over enterprises or state interference in economic activity. Productivity gains in the grain-processing and bread sectors, as well as in oil (before 1999) and electricity (until 2002), are uninspiring. The gas industry is at the bottom of the league.

While productivity increased even in the period before 1998, this resulted mainly from passive restructuring in the interests of short-term survival. Enterprises reduced staff as output fell. Then, in the period 1999-2001, there was a kind of "recovery". Productivity increased simply because overall production was increasing. There were, of course, enterprises and sectors that restructured very deeply during this period, but most were content simply to increase output. There were no further net reductions in industrial

Figure 1.4. **The composition of industrial productivity growth**

Annual percentage change



Source: Russian Federal Service for State Statistics and OECD calculations.

employment. By 2002, however, it became clear that the easy gains flowing from the devaluation had been exhausted, and large numbers of enterprises finally began actively restructuring with a view to improving their productivity. During 2002-2004, industrial output grew strongly while industrial employment fell (Figure 1.4). Despite rapidly rising wages, unit labour costs in 2003 were about 25% below those of 1997. The major exception to this trend was, again, the gas sector, where unit labour costs were about *107% above* pre-crisis levels.

The post-crisis expansion has coincided with a period of renewed structural reform

The 1998 financial collapse was the product of unsustainable macroeconomic imbalances that were largely the result of the lack of structural reform after 1993. The fragile macroeconomic stabilisation of the period 1995-1998 was never underpinned by the micro-level structural changes that could have rendered it sustainable without massive infusions of external financial support. The authorities were unwilling to impose hard budget constraints on large firms, which continued to receive substantial implicit and explicit subsidies.[28] Ultimately, macroeconomic stability cannot last where firms are free of real budget constraints. To say this is not to minimise the significance of the external shocks that hit Russia as the Asian crisis spread in 1997-1998 or to downplay the extent and importance of Russia's fiscal weakness. The point is rather that the lack of structural reform increased Russia's vulnerability to the Asian typhoon. The failure to press ahead with structural reform cost the state budget dearly. It contributed to the rapid, and ultimately unsustainable, growth of state debt. It was only after the crisis, then, that the

Box 1.5. **Progress on structural reform since the crisis**

In legislative terms, at least, the period since 1999 has witnessed considerable progress on structural reform.[1] The first important post-crisis achievement was the passage of Part Two of the new Tax Code in 2000, albeit lacking the chapters on the profit tax and resource taxes which were adopted only in the following year. Land reform, which had been stalled throughout the 1990s, moved forward with the unfreezing of Chapter Seventeen of the Civil Code, which governs property relations with respect to land, although agricultural land was excluded from its provisions.[2] This action was followed by a new land code and a new law on the purchase and sale of agricultural land. The new labour code reached the statute books in 2001, as did a trio of bills aimed at reducing bureaucratic interference in the economy and the major elements of the government's judicial reform. The basic legislation on pension reform was adopted in December 2001, with additional legislation following in 2002-2003. A further law authorised the creation of a new body to fight money laundering. Although it was criticised at first for being too weak, the law has subsequently been strengthened and in 2002 Russia was removed from the Financial Action Task Force's list of states that fail to combat money laundering. Several measures were adopted in 2001 and 2002 to improve the framework for corporate governance, including new laws on bankruptcy and joint-stock companies and a corporate-governance code, which broadly reflects the OECD Principles of Corporate Governance. The period 2002-2003 also saw the adoption of new laws on currency controls (almost all capital controls were phased out) and on technical regulation. A new customs code was adopted, as was the government's electricity-reform package. The pace of legislative activity slowed somewhat in 2004, but the government continued its reform of the tax and budget codes, particularly with respect to fiscal federal relations.

This legislative record is a considerable achievement. It is noteworthy for the large number of contentious measures passed in 2002 and 2003, when the opposition of entrenched interests and the approach of elections made the government's task much more difficult. On the whole, the new laws are an improvement on the legislation they replaced. In some cases, of course, the new legislation does not replace anything all; it simply fills gaps in the legal frameworks governing various spheres of activity. Russian commercial law in many fields is now of very high quality. But improvements in the quality of the laws have not yet been matched by improvements in the quality of the institutions that implement them or those that interpret and enforce them. The weakness, inefficiency and corruption of all branches of government are the most important obstacles to further progress in reforming Russia. Judicial reform exemplifies this problem. A major overhaul of the various codes of judicial procedure and the laws governing the judiciary was completed in 2001, but there is little evidence that it has improved the functioning of the courts. In much the same way, the impact of the three laws adopted in 2001 to reduce the bureaucratic burden on business has been limited – mainly because officials affected by the legislation resisted its implementation.

Progress on structural reform has not by any means been limited to passing laws. Since 2000, the authorities have tackled the painful but necessary task of rebalancing domestic and international rail fares and of raising the prices charged by the country's electricity and natural-gas monopolies. The implementation of pension reform began in 2003, although it soon encountered difficulties that led to some amendments. Finally, two crucial and long-delayed reform processes have begun to move forward since 2001: those affecting the power sector and banking. Both are meeting serious resistance and are moving less quickly than proponents would like. But progress over the last three years has

Box 1.5. **Progress on structural reform since the crisis** *(cont.)*

been dramatic indeed compared with the preceding decade, when both electricity and banking reform were repeatedly postponed. Moreover, despite the numerous delays, the pace of reform in both sectors since early 2002 compares favourably with the speed at which similar reforms have been executed in other emerging market economies.

1. For details, see OECD (2004a), Annex 1.A2.
2. When the code was adopted in 1995, the suspension of its highly controversial Chapter Seventeen was the price the government paid to get it through a Duma which was then dominated by opponents of land reform.

government resolved to move ahead with long-delayed structural reforms in spheres ranging from taxation to electricity to banking.

While reform in many areas accelerated after the crisis, the pace of privatisation slowed. This was partly because the most attractive state assets had already been sold off. As political infighting over the remaining prime assets intensified, further sales became more complicated. Moreover, there was little interest in buying residual state shareholdings in companies that were already controlled by a private owner or group of owners. The state was thus left holding a large number of less attractive assets that have not been easy to sell. Finally, the privatisation scandals between 1995 and 1997, followed by the financial crisis of 1998 and the political uncertainties of 1999 and 2000, impeded the process.

The period after 2000 saw improvements in investor confidence and in the state's performance in the field of privatisation, but these improvements were limited. In principle, major sales were now to take place on a transparent, competitive basis, with mechanisms designed to maximise the sale price. In fact, there have been few such sales. Year after year, ambitious privatisation programmes are unveiled but not implemented. Many of the sales that *have* gone ahead have been extremely controversial. In some cases, the authorities have ended up rewriting the terms of privatisation sales in the middle of the process, a practice which has done nothing to enhance either government credibility or investor confidence. While sale prices are a good deal higher now than they were in the loans-for-shares era, there is still a widespread perception that the winners in major privatisation competitions are determined in advance.

Regulatory reform: its contribution so far

Together with responsible macroeconomic management, regulatory reform has laid the groundwork for Russia's robust economic growth in recent years. Much, of course, remains to be done, and the main challenges are outlined below. First, however, we assess in detail the contribution of regulatory reform to Russian economic performance thus far.

More than a decade of reform has transformed the structure of ownership…

Perhaps the most dramatic change of the post-Soviet period – and certainly the most striking – has been the rapid shift to private property. By 2002, the private sector employed 63% of all workers. It now accounts for an estimated 70% of GDP, including about two-thirds of industrial production. Wholly state-owned and municipal enterprises account for just 9.5% of industrial output, while enterprises with mixed state-and-private ownership hold a 24.3% share.

Since 1992, the private sector has come to be dominated by a small number of large industrial groups, most of which are tightly controlled by a few core shareholders and organised around some commodity-exporting business. The ten largest industrial groups, together with the state-controlled gas and electricity companies, are responsible for roughly half of Russia's industrial output.[29] These groupings have in recent years tended to pursue strategies of vertical integration. Such strategies are in part a rational response to the uncertainties and risks connected with enforcing contracts in the Russian legal environment. Moreover, industry consolidation has led to better economic performance in a number of cases. Unlike the managers of the remaining large state-owned companies, most of the privately held industrial groups have restructured their businesses, the bulk of which are fairly well managed. The productivity of enterprises belonging to private industrial groups has increased briskly. While expanding into new sectors, most of these groupings remain heavily focused on their core businesses. Expansion tends to be into sectors closely related to their core businesses.[30] The consolidation around these large groupings has led to economies of scale that have made them more competitive with large non-Russian players.

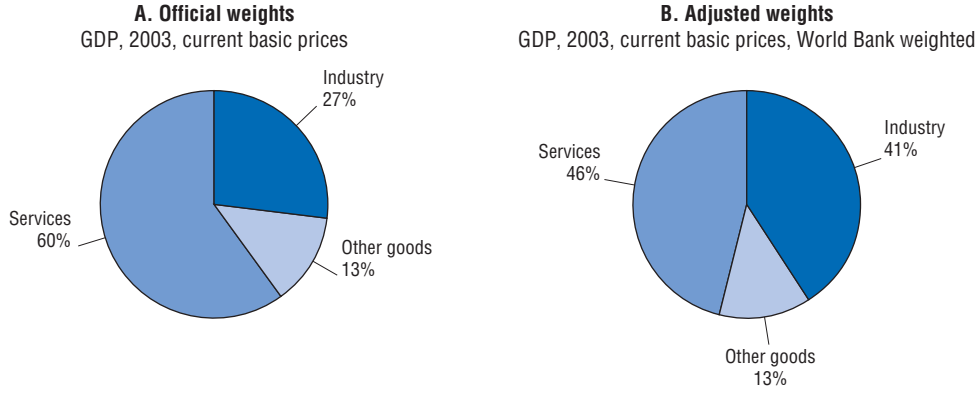
This concentration of ownership may, however, pose issues for competition policy. The groupings' growth appears to be driven by a desire to monopolise entire sectors, or even groups of related sectors. This is especially true of the most recent wave of industrial consolidation. In the 1990s, banks and cash-rich resource companies simply bought up whatever they could buy as fast as they could buy it. Since the crisis, however – and especially since 2000 – mergers and acquisitions have often been prompted by a determination to create vertically-integrated structures.[31] Often companies with monopoly or near-monopoly positions in one sector have sought to extend their reach up- or down-stream into related sectors. This has been particularly evident in the behaviour of some state-owned companies.

This behaviour by large companies may in part be conditioned by economic habits formed by the difficulties encountered under planning. The industrial structure of the Soviet Union was characterised by very long chains of dependence, which lacked the resilience and flexibility built on redundancy in markets.[32] The absence of alternative suppliers and customers left Soviet enterprises vulnerable and one response to that vulnerability was to take direct control of up- and down-stream activities. The fact that metals producers sought to control both coal mines and automobile manufacturers reflected the limited options they had for procuring their energy supplies or marketing their output.[33] Many major industrial sectors may thus face a future of monopoly or oligopoly. This consolidation threatens to suppress or prevent the emergence of competition in many product markets. In this situation, there will be a need for much stronger competition policy. In addition, the international openness of the economy may provide some competitive pressure in some sectors. This is a major reason why Russia's entry into the World Trade Organisation supports the success of economic reform. It will open the economy further and make it harder for domestic players to suppress competition in some sectors.

... as well as the structure of production, employment and foreign trade

In addition to changes in ownership, the early 1990s witnessed a major shift in the structure of production, especially in the industrial sector. The output of natural-resource-based sectors fell by about 40% between 1992 and 1994, while that of other industrial

Figure 1.5. **Structure of Russian GDP**



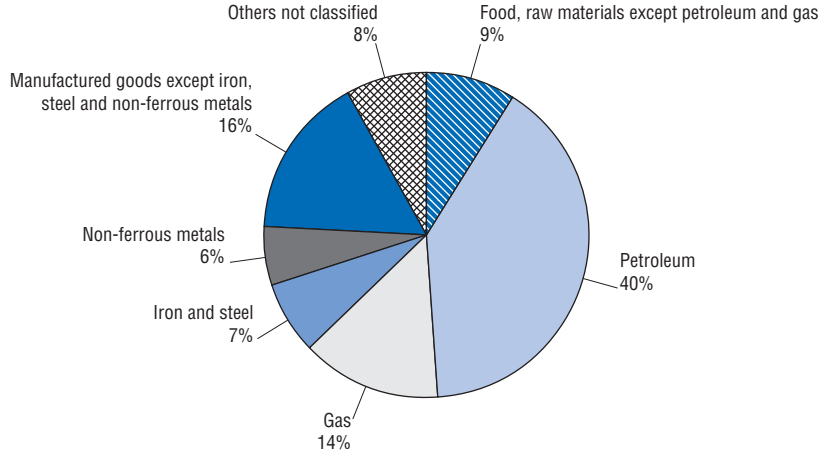
Source: Goskomstat, World Bank and OECD calculations.

sectors declined by roughly 60%, according to the official data. The weight of natural resources in the economy increased accordingly. There was also a shift away from producing goods and toward the service sector, but this shift was far less dramatic than it appears in the official data. The transfer pricing used by major resource exporters means that a large share of the value added in resource sectors shows up in official statistics under services (wholesale trade, in particular). Figure 1.5 shows the structure of the economy as it appears in official data and as it would appear based on weights computed by the World Bank in an effort to correct for transfer pricing.[34]

Changes in the structure of production were mirrored by changes in the labour market. According to one Russian study, more than 40% of the workforce changed profession between 1991 and 1998; two-thirds of these did so by 1996.[35] Industry's share in total employment fell by 12 percentage points between 1990 and 2002, to 30.3%.[36] In fact, the fall in industrial employment was even greater, because *total* employment fell by 12.8% over the same period. There were also important shifts within industry. Unproductive and loss-making sectors cut staff, sometimes very sharply, while others – especially the export-oriented, natural-resource-based sectors – maintained or even increased employment.[37] The service sector's share in total employment rose from 42.1% in 1990 to 55.9% in 2002. Employment grew faster in market services than in any other sector, gaining ten percentage points over the period. Nevertheless, the bulk of service-sector employment is still in non-market services, which accounted for 29.3% of total employment in 2002, up from 25.4% in 1990. Given that the output of non-market services sectors fell in absolute terms and relative to GDP over the period, this increase would appear to reflect a lack of restructuring and the flight of some part of the labour force from the market, rather than the dynamism of this sector.

Russia's trade structure has also undergone big changes, particularly in its geography. The break-up of the Soviet Union and the subsequent liberalisation of trade were accompanied by a massive reorientation of trade flows away from the former Soviet Union to non-FSU countries. This shift was accelerated by the break-up of the rouble zone, as well as by the difficult economic circumstances in which many of the ex-Soviet states found themselves. In 1993, 26.7% of Russian exports went to former Soviet republics and 30% of its imports came from them. By 2003, the corresponding figures were 15.7% and 21%

Figure 1.6. **Structure of Russian exports, 2003**



Source: United Nations, Commodity Trade Statistics Database (COMTRADE), SITC Rev. 3.

respectively.[38] Exports to and imports from the former communist states of Central and Eastern Europe also fell sharply in the 1990s. The region's share in Russian exports fell from 14.3% to about 10%, while its share of imports dropped by almost half, from just over 13% to about 7.3%. Trade with OECD countries shot up over the same period, particularly imports.

This reorientation proved especially painful for Russian manufacturers, as their products were generally uncompetitive on western markets. Basic commodities – chiefly hydrocarbons, but also metals, timber, pulp and paper, mineral fertilisers and diamonds – already dominated Russian exports before the market transformation, and this dominance has increased steadily over the post-Soviet period, leaving Russia with a very high concentration of primary commodities in its overall exports (Figure 1.6). The share of machinery and equipment in total exports fell from almost 20% at the end of the Soviet period to under 8% in 2003. This decline would have been even more precipitous had it not been for renewed growth in arms exports in the late 1990s. Moreover, an increasing share of Russia's exports consists of mineral products and semi-finished goods, the production of which is very energy intensive and entails environmental risks. Examples include base metals and chemicals, as well as cellulose and paper products. Rising domestic energy prices are reducing the competitiveness of many of these exports, and a serious effort to raise environmental standards would further reduce their price competitiveness. On the import side, the most visible shifts include a sharp increase in food and consumer goods. The import share of machinery and transportation equipment remains quite large, but it now consists mainly of consumer electronics and passenger cars rather than investment goods.

Price liberalisation, though painful, has brought significant benefits

It is hard to exaggerate the impact of the initial price liberalisation of 1992. It was aimed at ending the chronic shortages resulting from artificially low regulated prices for most goods and services, as well as at absorbing Russia's "monetary overhang". Even more important, it was intended to allow prices to perform their normal function of providing information about the interaction of supply and demand. There was widespread scepticism at the time about the ability of Russian enterprises to respond to price signals,

but they did indeed react fairly quickly, adjusting prices and output in response to feedback from the market. Queues and the shortages that gave rise to them disappeared, while the structure of production and employment began to change rapidly. The subsequent rapid development of the private trade and service sectors, which had been neglected under central planning, owed much to the signals generated by free prices. Price liberalisation dramatically increased the availability of goods and services that had been difficult or impossible to obtain before the reforms. However, low purchasing power limited what most of the population could buy, and the distributional impact of liberalisation was highly unequal.

Price liberalisation helped to protect the integrity of the still-fragile Russian Federation and to reconstitute Russia as a unified economic space. In late 1991, the centrifugal tendencies that had contributed to the break-up of the Soviet Union appeared to be threatening Russia itself. The breakdown of the Soviet system had not replaced administrative allocation with market mechanisms. Rather, it had devolved administrative power to regional and local governments, which aggravated the country's worsening shortages by setting up their own trade barriers and striving for regional self-sufficiency. The federal government could no longer ensure that Moscow was supplied with food and goods. The national economy began to fragment. Price liberalisation met the challenge. Barter and administrative allocation declined and money began to matter again. The growing role of money enhanced the authority of the federal centre, which controlled monetary policy. In August 1992, the government asserted that the changes had strengthened the federation *vis-à-vis* the regions.[39] This declaration of victory was undoubtedly premature, but it was not without foundation. The fear of economic fragmentation was an important, if often overlooked, part of the story of price liberalisation.[40]

The liberalisation process imposed hardships on enterprises and households, and it would have done so even if the government had managed quickly to stabilise the overall price level. The move from a system in which the allocation of goods owed more to rationing than to purchasing power was bound to produce both winners and losers. Some of the initial losers, such as pensioners, were also hard-hit by the continuing high inflation that followed the original adjustment. The big-bang nature of the initial liberalisation package has attracted much criticism. But the system of fixed prices had more or less broken down by late 1991, and it is not clear that a more gradual approach would have been feasible. Moreover, the big bang of January 1992 was not as big as is sometimes supposed. Although more prices were freed two months later, remaining national controls on hydrocarbons and other basic commodities had knock-on effects in other markets. Regional authorities were permitted to introduce local controls, and most did. Energy prices, in particular, continued to be regulated, for fear that a rapid convergence between domestic and international energy prices would bankrupt large swathes of industry.[41] An estimated 30% of GDP was still covered by price controls in 1995.

Liberalisation of foreign trade and investment has benefited consumers and increased competition

Once price controls were removed, trade measures were used to hold down the domestic prices of some key industrial inputs. In many cases, the differential between the domestic and international prices for such goods actually increased. Most important among these commodities were oil and gas. They were also the commodities on which export restrictions were kept in place the longest. Price regulation, export tariffs and quotas, and the allocation of access to export pipelines were all used to hold down the

internal prices of these two fuels. By the beginning of 2002, a decade after the big bang, the domestic price of oil was still less than 30% of the world market price of Urals crude. The domestic wholesale price of natural gas was about 12.5% of the export price. In the early stages of transition, import controls were imposed on many other commodities, and the importing of some necessities was subsidised. Russia began the transition with a very open import regime but heavily regulated exports. This situation, however, quickly began to change. As the rouble strengthened and protectionist pressures mounted, the country moved to an increasingly complex import-tariff structure. By the mid-1990s, it included some 3 500 product categories. This complex and cumbersome system gave rise to much corruption, largely because officials could misclassify heavily taxed goods into lower-tariff categories.

The continued over-regulation of foreign trade had serious consequences. The fiscal cost of import subsidies and the remaining price controls made macroeconomic stabilisation virtually impossible to achieve in the early 1990s. Controls on exports and imports also created enormous opportunities for official corruption and for highly profitable arbitrage operations. The officials and entrepreneurs who profited from such activities swelled the resistance to further liberalisation. As a result, many of the steps envisaged by the government in its policy memorandum of February 1992 were never implemented. The liberalisation of exports and the elimination of subsidies and quotas on imports were, in fact, too slow and too limited – not too rapid, as some would claim.

It would, however, be wrong to exaggerate the impact of these shortcomings. On the whole, Russia has moved steadily along the path to trade liberalisation, and the process has been reinforced in recent years by its determination to enter the WTO. During the 1990s, exports were gradually liberalised while sectors that competed with foreign imports were granted a degree of protection. But in recent years, Russia's tariff structure has come increasingly to resemble those of OECD countries. The overly complex import-tariff structure that evolved in the 1990s underwent a fundamental overhaul at the end of 2000. By the start of 2001, over 30% of products had been classified into just four categories, with tariff rates of 5, 10, 15 and 20%. A few products – including cars, sugar, alcohol and tobacco – continued to be taxed at rates well above 20%, but the changes brought the average rate down to between 11% and 12%. Over time, the number of "peaks" in the tariff schedule has declined; there are few tariffs now above 15%.[42] As a result of this simplification of schedules, the intentional misclassification of imports, and the corruption it entails, appears to have diminished. Moreover, the simplification of tariff schedules and the legal requirement that tariffs be revised no more than twice a year have made tariff policy more transparent and predictable.

Russia eliminated many formal obstacles to foreign investment in the earliest stage of the market transformation, ending a 75-year period during which it had been almost entirely closed to outside investment. A further push to improve the legislative framework for foreign investment – particularly for foreign *direct* investment – was undertaken after the 1998 financial crisis. A law adopted in 1999 and amended in 2002 and 2003 establishes the principle of "national treatment" for foreign investors and their right to engage in any form of investment activity allowed by law. It also guarantees investors compensation in the event of expropriation and it authorises the repatriation of profits. Nevertheless, restrictions remain in a number of fields including insurance, banking, media, aviation, land transport, agricultural land, electric power and natural gas.

While foreign trade has grown strongly in recent years, foreign direct investment (FDI) has been disappointing. The cumulative *stock* of FDI in Russia came to just USD 26 billion at the end of 2003, equal to about half the FDI *inflow* to China in that year. Russia's stock of FDI is also smaller, in both absolute and *per capita* terms, than that of the more advanced transition countries. FDI inflows into Russia amounted to just USD 26.7 per capita in 2002. They were USD 88.6 for Hungary, USD 106.1 for Poland and USD 817.8 for the Czech Republic.[43] The paucity of foreign investment is a problem not only because Russia is not benefiting from the spillover effects that FDI induces but also because Russia's overall investment rate is still low. Despite a recovery from 2001 to 2003, gross fixed capital formation amounted to just 20% of GDP in 2003, slightly below the OECD average and well below that of countries enjoying sustained rapid growth. There are signs that the situation is improving: according to data from the Federal Service for State Statistics, FDI inflows rose to almost USD 6.8 bn in 2003, after fluctuating around USD 4.2 billion during the previous four years. Preliminary data for January-September 2004 show a further increase of about 19%, year on year. This is still fairly modest for a country of Russia's size, but the trend is better than that of domestic investments. Domestic investors, unsettled by signs of deterioration in the investment climate, are cutting back their investments in Russia in favour of acquiring assets abroad.

It is extremely difficult to quantify the impact of trade reform or the opening up to foreign direct investment on economic performance. There is no simple way to isolate the effects of trade and investment liberalisation from those of other policies, let alone from such macroeconomic variables as the exchange rate and the terms of trade. There is, however, broad agreement that trade fosters economic growth: it stimulates technological progress, it makes possible the achievement of economies of scale and it enhances competition.[44] The last of these factors is particularly relevant in Russia, because of the highly concentrated structure of many sectors of the economy. Foreign competition for product markets has a critical role to play in safeguarding competition while preserving the efficiency gains that can flow from industrial consolidation.

Studies of Russian trade and FDI liberalisation indicate that competition with imports and with foreign direct investment has had a positive effect on domestic firms. Bessonova *et al*. (2003) found that the increased availability of imported inputs helped improve the productivity of domestic firms between 1995 and 2001 (although the 1998 devaluation did hurt firms dependent on foreign inputs). The same study found that competition with foreign imports and with goods produced by foreign-owned firms in Russia has led to faster restructuring of domestic firms. On the other hand, the authors found that the effects of liberalising trade and investment depend on other policies, including financial-sector reform, measures to increase labour mobility and reductions in regional bureaucracy. These conclusions dovetail with the analysis of industrial competitiveness presented in OECD (2004a), which draws attention to the large productivity improvements recorded in sectors with high levels of foreign participation. FDI has brought benefits to some specific sectors and localities, but it has so far been too small to contribute much to overall economic growth: even at regional level, there appears to be no relationship between FDI inflows and growth.[45]

Russia's privatisation policies have attracted much criticism

Privatisation has proved to be the most controversial major element of reform. Before examining its impact, therefore, it may be useful to "put privatisation in its place". In

Russia and other transition countries, the importance of privatisation was greatly exaggerated at the beginning of the market transformation. The effects of privatisation depend critically on context and are thus inextricably linked to changes in the wider economic environment. In particular, the impact of privatisation depends on market structures and the presence of competition, changes in corporate governance, and the imposition of hard budget constraints.[46] These factors need to be considered jointly. While some critics have tended to attribute Russia's economic travails in the 1990s primarily to flawed privatisation, the evidence actually suggests that the impact of privatisation on performance was positive.

This is not to suggest that privatisation policy in Russia has been above criticism. Voucher privatisation did succeed in transferring ownership out of the hands of the state, which had been an extremely inefficient owner, but the resulting ownership structure reflected political expediency rather than economic efficiency. In fact, the authorities realised from the start that the voucher scheme would lead to so much dispersion of ownership that enterprises would in fact be controlled by insider-managers with little interest in restructuring. The government believed, however, that rapid privatisation would make portfolio investment and acquisitions possible, so that the immediate post-privatisation ownership pattern would quickly be replaced by a more efficient one, in which control passed to owners with both the means and the inclination to restructure. Eventually, that is what happened, but the transition from the first stage of this process to the second proved extremely difficult, largely because Russia lacked the institutions to deal with the corporate governance problems posed by the initial pattern of insider control. In this respect, Russia's experience was typical of economies that opted for rapid mass privatisation.

In the absence of hard budget constraints, effective competition and functioning capital markets, insider-managers were able to entrench themselves and to resist both restructuring and liquidation. Operating in an environment of political and economic uncertainty and aware of the limitations of their newly acquired property rights, large numbers of managers opted for asset-stripping and capital flight over investment and restructuring. This was a rational, if unattractive, strategy in the circumstances. Shareholders had no way to control management and there was little protection for the rights of minority shareholders. In these conditions, some managers simply expropriated the assets of other stakeholders. Moreover, dispersed ownership gave rise to conflicts – many of them violent – among shareholders seeking to exercise effective control. Restructuring was not much of a priority so long as control over assets was being contested. Because Russia provided little protection for property rights, control contests tended to be zero-sum games: the winners often drove out the minority shareholders.

The loans-for-shares process generated even more criticism than the voucher scheme. Loans-for-shares undermined the legitimacy of the ownership rights created via privatisation and weakened popular support for the protection of property rights in general. They continue to haunt Russian big business to this day. However, the story is more complex than is often acknowledged. Most of the enterprises involved in loans-for-shares, though among Russia's most valuable companies, were in very bad shape. Their main assets consisted of legal claims to reserves of valuable natural resources, and those claims were often ill-defined. The low prices paid for them reflected real political and commercial risks, as well as the fact that "outsiders" were systematically excluded from the process. Moreover, the loans-for-shares deals were unusual only in their transparency.

Both the auction process and the sums involved were widely publicised. In reality, the loans-for-shares deals are perhaps best understood as a further stage in the insider-dominated privatisation process that began in the late Soviet period and continued during the voucher phase of 1992 to 1994. In every loans-for-shares auction but one, the winner already held a significant degree of control over the company acquired.[47] Insiders have tended to predominate in Russia, no matter what privatisation mechanisms were used. Where assets were *not* privatised, insiders have often "privatised" financial flows, by siphoning off funds and assets from state enterprises into their own vehicles.

What the government has earned out of privatisation has been very modest compared to the value of the assets sold. In 1997 (until 2004, the peak year for privatisation revenues), income from the sale of state property totalled 0.9% of GDP. In most years during the 1990s, privatisation income was around 0.1% of GDP. The sale of state property generated just 1% of the consolidated state budget in the 1990s.[48] The state's savings from privatisation on the expenditure side are harder to assess. One of the major aims of privatisation was to separate failing enterprises from the budget and thus relieve the state of the burden of subsidising them. However, state bodies at all levels continued to extend implicit and sometimes explicit subsidies to distressed enterprises long after privatisation.[49] However, the experiences of other transition economies, where privatisation went much more slowly, suggest that these subsidies might have been even heftier had the recipients remained in the state sector.[50]

It is unfortunate, but hardly surprising, that the Russian state has earned so little from the privatisation process. With a few exceptions, Russian privatisations have not been motivated by revenue concerns. Moreover, the process has largely boiled down to transferring assets to those who already controlled them. In a way, privatisation served to formalise, and to extend somewhat, the pre-existing pattern of *de facto* asset control.[51]

Nevertheless, privatisation has improved business performance

In assessing the contribution of privatisation to overall economic performance, it is important to distinguish between the *process* by which state assets were sold off and the *impact* of those transfers on the privatised enterprises. The defects of Russia's privatisation process cannot be denied, but they should not obscure the strong evidence that *privatisation has improved enterprise performance*.[52] This holds true for enterprises handed over to insiders during the voucher phase as well as for companies involved in the loans-for-shares schemes and other post-voucher privatisations. Recent studies vary widely in their assessments of the extent and speed of change, but virtually all of them report improved performance in enterprises after privatisation.[53] There is evidence of higher average productivity and faster productivity growth, as well as faster sales growth. Privatised firms shed excess labour more rapidly than state-owned firms and they were far more likely to change product lines, invest in new equipment and adopt pay schemes linked to productivity.

The beneficial effects of privatisation have been most pronounced where strong outside owners have taken over, but performance improved even where insiders retained control. After the voucher period, there were substantial changes in the structure of ownership, generally in the direction of more concentrated (and thus more effective) ownership. The problem was not that insider ownership was bad in itself but that, in Russian conditions, insider control made market-oriented restructuring less likely. Managers often lined their pockets, through asset stripping and other forms of corruption.

Workers' chief concern was to preserve their jobs. In theory, of course, market disciplines should have compelled insider-managers in failing enterprises either to restructure or to surrender control to those who could and would do so. As market disciplines have become more effective (in other words, as the authorities have become less willing to prop up failing firms), the problem has become less acute.

The Russian state has in any case proved to be an extremely inefficient owner of those assets that it continues to hold. The records of most state-owned companies in Russia are strong *prima facie* arguments in favour of privatisation. As a rule, output and productivity have grown much faster in sectors that are free of state ownership and interference.[54] In sectors such as oil, where private and state-controlled companies operate side by side, the private companies have been much more efficient.[55]

Russian privatisation did not achieve all that it might have done. Many criticisms of the process are valid. It is true, for example, that the chaotic and often corrupt privatisation processes of the 1990s have made it difficult to secure and legitimate the post-privatisation property settlement. The continuing insecurity of property rights in Russia is partly the result of past privatisation processes. Nevertheless, the Russian experience is beginning to confirm that of a number of other transition economies: privatisation is associated with increases in sales revenues and labour productivity and, to a lesser extent, fewer job losses.[56] The positive effects of privatisation grow as time passes. Enterprises privatised for less than two years perform about as well as state-owned enterprises, while those privatised for three years or more outperform those still owned by the state.

Financial-sector development has so far produced only limited benefits to the economy as a whole

The Russian banking sector and financial markets are both small relative to GDP and their role in financing productive investment is still limited.[57] The insurance sector is even less developed. All three are growing rapidly, but further regulatory reform is needed if they are to develop over the long term and to perform their normal functions in a market economy.

Fifteen years after the appearance of Russia's first commercial banks, the country's banking sector remains small, fragmented and dominated by a few state-owned institutions. Formal barriers to foreign banks have been relaxed, but the foreign presence in the sector is still limited. Despite very rapid growth after the 1998 financial crisis, banking sector assets amounted to just over 42% of GDP in 2003, well below the holdings of banks in the more advanced transition economies and a small fraction of those in EU member states. The deposit base, though growing rapidly, is still small. By end-2004, credits to non-financial enterprises and organisations were about 18.8% of GDP. Bank credits financed only about 4.8% of fixed investment in 2003. The ownership structures of the banks tend to be opaque. There is little trust among banks, or between banks and clients with whom they have no special ties. The sector is still highly segmented. The inter-bank market is under-developed, and there is little of the interaction among banks that is commonly found in a well-functioning network of financial intermediaries. There is little pooling, trading or sharing of risk.[58] Bank portfolios tend to be highly concentrated on both the asset and liability sides, and a large share of lending is still to related parties.

Russia's financial markets are in a similar situation. After more than a decade of development, they have begun to acquire the technical and functional characteristics of mature markets. However, they are still small and not very liquid. Total stock-market

Table 1.2. **Banking sector development in selected economies**

2002

	Russia	Hungary	Poland	Czech Republic	EU
Per capita GDP (USD)	3 100	5 150	4 600	5 500	26 000
Number of banks	1 329	64	64	37	7 219
Per cent of foreign capital	5	66	69	94	n.a.
Assets, as a per cent of GDP	38	72	67	121	280
Credits, as a per cent of GDP	20	32	26	36	118
Capital, as a per cent of GDP	5	8	8	7	120
Deposits per capita (USD)	350	2 700	2 400	4 850	17 500

Source: CBR, World Bank, BIS statistics.

capitalisation in early 2004 was fairly high for an emerging market, at about USD 200 billion (almost 50% of GDP), but indicators of liquidity and depth were still poor. The shares of only ten companies, mainly in oil and gas, accounted for about 90% of turnover on the two major stock exchanges. The corporate bond market more than doubled in size in 2003, but the volume of placements still amounted to just 1% of GDP. Activity in the bond market is somewhat more diversified than on the stock market. The oil and gas sectors account for only about 40% of outstanding issues. Somewhat larger than the corporate bond market is the market in unsecured promissory notes (*vekselya*), where about USD 10 billion was outstanding at the end of 2003. Though *vekselya* are popular as a liquidity-management instrument, they are a riskier investment than corporate bonds, as their issuing requirements are less demanding and their legal status less well defined.[59] Domestic financial markets thus remain a very limited source of investment capital. Even the government debt market is under-developed. The total volume of rouble-denominated government debt outstanding at the end of 2003 was equal to roughly 5% of GDP, but only about 40% of this was tradable. A liquid, well-functioning market in government debt would help the central bank manage the money supply and sterilise foreign-exchange inflows. It would also give banks greater freedom to manage their liquidity and provide a proper market for interest-rate formation.[60]

The insurance industry is even less developed than the banks and capital markets. Over 2 000 insurance companies were created in the 1990s, but the vast majority were under-capitalised entities designed to serve a very narrow clientele – usually, their owners. Estimates of how many such "pocket" or "captive" insurance companies exist vary widely, but there is no doubt that they make up most of the sector. One recent Russian study estimates that only about 10% of premiums in 2002 were paid at arm's length – that is, paid by customers to insurers with whom they were not linked by common shareholdings or similar ties. Companies which insure themselves are not so much securing insurance cover as using insurance to write off expenses and avoid taxes. This is particularly true with respect to life insurance. In 2002, it was estimated that over 80% of Russia's life-insurance business consisted of tax-free salary-enhancement schemes. No one really knows what proportion of the non-life sector's business consists of such "grey schemes", but a recent Russian study concluded that just 36% of premiums in 2003 were paid for real insurance.[61] Tax changes adopted in recent years have reduced the scope for employing such schemes, but insurance dodges have hardly been eliminated. The Federal Insurance Inspectorate

estimates that grey schemes accounted for more than 40% of premium income in 2003. Some Russian insurance companies put the figure closer to 65%.

Because of Russia's inability to attract large-scale foreign investment and because few firms outside the resource sector can finance capital investment from retained earnings, the country's future growth will depend to a great extent on the mobilisation of domestic savings.[62] A more efficient financial system could also play a role in fostering the diversification of economic activity in Russia. The lack of mechanisms for efficiently allocating investment resources across economic sectors is therefore a major problem. Indeed, the financial system in its current state may well be reinforcing the economic *status quo*, rather than facilitating structural change.

Russia's experience shows both the benefits of competition and the need for stronger competition policy

The performance of various Russian sectors since 1992 has underscored the benefits of competition. Many of the most dynamic sectors in Russia are relatively new activities (*e.g.* mobile telephony), where competition among providers has developed in the absence of an already existing dominant firm or group of firms. Productivity has generally increased fastest in sectors where there is robust competition and slowest in those that are still dominated by state-owned companies with monopoly power. These trends underscore the importance of policies and institutions designed not only to safeguard but to promote competition.

Russia created its first competition authority early in the transition period and has since developed a large body of competition law. Both the Constitution and the Civil Code express strong support for competition. But competition policy has been less of a priority in practice than on paper. Successive competition authorities (the name and status have changed frequently) have been over-stretched, under-empowered and under-resourced. Instead of focusing narrowly on protecting and promoting competition, the authority was assigned numerous additional tasks. But it was not given the staffing and resources to cope with its many – and frequently changing – duties. In its core role as promoter and preserver of competition, it was endowed with weak investigative and enforcement powers. In the spring of 2004, the Ministry for Anti-Monopoly Policy was liquidated as part of the broader reorganisation of the federal executive and replaced by a new Federal Anti-Monopoly Service. The new service's mandate is somewhat narrower than the ministry's was, since consumer protection and utilities issues have been shifted away from it. It is too early to assess the impact of this change, but the focusing of the service's mandate is probably a step forward for competition policy.

The frequency with which the authority's legal status and tasks changed undermined its effectiveness. Nevertheless, Russia's competition-policy achievements since 1992 have been noteworthy. The authority played an important role in reducing barriers to the movement of goods and services within the country. These barriers were enormous when the transition began, and they are still a problem in many sectors. The competition authority devoted much of its energy to combating regional and municipal regulations that impeded inter-regional trade. It also took the lead in efforts to advance consumer protection and reform Russia's regulated monopolies. While there is still much to be done in all these areas, it is important to recognise what has been achieved so far.

Judicial reforms have ended some abusive legal practices, but the administration of law remains uneven

An extensive package of judicial-reform legislation was adopted beginning in late 2001.[63] The package included a new code of civil procedure and a new procedural code for the arbitration courts, Part Three of the Civil Code, and new laws on the status of judges and on the constitutional court. The adoption of these statutes, which were opposed by an array of vested interests, was a significant achievement. Of particular importance was the clarification of the jurisdictions of the arbitration courts and the general civil courts, which previously overlapped. Cases could be, and were, tried in parallel in both systems. One side might win in the arbitration court, while the other prevailed in the court of general jurisdiction. In the absence of a single supreme authority, there was no way to determine which judgment took precedence.[64] Such situations often reflected non-legal factors (each side would sue in the court over which it expected to enjoy some influence), but they also reflected differences in the law that the two types of court applied. A further important step taken in 2001 was a reduction in the supervisory role of the prosecutor's office. The prosecutors had previously had the right to challenge court rulings on the grounds that they were contrary to the public interest. This could happen even in cases in which the state was not involved. As a result of prosecutorial interventions (often initiated on the basis of political considerations), winners in civil cases found their awards overturned and their cases returned to the court of first instance for re-trial. The passage of new legislation does not ensure that the law will be fairly and consistently applied, but the new measures did put an end to a number of abusive legal practices that arose in the 1990s.

The law on technical regulation could be a major step forward

A major weakness of Russian economic policy since 1991 has been the failure to initiate and enforce cost-effective, "fit-for-purpose" regulations and regulatory regimes. This has begun to change. A major step forward was the adoption in December 2002 of a new law on technical regulation. The law set in motion a major review of some 60 000 norms and regulations for the certification of products on environmental, health, safety and other grounds. Many previously mandatory norms are to become voluntary, while others are to be scrapped altogether. Moreover, the law outlines new procedures for proposing, evaluating and adopting standards and regulations. If they are fully implemented, these procedures will make the regulatory process more predictable, transparent and inclusive. They will facilitate widespread consultation and full assessment of the potential economic impact of new regulations. The procedural provisions of the law also emphasise the need to avoid discriminatory or unnecessarily restrictive measures, to apply internationally recognised standards where possible and to recognise the equivalence of other countries' regulatory measures. The procedural aspect of the reform represents a major breakthrough for Russia, and it is to be hoped that the law's focus on reforming the regulatory *process* (rather than the substance of regulation) will be replicated in other spheres. If implemented fully and consistently, the reform of technical regulation will reduce the regulatory burden on businesses, particularly in manufacturing sectors. The reform will also reduce a number of constraints on innovation and the introduction of new products. Nevertheless, much remains to be done. The implementation period set out in the law is seven years, and Russia is still a newcomer to the idea of a formal policy on regulatory governance.

"De-bureaucratisation" has helped reduce the bureaucratic burden on private firms

In an effort to reduce bureaucratic abuses and to create a more favourable climate for small and medium-sized businesses, the government in 2001 and 2002 secured the adoption of a trio of "de-bureaucratisation" laws. The package cut the number of activities subject to licensing, streamlined procedures for registering new businesses and set limits to the arbitrary inspections of enterprises by the police, fire, sanitation, tax and other authorities. (Such inspections are often an occasion for the extraction of bribes).[65] Another law, further simplifying registration procedures, was adopted in October 2003. These measures have had a positive impact, but survey data suggest that implementation has been uneven. Small-business surveys conducted by the World Bank and the Centre for Economic and Financial Research (CEFIR) show improvement in all areas after the laws were adopted, but the picture varies from region to region and it is clear that many officials are not adhering to the new procedures. It also appears that implementation slowed in 2003:

- Licensing requirements, both formal and informal, have been substantially reduced, but they remain more widespread than the law allows. The average cost of a license more than quadrupled between early 2002 and late 2003, while the average time involved increased by 14 days.[66]
- The number of inspections, both planned and unplanned, fell steadily from 2001 to 2003, but they were still much more frequent than is permitted under the new legislation. About half the unplanned inspections were conducted without a warrant, and multiple inspections remained common. A second inspection by a state body vastly increased the probability of still further inspections. The survey data show no evidence of a reduction in bribery. Indeed, financial losses from inspections rose in 2003, after falling in 2001 and 2002. About 62% of payments to police in the wake of inspections were described by firms as "unofficial".
- Registration appears to be the area of greatest improvement. The survey data show that registration became simpler and faster during between 2001 and 2003. The role of professional intermediaries, acquaintances and bribes in the registration process declined markedly.

The importance of such measures is all the greater in view of the increasing evidence of dynamism in Russia's small business sector. While the official data on small business are problematic, the evidence suggests that this sector has also been developing relatively rapidly in recent years, albeit from a very low base. This holds true even when adjusting for the unusually large role played by unincorporated entrepreneurs (the so-called *PBOYuL*)[67] in the small business sector.[68] This is important because PBOYuL do not currently appear in official statistics covering the small enterprises' (SE) sector. The number of people working in the SE and *PBOYuL* sectors is roughly of the same order of magnitude, and together they account for somewhat above 20% of the work-force. While the small business sector is thus larger than usually claimed, it is still relatively small by the standards of OECD countries or the more advanced transition economies. In the OECD area, it is not unusual for more than half of the labour force to work in SMEs. The available data suggest that the combined SE/*PBOYuL* sector has been growing at around 15-20% per year since 2001, with growth accelerating to around 30% in 2003.[69] The acceleration in 2003 was mainly driven by the ongoing consumption boom, as witnessed by particularly strong increases in the retail sector and transport. Creating conditions that favour the emergence and development of more small businesses – especially in sectors where they remain few

and far between, such as manufacturing – provides an important way not only to help sustain economic growth but also to foster the diversification of economic activity.

Regulatory reform: the challenges ahead

In assessing the most important regulatory reform challenges facing Russia, it is important to bear in mind not only the achievements just described but also the lessons for future reform suggested by Russia's recent history. First, it is important to note the extent to which the impact of the reforms discussed above did or did not reinforce one another. Thus, it is clear that the benefits of privatisation and competition appear to have been greatest in those sectors where both were present. Similarly, limited progress with respect to issues like the rule of law and corporate governance tended to reduce the beneficial effects of privatisation and undermined the development of the financial system. This suggests that complementarities among different strands of reform are more than just a theoretical issue. Secondly, it is clear from the foregoing that the basic institutional framework of Russia's new economy is still very much a work in progress. Much more remains to be done to strengthen property rights, establish the rule of law and foster competition in product markets. While the Russian authorities have embarked on some impressive – and often technically complex – "second-generation" reforms in fields such as electricity restructuring, many "first-generation" reforms have yet to be completed.

Improving the quality of state institutions is the key priority

By the end of the 1990s, the Russian authorities and many outside observers had come to regard the reform of state institutions themselves as the most important item on the country's reform agenda. In recent years, attention has focused on reforming the courts, the civil service[70] and the major regulatory institutions, and on recasting relations between the federal centre and the sub-national governments. However, progress in rebuilding state capacities has been very uneven. Since 1998, there has been a dramatic strengthening of the state's ability to tax and of its rule-making capacity, but the same cannot be said for rule enforcement. Doubts persist about the independence, competence and probity of the courts, the prosecutors and the police. Considerable doubts also surround the "relative autonomy" of the state. State bodies are sometimes penetrated, or even "captured," by private interests. This weakens rule enforcement and the Russian state's still limited administrative capacities. The state bureaucracy is large. It is often unresponsive to either the public or its political masters, and it is riddled with corruption.

These weaknesses impinge directly on the state's ability to devise, adopt and implement effective regulatory policies. Building an honest, effective state administration may, therefore, be the most important priority for regulatory reform. Doing so will take considerable time, and in the interim the weaknesses of the bureaucracy will make the implementation of other structural reforms more difficult. Russia does not merely need a strong state; it needs a state that is *different in kind* from the one it inherited from the Soviet Union. The Soviet bureaucracy's job was to *direct* economic activities, to assign economic tasks to agents and to reward or punish them for the fulfilment or non-fulfilment of those tasks. The role of the state in a market economy, by contrast, is overwhelmingly *regulatory*. In most cases, the state's function is not to tell economic agents what ends to pursue but to act as an impartial referee in a marketplace full of autonomous actors. Unfortunately, the mindset of the Soviet bureaucracy is often reflected in the behaviour of its Russian successors. After more than a decade of reforms, the Russian state still relies too much on

direct control over assets and on intervention in markets. One of the chief aims of regulatory reform is to move toward greater reliance on law and regulation instead.

The reform of state institutions in Russia has a number of distinct strands. The general rubric of "administrative reform" encompasses both the reorganisation of federal executive bodies undertaken in early 2004 and the reform of the civil service. A major reform of the judiciary was undertaken in 2001,[71] but much remains to be done to rid the courts of corruption and political influence. There is an on-going redefinition of the relationships among national, regional and local governments. And there is still much work to be done in creating the conditions for good regulatory policy making – improving the transparency and regularity of the policy process and building more effective regulatory agencies.

The reform of federal executive bodies got off to a rocky start

A major reorganisation of federal executive bodies was undertaken in March 2004, after several years of debate. The federal executive was divided into three types of institutions, each with a specific role:

- Federal *ministries* are policy-making bodies. They analyse, develop and evaluate policies in their respective domains, and they draft new legislation. They co-ordinate and monitor the activities of federal services and agencies within their jurisdictions. The reform reduced the number of ministries from 23 to 15.
- Federal *services* are supervisory and regulatory bodies. Funded from the state budget, they can issue individual regulations but not normative legal acts.
- Federal *agencies* are direct providers of public services to the state and private sectors. Their funding can come in part from charges and fees paid by their "customers".

The reorganisation appears to reflect the desire to separate the functions of policy making, service provision and regulation. In principle, such a separation should increase the efficiency of executive bodies while reducing the conflicts of interest that arise when these functions are combined. Unfortunately, there is little evidence that the reorganisation has achieved either aim. It disrupted the work of many government bodies for much of 2004, as officials concentrated on setting up the new structures and sorting out their respective roles. In some cases, regulators continue to be subordinate to ministries whose actions the regulators may at times be called upon to judge. The Russian authorities have not yet demonstrated that they are committed to creating regulatory organs that are genuinely independent and properly shielded from outside pressure. The subordination of the new Federal Anti-monopoly Service to the cabinet is a particularly striking instance, as this service is required to evaluate many of the government's own acts.

Civil service reform is likely to prove an even greater challenge

The challenge posed by civil service reform in Russia is enormous. The administrative system inherited from the Soviet regime is in many ways the precise opposite of the ideal of a public bureaucracy as it is understood in most OECD countries.[72] The Western model, as laid out in the writings of Max Weber, emphasises a strict functional-hierarchical division of labour; the corps of career civil servants as a distinct group, formed on the basis of competitive recruitment and merit-based promotion; a distinctive rationality based on legality, impartiality, objectivity and regularity; and a public-service ethos. Good salaries and security of tenure, together with a clear career path, make it possible to recruit and

retain able administrators. The Soviet hierarchy, by contrast, rejected both the separation of the political and administrative spheres and the autonomy of the administrative bureaucracy. The state administration was intertwined with, and penetrated by, the ruling party at every level. Recruitment was politicised in principle (*via* the party-administered *nomenklatura* system)[73] and often personalised in practice. The rule-oriented rationality of Weber's model was rejected in favour of an overriding emphasis on the implementation of party decisions, which took precedence over legal norms.[74] Far from having a clear functional division of labour, the Soviet system was a web of complex and often overlapping jurisdictions and lines of authority. These were intended to facilitate the monitoring and control of officials by the political leadership. In most respects, the Russian bureaucracy today resembles its Soviet predecessor far more than it does the western model.

The highly personalised nature of the administrative system inherited from the Soviet state merits particular attention. The Soviet administrative hierarchy, despite its complex and seemingly well-defined formal institutions, relied heavily on an informal set of personal networks within the party-state apparatus. Authority was often vested more in persons than in offices. Ties between patrons and clients and the distribution of rewards generally mattered more than the enforcement of rules and formal codes of behaviour. Such "personalistic" administrative practices breed graft and corruption, and they raise the costs of monitoring and enforcement. Russia's first post-Soviet governments made little headway in tackling this problem. Indeed, senior officials still seek to bolster their authority over the institutions they run by placing trusted personal associates in key posts.[75]

This personalism lies at the heart of one of the paradoxes of post-Soviet Russia: it is a weak state with strong officials. The patronage dispensed by individual officials – particularly those charged with managing state property or large financial flows – can be enormous, while the weakness of the administrative machinery makes it easy for officials to use that power to pursue narrow private or political ends. Some state institutions rate highly on criteria of cohesiveness and effectiveness,[76] but in the absence of a strong co-ordinating centre, these institutions often pursue narrow institutional interests, working at cross-purposes with each other and with the government itself. This lack of co-operation has been one of the main obstacles to administrative reform. It also motivates the current push to restructure the federal executive bodies so as to facilitate more efficient policy making and better policy implementation.

The Russian bureaucracy has undergone massive change, but little reform, since 1991

Not all the pathologies that afflict the Russian bureaucracy can be attributed to the Soviet past. Over a decade of transition has also left its mark. The bureaucracy underwent dramatic changes during the 1990s, generally as a result of economic and political developments rather than of any reform strategy:[77]

- The 1990s witnessed a large-scale exodus from the bureaucracy. Many of those who left were well-qualified mid-career officials able to command much higher salaries in the private sector. As a result, the civil service today is older and less well educated than its late Soviet counterpart. Mismatches between skills and duties are increasingly common.[78] The lower echelons of the administration are made up mainly of women and younger men, while the upper echelons are dominated by older men, most of whom began their administrative careers before 1985. Turnover among the lower ranks is very high, as the service gives younger officials little incentive to stay. Higher officials, many

of whom are already eligible for pensions, face little competitive pressure from below or from outside the service.[79]

- The problem of official corruption has grown worse since 1991. This reflects a combination of factors, including the breakdown not only of the political and bureaucratic controls that existed in the Soviet system, but also of the norms and beliefs that, however imperfectly, supported the old order.[80] Another factor is the very low pay received by officials, particularly as many low-paid functionaries find themselves in charge of valuable state assets or managing large financial flows. Opportunities for personal enrichment grew dramatically in the post-Soviet period, even as the remuneration of officials declined.
- The bureaucracy has grown in size, but not as rapidly as is widely believed. In fact, the number of officials in the public administration grew by just 13.6% from 1994 to 2001, with sub-national administrations accounting for most of the increase. The balance of this growth occurred among federal employees posted in the regions. The "centre" actually *shrank*. Indeed, Russia's public administration employs an unusually small portion of the labour force compared with most OECD and transition countries.[81] Some growth has resulted from the creation of new agencies to regulate a market economy, such as the bankruptcy service and the securities regulator, but these agencies are still small.[82]

There is still little clarity on the strategic direction of civil service reform

Reform of the bureaucracy has been actively discussed for several years, but the strategic direction of reform is still far from clear. The government's 2001 programme enunciates a number of worthy goals, including greater openness and accountability, a higher level of professionalism, the eradication of corruption and clearer legal definitions of the rights, duties and competences of civil servants. However, the programme is thin on specifics and says little about how these ends are to be achieved. It is hard to find a clear model either in the programme or in the decrees and statutes adopted over the last few years. Many of the proposals *seem* to reflect the classic Weberian model. The 2001 programme, for example, envisages the civil service as a distinct caste made up of individuals pursuing long careers in the service. Promotion would be for the most part within branches of service and would be based largely on seniority. But the programme and much of the discussion surrounding it also reflects the influence of the so-called "new public management" (NPM). This is an approach that has been influential in the West since the early 1980s, especially in the English-speaking countries. Russia does not by any means face a stark choice between the Weberian model (an ideal type that does not actually exist anywhere) and the NPM. Indeed, there are elements of both approaches in the changes adopted in 2003 and 2004. However, a comparison of the two models may help to illuminate some of the issues to be resolved in reforming the Russian civil service.

NPM is more of an approach than a model. It emphasises competition, performance incentives, competitive recruitment into the middle and upper civil-service grades and more movement into and out of the service. It also stresses the centrality of the citizen-consumer and the accountability of public-sector bodies (and even of individual officials) for the results of their work. NPM is particularly attractive to those wishing to reorient Russian officials away from the idea of "state service" toward that of "public service". Advocates of NPM also favour separating the function of policy making from that of providing services, with the latter to be taken over by semi-autonomous agencies. Such agencies would operate in markets or quasi-markets, competing for resources with other

Box 1.6. **Civil service reform, 1992-2004**

Civil service reform made little headway in the 1990s. The first steps, taken in 1995, represented a throwback to traditional caste or corporatist views of the bureaucracy, focusing on the status of officials and their privileges, perquisites and protections. A much more ambitious set of proposals began to be developed in 1997 under the Commission on State Construction (later the Commission on Administrative Reform). A draft strategy was designed to turn the "state service" into a "public service", a transformation that would require a dramatic shift in the culture and outlook of Russian officials. The strategy included proposals to make the bureaucracy smaller, more transparent and less expensive, and it envisaged the possibility of contracting out to private firms some functions performed by the state. It also called for competitive recruitment, which had been mandated under legislation adopted in 1995 but never implemented. The draft encountered fierce resistance, however, and no progress was made until late 2001, when the *Federal Programme for Reforming the State Service of the Russian Federation* (2003-2005) was adopted. The 2001 programme was based largely on the ideas contained in the 1997 strategy, and it, too, has met stiff opposition. The first legislation adopted pursuant to the programme was the 2003 law on the "System of State Service of the Russian Federation". Opposition to the bill from within the administration was clearly reflected in the fact that, while the original draft bill had 119 articles, the text that reached the statute books was only 19 articles long. A much longer law was adopted in 2004, setting out the basic framework for the non-diplomatic civil service.

The 2003 law enshrines in statute a set of goals and principles but does not lay out how they are to be achieved. It refers to numerous issues to be resolved by other still-to-be-adopted regulations.* The law defines three types of state servant (civil, military and police) and describes other legislation that will form the basis for their activities. It also provides for a register of state-service posts and sets a mandatory retirement age. It stipulates that the rank-structures of all three branches of service will be co-ordinated to make possible transfers among them. In this, it resembles the pre-revolutionary "table of ranks", which ensured equivalence among military, police, civil-service and even ecclesiastical ranks. Since it is difficult to imagine senior civil servants being put into high military or police posts, there is some concern that the new structure will lead to the colonisation of the upper reaches of the civil administration by senior officers of the military, police and security services. The civil-service law of 2004 goes further, outlining the legal status of civil servants and the procedures for appointing, evaluating and promoting them.

* In this, it resembles its 1995 predecessor, "On the Bases of State Service", which made reference to 79 other pieces of federal or regional legislation that were never subsequently adopted. The 1995 law remained a dead letter.

public or private service providers. The separation of policy making from service delivery is meant to free up policy makers. By putting agencies on a contractual footing, it would also make it possible to offer performance incentives to the actual service providers. On paper at least, the March 2004 reorganisation of the federal executive reflects just such a desire to separate policy making from service provision.

Implementing NPM-style reforms would be very hard in the current institutional environment. NPM emerged as a set of measures to reform traditional western administrations, making them more flexible and efficient. It assumes a more-or-less

Weberian starting point, including clear lines of authority, a culture of rule-observance, and officials who perform their duties in virtue of the offices they hold rather than their personal connections. A successful NPM-style reform would also presuppose predictable resourcing, credible regulation and monitoring of staff, and a generally sound contracting environment. NPM-inspired reforms are unlikely to achieve their desired results in systems characterised by patron-client networks and by a lack of transparency, accountability and respect for legal norms. Merit pay, performance incentives and more flexible recruitment could degenerate in such an environment into pork-barrel politics and patronage, except perhaps in situations where official performance is clearly visible to outside observers.

Any attempt to refashion the state administration into a classic Weberian public bureaucracy would also face a large and difficult set of challenges. It would require a greater differentiation of tasks and personnel between the political executive and the administrative bureaucracy, the creation *and application* of a well-designed system of administrative law and the creation of a professional, non-partisan civil service. Nevertheless, many argue that the Weberian model represents the logical endpoint towards which Russian reformers should direct their efforts. Other post-communist states have largely steered clear of NPM approaches.[83] However, some in Russia detect a "conservative" bias in the Weberian model. They fear that a model based on a closed career civil service, on hierarchical structures and vertical integration could easily be manipulated to create a Weberian façade, behind which little real change would take place.

Whatever overall orientation is ultimately chosen, the Russian authorities face a number of specific choices on civil-service reform, including:

- *The degree of unity or diversity to be achieved.* Historically, Russian ministries and other agencies have operated according to rules, organisational cultures and career paths specific to each of them. The question of whether, or to what extent, Russia will maintain separate arrangements for each major group of officials continues to be contested.
- *The vertical integration of state administrative bodies.* One issue here concerns the relations between federal institutions and the sub-national authorities. Civil service rules for the federal, regional and municipal bureaucracies are just beginning to be standardised. A second issue concerns officials working for the branches of federal ministries and agencies in the regions in such fields as law enforcement. Such "territorial" federal officials are often heavily influenced, or even co-opted, by regional authorities.
- *Recruitment and promotion.* The legislation adopted in 2003 and 2004 establishes a basis for competitive recruitment, though it allows many exceptions. It envisages the recruitment into the initial grades of individuals who will become career civil servants. Questions remain as to whether, and under what circumstances, individuals might be recruited into the service at higher grades. Nor is it yet clear that there will be promotion procedures that are transparent, efficient and fair.
- *Civil service pay*. It is widely agreed that raising civil servants' pay is a necessary – though by no means sufficient – precondition for curbing corruption. Corruption will be hard to root out so long as public officials on very low salaries are called upon to take decisions affecting the interests of wealthy and powerful companies. The recent move to reduce the size of the federal administration while significantly increasing officials' salaries is therefore to be commended. However, there is still no consensus on how large the pay differentials within the service should be or on who should set pay scales. Nor is there

agreement yet on the use of merit-based pay and similar incentives or on reducing the share of officials' remuneration that is provided in kind rather than in cash.

Changes in the broader institutional environment will be crucial to the success of civil-service reform

Civil-service reform in the narrow sense of reorganising structures and redefining roles will achieve little on its own. Its effects will depend on the wider institutional environment. Indeed, changes in that environment may matter more than the specific model of administrative reform. Whatever the ultimate shape of Russia's reformed public administration, there are a number of basic issues that will have to be addressed if reform is not merely to reproduce the old pathologies in new configurations. These include:

- *Strengthening the rule of law*. The courts will have to be better protected from pressure or interference by state bodies and private parties. State bodies will have to become more willing to be bound by the law and to follow through on their legal undertakings. There have been several episodes recently in which the state has unilaterally withdrawn from legal agreements or prosecuted individuals for actions it had previously acknowledged, implicitly or explicitly, as legal.
- *Increasing the transparency of state institutions*. Real bureaucratic accountability – to ordinary citizens or elected political leaders – will require greater access to officials and better information about what they are doing. This will not come easily. Recent surveys of civil servants at regional and local levels indicate that they are generally opposed to greater transparency. There is no reason to believe that the views of federal officials are any different.[84] Legal requirements for openness will probably not suffice to generate real transparency. Equally important will be the vigilance exercised by executive and judicial bodies, by the legislature, by the Accounting Chamber and by the press. A more independent press would enhance both transparency and accountability.
- *Strengthening the institutions of civil society*. The state administration does not operate in a political or sociological vacuum. The extent to which it can be made accountable to the public is partly a function of the wider relationship between state and society. There is abundant evidence that corruption is less prevalent in countries that follow the rule of law and possess a highly developed civil society.[85] Civil-service reform would benefit not only from a stronger judicial system, but also from steps to foster the development of civil society and a freer press.
- *Reducing opportunities for corruption*. The laws and rules that bureaucrats administer can be made more corruption-resistant. Rules should be simple, transparent and standardised, with few exceptions and as little reliance as possible on bureaucratic discretion. Where discretion is required, the criteria that determine officials' choices should be explicitly set out. Their actions should be subject to some form of administrative or judicial review. Many recent changes to the law appear to be motivated by this kind of reasoning. Among these are changes to fiscal federal relations and measures to curb bureaucratic interference in commercial activity by limiting inspections, simplifying registration procedures and reducing the number of activities subject to licensing. The draft law on the subsoil submitted to the government at the end of 2004 also included provisions to regularise procedures and to reduce arbitrary decision making and corruption. One of the best reasons for avoiding unnecessary regulation is that it creates opportunities for corruption. Indeed, there is some evidence

that superfluous regulations are sometimes adopted or maintained for this very reason – that officials are reluctant to give up the illicit income they generate.

- *Strengthening enforcement*. While corruption-resistant legislation is important, it will not on its own reduce corruption so long as crimes go unpunished. Those who try unduly to influence the decision making of judicial or administrative institutions must be brought to account in a fair, transparent process. This will require a good deal of political will, because big offenders are often wealthy private citizens or high-ranking officials. Moreover, a consistent approach to enforcement will be needed in order to ensure that anti-corruption cases are not (and are not perceived to be) merely political or commercial weapons.

It is critical to note that such changes in the institutional environment will also help advance reform in other areas. In particular, they will facilitate – though not guarantee – improvements in private-sector institutions as well as in the state administration. To a significant extent, the opacity of Russian business and the complex (and often shady) structures used to exercise ownership and control are defensive. They reflect a desire to shield business from possible attacks by state institutions or private-sector rivals. Improvements in corporate governance, for example, would be easier to achieve if Russian firms did not believe that transparency was likely to render them more vulnerable to bureaucratic predation. Of course, there are other motives for opacity, such as tax evasion. Nevertheless, substantial improvements in corporate governance and private-sector behaviour are unlikely in the absence of similar improvements in the functioning of state institutions: state reform is a necessary, though by no means sufficient, condition for "civilising" Russia's private-sector business practices.

An effective anti-corruption strategy will have to be multi-faceted

There are two basic forms of official corruption.[86] One involves collusion between officials and private citizens at the expense of the state. The other involves the abuse of power by officials to extract money from private citizens. An official might, for example, be charged with allocating some sort of permit to those who meet specific criteria and pay a certain fee. The official might accept bribes from private citizens for issuing permits to those who do not meet the criteria or do not pay the fee. In this case, it is the state that is victimised. Alternatively, he might demand payment over and above what is required by the law for issuing the permits. In this case, it is the citizen who is being cheated.

Different approaches are needed to combat these two forms of corruption. The best way to prevent the former is to make it as difficult as possible to steal from the state. Otherwise, detection will always be difficult, because the citizens involved will not complain. This approach is reflected in efforts to tighten control over budgetary expenditure and to increase the top-down monitoring of officials and executive bodies by organs like the Accounts Chamber. A free press that can rely on legal norms favouring the transparency of state bodies also has a key monitoring role to play. Where officials try to extract money at the expense of the public rather than the state, the best approach is to give citizens the means to defend themselves against racketeering by officials. Little has yet been done along these lines, even with respect to the notoriously corrupt traffic police and other law enforcement bodies. Rooting out this latter form of corruption will depend crucially on creating effective institutions to which the victims of such corruption can appeal. These institutions must be willing and able to discipline officials. They might include not only the courts but also some regulatory bodies or ombudsmen.

Greater transparency, the elimination of unnecessary regulation and the simplification of administrative procedures will be critical to fighting both forms of corruption. The "de-bureaucratisation" legislation of 2001 and 2002 headed in this direction. By simplifying regulations, it sought to eliminate opportunities for corruption, as well as to reduce the paperwork burden on businesses. But it sought to achieve both *in the absence of civil service reform*. Apparently unable to alter the predatory behaviour of street-level officials, the government tried to take away some of their power. The aim was commendable, but the strategy clearly has limits. Bureaucrats always find ways to resist curbs on their authority. In any case, because the Russian economy needs efficient, good-quality regulation, de-regulation of this kind can be only a partial solution to the problem.

Of course, the state is not the only source of corruption. The suborning of officials by private individuals is no less a problem than the abuse of power by officials for personal gains. Here, too, there is much that can be done to prevent, detect and punish corruption. Russia still needs to bring its rules and regulations into line with international standards by criminalising the giving of bribes to domestic or foreign public officials.[87] Measures to protect "whistleblowers" could also help.

Judicial reform is far from complete and much remains to be done to establish the rule of law

The major remaining challenge in the field of judicial reform is to rid the courts of corruption and political influence – to eliminate the so-called "shadow justice" that President Putin decried in his 2001 message to the Federal Assembly. The involvement of state prosecutors and of the security services in commercial and political disputes remains a problem. The courts are still widely regarded as susceptible to outside pressure and inducements, and a considerable body of circumstantial evidence suggests that this perception is accurate.

Some steps have been taken to strengthen judicial independence, including a new law on the status of judges which raises judicial pay and creates new mechanisms for punishing judicial malfeasance.[88] But it will be hard to implement the latter provision effectively and consistently. The federal government has also sought to improve the financing of the entire judicial system, so as to reduce the dependence of judges on regional authorities. More important will be the creation of a new tier of arbitration courts. The new arbitration appeals courts will each encompass a number of jurisdictions. Until now, appeals against arbitration-court decisions have been heard in the court of first instance, often with the judge who issued the contested decision presiding. By creating a higher-level tier of courts to hear appeals, the authorities hope to enhance the chances for a fair hearing for the appellant and to reduce the ability of regional bosses to meddle in judicial decision making.[89]

These are all desirable steps, but the power of regional or municipal authorities is by no means the only problem here. There is a need for effective arrangements to insulate the judiciary from pressures emanating from *any* level of government, not least the federal authorities themselves. There are thus substantial complementarities to be realised between judicial reform and administrative reform. Attempts to pursue the former in isolation from the latter – such as the judicial reform package of 2001 – have had limited impact, largely because the real relationship between the judiciary and the executive changed little as a result of the new legislation. Reducing the scope for executive branch interference in judicial processes is arguably a *sine qua non* for preventing private parties

from seeking to subvert the course of judicial proceedings. As long as it engages in such practices itself, the state will find it hard to curtail corruption in the judicial system or to prevent powerful private-sector interests from abusing judicial processes. Some straightforward steps that could be taken to curb judicial bias and corruption include the random assignment of cases to judges and the mandatory publication of all significant judicial decisions, together with the legal reasoning underlying those decisions. The Supreme Arbitration Court, which already publishes its own decisions, plans to extend this practice to its appellate courts and, eventually, to courts of first instance.[90]

Establishing the rule of law will require more than just the reform of the judicial system. It will need a strong state, capable of protecting individual rights, of interpreting the law impartially and of enforcing it effectively. But a state strong enough to perform these functions might succumb to the temptation to act arbitrarily itself. So the establishment of the rule of law will require not only a strong state but also strong institutions capable of constraining it.[91] Russia lacks such institutions. The Russian state is often, and accurately, described as a "weak" state, but its capacity for coercion is great – greater, indeed, than its capacity for providing effective regulation or delivering public services. The strongest political institutions in Russia are those best equipped for coercive action, while the weakest are those that are supposed to regulate the state's exercise of its coercive power. The state, therefore, cannot easily make a credible commitment to rule-governed behaviour. The weakness of that commitment has been evident in the political and legal campaign against the oil company Yukos since July 2003. However, the Yukos case is unique only in its scale and visibility. The security services, the prosecutors and the police remain highly politicised and have frequently been deployed against businessmen who were in conflict with federal or regional authorities.

Greater coherence is needed in the application of rules at all levels of government

One of the major aims of Russian policy since 2000 has been the reconstruction of the country as a unified legal space. By the end of the 1990s, thousands of laws adopted by Russia's constituent regions were in conflict with federal norms, as indeed were many provincial charters and republican constitutions. It was estimated at that time that up to 30% of sub-national legal acts would need to be amended, if not abolished, to bring lower-level legislation into line with the federal Constitution and federal statutes. Over the last four years, several thousand regional and local laws and other normative acts have been eliminated or amended. Yet the impact of this tidying up of the legal order has been limited in practice. Surveys of both foreign and domestic companies indicate that laws and regulations are still interpreted and applied inconsistently, particularly by sub-national governments. The formal rules of the game have changed, but the informal rules remain and they are often complex, arbitrary and opaque.

The scope of state ownership and the governance of state-owned entities need further attention

The current focus on the role of the state raises issues of state ownership and the governance of state-owned companies. One reason for the state's ineffectiveness as a property owner is the presence on its books of thousands of more or less "accidental" holdings – residual stakes in enterprises that the authorities, for various reasons, have never sold. The main aim of most privatisation sales in recent years has simply been to rid the state of the burden of managing large numbers of enterprises and shareholdings that

it has no interest in keeping. This is, however, proving rather difficult. In 2003, the state sold only 59% of the 970 enterprises slated for privatisation and 37% of the 1 695 blocks of shares it offered. Further adjustments to the privatisation legislation may accelerate the process of selling off small, illiquid blocks of shares and small enterprises. The main difficulty in selling off the state's shares in joint-stock companies is that most of these remaining stakes are small. Given the current state of corporate governance, it is very hard to sell small stakes in companies that already have a clear owner. In 2003, for example, 67% of the shareholdings put up for sale were in blocks that made up 25% or less of the companies' equity – not even blocking minorities.[92] Only 8% were majority stakes. The illiquidity of small stakes makes it difficult to auction them even where the companies involved are relatively attractive. In 2003, 62% of the auctions held to sell state shares did not result in a sale.

Part of the problem is that the privatisation law that entered into force in 2002 makes it difficult to offer such shares for sale in other ways. The law was largely written to prevent a recurrence of the privatisation abuses seen in the 1990s. It makes it difficult to sell state assets cheaply. The cost of preparing a small, illiquid shareholding for sale according to the law may now exceed the price it will fetch. This is not an insoluble problem. The government is now working on steps to streamline the disposal of such small stakes. But this will have to be done with care, however, in order to ensure that the streamlined procedures are not abused. At the same time, the Ministry of Economic Development and Trade is pressing for better organisation of auctions, including better marketing and provision of information to potential buyers.

A much more serious issue arises out of the state's holdings in companies that it considers to be strategically important and has no intention of privatising. Some of these strategic holdings are in the defence sector. Others are infrastructure providers or are otherwise involved in activities characterised by a high degree of natural monopoly. Many, however, operate in competitive, or potentially competitive, sectors, such as banking, oil and natural gas. The boundaries need to be clarified between the state and the private sector, especially where state-owned entities combine commercial activity with what are effectively regulatory and social-service functions. There is a strong presumption in favour of shifting to the private sector activities that are commercial and (actually or potentially) competitive, and that do not involve sensitive regulatory or public-service functions. There is room for further privatisation of state-owned assets, particularly in sectors like banking and electric power. Over the past two years, however, evidence has accumulated of a shift in the opposite direction – toward *expanding* the state's role in "strategic" sectors, such as oil. Given the record of most state-owned companies in Russia, this is not encouraging. The extension of state control over the resource-exporting industries is likely to lead to less efficiency, more rent-seeking and slower growth in the very sectors that have led the economy in recent years.

With respect to the governance of state-owned companies, several priorities should be borne in mind:

- State-owned entities engaged in commercial activities should not perform regulatory functions. The most egregious examples of this phenomenon are RAO UES and OAO Gazprom, the electric power and natural gas monopolies.[93] While reform of the power sector is now under way, there is little indication that reform is coming in the gas sector.

- The management of state-owned enterprises should be structured in ways that minimise the possibility of their being used as instruments of economic and social policy. They should not enjoy privileged treatment in regulatory matters, as is now the case with Gazprom and Vneshtorgbank. Ownership of commercial enterprises should be separated from all policy making and regulatory functions. CBR's control over Sberbank is a striking case in point.[94] The fact that governance arrangements cannot entirely eliminate such conflicts of interest is a strong argument for eventual privatisation.
- State-owned companies should be held to the highest standards of corporate governance, especially in the areas of transparency and the fair treatment of minority shareholders. In both areas, state-controlled entities have sometimes fallen well short of the ideal.

Steps are needed to improve privatisation processes

A new law on the privatisation of state and municipal property was adopted in 2001 and entered into force the following year. In an effort to reduce conflict among the state bodies involved in privatisation, the new law allocates responsibility for different categories of privatisation to different levels of government. Preparing the list of "strategic enterprises" and naming the categories of state assets excluded from privatisation is now left up to the President. The Federal Assembly shares responsibility for the possible privatisation of large state-controlled monopolies with the executive branch. The privatisation of all other federal property falls within the competence of the government, while the privatisation of municipal or regional property is handled by the corresponding level of sub-national government. The law provides for a system of auctions and tenders in which all participants will have, at least in principle, an equal chance to acquire the assets up for sale, but it does little to increase the transparency of the privatisation process or to ensure equity in the conduct of privatisation tenders. The practice of structuring privatisation requirements so as to favour specific bidders remains widespread. Recent privatisations, including the sale of the state's remaining stakes in Lukoil and Slavneft, have looked like pre-arranged affairs.

More needs to be done to curb the interference of officials in the day-to-day activities of private firms

Private business in Russia is still over-regulated. Private entrepreneurs continue to be subject to too many rules and procedures that no longer serve any legitimate purpose, if indeed they ever did. Regulations and regulatory procedures are also more complicated than they need to be. Excessive red tape, however, is only part of the problem. Surveys of entrepreneurs show that businesses continue to face major problems because of the *instability* of the regulatory frameworks they confront. The interpretation and administration of regulations is still inconsistent, particularly at local level.[95] The combination of excessive regulation, frequent rule changes and inconsistent application makes it extraordinarily difficult for private businesses to be sure they are on the right side of the law. Moreover, the situation leaves considerable discretionary power in the hands of officials dealing directly with businesses, and this creates opportunities for corruption. The nature of the problem is well illustrated by a recent cross-national assessment of the business climate in 16 emerging market economies. Managerial surveys in these countries suggest that only two had lighter tax burdens than Russia's, but Russia ranked tenth in terms of the quality of tax administration, twelfth in terms of managerial time spent

overcoming bureaucratic hurdles and last in terms of the proportion of enterprises reporting that they encounter official corruption.[96] Small and medium-sized businesses are more vulnerable to official racketeering than are larger firms. Over-regulation is thus a significant impediment to the development of the SME sector and hence to the diversification of economic activity.

Rectifying this state of affairs will not be easy. As noted above, the "de-bureaucratisation" package did bring about some improvement, but progress slowed in 2002 and 2003, and officials have found increasingly ingenious ways to get around the de-bureaucratisation measures. Much has clearly still to be done. Excessive requirements for documentation remain high on the list of entrepreneurs' complaints. In recent surveys, about half the respondents identified one or more regulatory issues (licensing, registration or inspections, for example) as either a "very serious" problem or as one that "threatened the existence" of their firm. Licensing regimes, in particular, merit further attention. When the bill that reduced the number of activities subject to licensing was under consideration by the government in 2001, individual ministries and departments fought hard to preserve their own licensing powers. The number of areas that *are* subject to licensing more than tripled during the course of the bill's passage into law, despite the fact that many fields of activity in which licensing regimes exist were expressly excluded from its provisions.[97] Scores of activities continue to be subject to licenses that would not be required in most developed market economies, and many of these licensing regimes should be scrapped. Much still remains to be done to reduce arbitrary behaviour with respect to tax administration and enforcement. The problem here is highlighted by the dramatic increase in back-tax cases in 2004.[98] Many of these cases reopened claims that were several years old and involved tax practices that the tax service itself had previously approved. The government, in January 2005, put forward proposals that, if passed into law, would limit the tax organs' power to engage in repeated, and often open-ended, re-audits of previous tax years. Tighter regulation of such practices would do much to improve the stability and predictability of the business environment for entrepreneurs.

It will take further effort to ensure that the abolition of licensing regimes becomes a reality, not a mere formality. In some areas, the abolition of many licenses has given rise to new systems of "permissions" (*razresheniya*), which are neither authorised nor forbidden by law. Bureaucrats thus continue to regulate market entry even where it is clear that they are not supposed to. The principle must be established – in practice and not just on paper – that whatever is not forbidden is permitted. Where it is necessary to keep licensing regimes in place, they should be revised to increase transparency and limit official powers of discretion. Some of the most lucrative activities in the Russian economy are based on licensing regimes, including resource extraction, telecommunications and banking. In those sectors, bureaucratic discretion can represent a deadly threat to a business – a threat that officials are wont to exploit from time to time. The new draft law on the subsoil, which envisages a shift from licensing and bureaucratic discretion to a regime based on civil-law agreements, is therefore to be welcomed. A further important step would be to remove the powers of the police, fire departments and sanitation inspectors to close down businesses on their own authority. A bill approved by the cabinet for submission to the Federal Assembly would require officials to apply to the courts if they wished to close down businesses for regulatory violations. Despite the well-known weaknesses of the judicial system, this could significantly reduce small businesses' vulnerability to bureaucratic intimidation.

Competition policy should play a stronger role

Many sectors of the Russian economy are characterised by high levels of ownership concentration. These levels of concentration cause problems in domestic markets, including facilitation of collusive behaviour and provision of opportunities for abuses of market power to prevent new entry or the growth of competing firms. The effects of such behaviours, including less efficiency, slower growth rates and higher costs for both consumers and producers, can be substantial. Competition law has been weak in its provisions on these types of anticompetitive conduct, and the competition authority's attention has been diluted by too many tasks. As the government concentrates efforts on producing more broadly-based economic growth, more effective prevention of anti-competitive behaviour will be vital. The competition authority should be strengthened, and stiffer penalties should be set for anti-competitive behaviour.

Further efforts to improve corporate governance will also serve to strengthen competition policy. The competition authority's ability to monitor mergers and acquisitions, to investigate collusion and to deal with possible abuses of market power depend in no small measure on transparency of ownership. Competition law can now be circumvented through the use of dummy companies to conceal beneficial ownership. Even where the identities of the true owners are known, proving ownership can be difficult. Russia is by no means the only economy in which shady devices are used to conceal effective ownership, but these practices are so pervasive in Russia that they pose a real problem for the competition authority – as well as for agencies that conduct tenders and grant licenses. There is much still to be done this area. Russian law still lacks a clear, explicit definition of beneficial ownership. The definition provided in the law on joint-stock companies is both narrow and ambiguous.[99] Full disclosure of beneficial ownership and stricter controls on related-party transactions would reinforce both the protection of shareholders' rights and competition. Here, as elsewhere, reforms in seemingly distinct spheres are in fact closely related and indeed complementary.

The Government is particularly concerned with the promotion of the competitiveness of Russian firms at the international level and also with domestic economic diversification. The role of competition policy will be particularly important to achieve these ends. Competitiveness is driven not only by competition among potential exporters but by competition among their suppliers, which ensures efficient, low cost markets for inputs. Moreover, diversification and growth in the domestic economy will be significantly retarded by over-concentration and/or anticompetitive conduct by the largest players. Competition policy, including competent and effective merger control, control of abuse of dominance, and appropriate use of structural remedies are essential if the goals of competitiveness and diversification are to be achieved.

Structural reform of major infrastructure sectors is also necessary, not least because the current configurations of the gas and electricity sectors make it extremely difficult to identify anti-competitive behaviour and take action on it in a timely fashion.[100] Reform of the electricity sector is now under way, but there has been no sign of willingness to restructure the gas sector or even to reassess the role of Gazprom, which combines commercial and regulatory functions in a highly untransparent fashion. This has constituted a significant impediment to the development of the sector in recent years. Competitiveness would be enhanced by the elimination of many of the administrative

barriers erected by regional and local authorities in such sectors as fuel and energy, rail transport and communications.

More needs to be done to reduce regulatory barriers to foreign economic activity

Reducing unnecessary restrictions on foreign trade remains a major challenge for regulatory reform. Since the state monopoly on foreign trade was broken, there has been a shift from regulation through non-tariff measures to tariffs as the main instrument for regulating foreign trade. This has made regulation more transparent and less likely to distort markets and has eliminated many opportunities for official corruption. In recent years, Russia has also accelerated the harmonisation of its trade regulations with international norms. But the general trend toward trade liberalisation continues to meet stiff resistance from some parts of the state administration and from sectoral interest groups that favour a stronger role for the state in the economy and a development strategy based on import-substitution. While the legal and regulatory framework has undergone a massive overhaul, major reforms are still needed in the administration of customs duties and trade regulations.

Business surveys highlight the nature of the challenges ahead. The respondents' perceptions of the trade environment have improved. They are pleased with increased availability of information about rules and regulations. But entrepreneurs still find regulatory *processes* to be opaque, and they want more public consultation when new rules and procedures are being developed. There is much concern about the inconsistent and apparently arbitrary application of rules across the federation. Exporters, importers and consumers all complain of excessive delays and of high and unpredictable transaction costs. Many, perhaps most, of these costs are borne by *Russian* entities engaged in foreign trade. While overly bureaucratic and arbitrary procedures can amount to a sort of informal protectionism, they also handicap the domestic export sector. Thus, it is wrong to think of their simplification and regularisation as some sort of concession to the Russia's trading partners.

The new Customs Code of the Russian Federation is currently being implemented. Adopted in April 2003, the code entered into force on 1 January 2004.[101] It is a comprehensive document that incorporates many existing rules and practices of the customs regime while introducing some significant new elements. The lack of clarity of the previous legislation had led to a proliferation of confusing orders, instructions and directions issued by the State Customs Committee (GTK). This confusion often resulted in wide powers of discretion being exercised by individual customs officials, which in turn created opportunities for discriminatory treatment and corruption. The old regime was also characterised by slow and cumbersome procedures, and by a lack of incentives and technical facilities. The new code aims to increase the clarity and transparency of rule making, to improve the efficiency of customs procedures, to increase the predictability of customs payments, to assure effective customs controls and to define more clearly the duties of customs authorities. The success of the new code will, of course, depend on effective implementation. Major work remains to be done in drafting regulations that provide precise direction to the customs authorities. The new regime's performance will have to be closely monitored to ensure that the principles and guidelines embodied in the code are translated into new operating procedures.

There is still room for further tariff reform. The high proportion of non-*ad valorem* duties in Russia's tariff schedule is an understandable response to transfer pricing, under-reporting of import prices and other tax-evasion strategies. But this arrangement leaves

considerable discretion to customs officials. At the same time, the absence of binding international commitments on tariffs creates uncertainty both for foreign traders entering the Russian market and for domestic producers and consumers. Legislation limiting tariff revisions to twice a year has made tariff policy more predictable, but Russia's accession to the WTO will be a decisive step in this area.

Customs duties have typically constituted around 20% of federal revenues (excluding the Unified Social Tax), a figure that, on the preliminary data, jumped to 39% in 2004 (8% of GDP) as a result of rising export volumes, high prices for major export commodities, increases in some export taxes and the reduction of other tax revenues following the cut in VAT at the beginning of the year. Because of the very large contribution that customs duties make to the federal budget, their reform must be approached with great care. Export duties on oil, natural gas and other raw materials represent the bulk of customs earnings. Russia has imposed export duties since the early 1990s, partly in order to limit domestic price rises for fuel and other commodities, but also because these duties have proved to be much easier to collect than most other taxes. Over the medium term, it would be desirable to reduce reliance on export taxes and move toward a system that taxes the natural resource sectors on the basis of royalties and an excess-profit tax, together with the normal profit tax. Any further changes to the customs regime will need to be made in a way that avoids unnecessary disruption, as the instability of the tax system has posed a major deterrent to investors in the past. The prospects of future changes will in any event depend on other improvements in the institutional environment, particularly in tax administration, in corporate governance and in financial reporting. In view of the widespread corruption and transfer-pricing that prevail in the natural-resource sector, it may well make sense at present to tax it mainly through excise and similar taxes, as well as export taxes.

Many sectors would benefit from a relaxation of restrictions on foreign investment

As noted above, the law on foreign investment now extends national treatment to foreign investors in most respects. But formal and informal barriers to foreign investment remain, many of them sector-specific, such as limits on foreign ownership in some sectors, permit procedures that apply only to non-residents and regulations governing the employment of foreign personnel in foreign-owned firms. These serve little purpose except to protect incumbent firms in the sectors affected – usually domestic producers, but sometimes also foreign firms that were established in Russia before the regulations were adopted. These restrictions discourage foreign investment, and they may also skew its sectoral distribution. Among the formal restrictions that should be relaxed, if not eliminated altogether, are limits on foreign activities in the financial sector and agriculture, as well as in such industries as aviation, land transport, telecommunications and media.[102] Many of these sectors, especially agriculture and aviation, are in dire need of investment. Some other restrictions are general rather than sector-specific, such as the 1999 law on government procurement, which limits foreign participation in tenders.[103] The main barriers that non-residents must overcome, however, are not formal legislative restrictions but rather the overall complexity of regulation and the inconsistency and unpredictability with which much of it is applied. There is, moreover, a wide gap between the formal and informal rules of the game. A system of unwritten rules tends, of course, to favour insiders and to handicap outsiders in general and foreigners in particular. This reliance on informal norms and unwritten rules also tends to foster corruption, which some recent surveys have identified as the number one deterrent to foreign investment in Russia.

There has been much discussion recently about writing severe restrictions on foreign participation in the development of natural resources into the new law on the subsoil. This could have a strong adverse impact on foreign investment in the oil industry, hitherto the sector of greatest interest to foreign investors. The draft submitted to the government in December 2004 would authorise the government to limit the access to auctions of any firm with a foreign partner, on national security grounds. While this would not, in fact, change the *status quo*, the text is vague about how the limitation might be applied. Taken literally, it could apply to any company with foreign shareholders, thus to the vast majority of Russian firms. Such a radical interpretation of the provision is highly improbable. It is more likely to be used as a legal basis for the authorities to determine – possibly in a somewhat *ad hoc* fashion – which companies will be allowed to participate in competitions for exploration and production rights. Finally, some regulations that apply in principle to all companies are more likely to affect foreign investors; the remaining currency controls are a case in point.

Reducing the discrimination against non-residents will surely help to attract investment, but sustained growth in FDI will depend on many of the same factors as investment growth generally. The main restraints on foreign investment are not so much formal restrictions as problems with the institutional environment that affect both domestic and foreign businesses. These include high barriers to entry in many sectors, the weakness of the judicial system and bureaucratic interference in private businesses. While these maladies may affect foreigners more than domestic actors, curing them will bring benefits to foreign and local investors alike.

The removal of currency controls is to be welcomed

In June 2004, a new law on currency regulation and control entered into force, relaxing many of the remaining restrictions on foreign-exchange operations. Some of these had been in force since the start of the transition; others had been adopted in the aftermath of the 1998 financial crisis.[104] The government has been dismantling the currency-control regime piecemeal for several years, but the 2004 law took a fundamentally new approach. It generally imposed the principle that "all which is not forbidden is permitted", and it replaced the licensing of many types of transactions with a regime based on deposit requirements for capital-account operations deemed to be potentially destabilising, advance registration and special accounts. The new regime may only be applied to the specific operations and under the specific circumstances that the law spells out. This is a most welcome development, because the obtaining of licenses is a time-consuming and overly-complicated chore. Many important parts of the new regime are subject to a sunset clause. They will be void from 1 January 2007. Controls on the opening and operation of foreign bank accounts by Russian entities will be eased in 2005.[105]

Overall, the law reflects a clear awareness that capital flight cannot be prevented by administrative means. Its drafters believed a more liberal approach would reduce both transaction costs for business and opportunities for corruption, while encouraging capital flows into legally monitored channels. The restrictions still in force in 2003 were, in any case, much less stringent than those of the late 1990s. Yet all sorts of cross-border operations took longer and cost more than they otherwise would have done, and the controls added to the uncertainties facing everyone involved in such activities. Many observers predicted that the CBR would make maximum use of the powers it retained under the new law, but the bank has so far taken a relaxed stance. It reduced the foreign-

exchange surrender requirement from 25% to 15% in December 2004 and indicated that it would abolish reserve requirements on capital-account transactions in early 2005.[106] Special accounts will remain for the time being, however, and the CBR has said it would reintroduce reserve requirements if necessary. In view of Russia's resource-dependent economic structure and its consequent exposure to sharp swings in short-term capital flows, this is probably a prudent policy.

Steps are needed to reform the sectors dominated by state-controlled monopolies

Natural gas, electricity, rail transport and banking are four areas in which structural reforms are of tremendous importance. The infrastructural character of all four sectors means that improvements in the efficiency of each could have powerful knock-on effects in other sectors. For the same reason, failure to reform them is likely to impede not only their own development but the growth of the economy as a whole. The authorities have launched major reforms of the electricity, railway and banking sectors, with rail reform being the most advanced at present, but there has been almost no progress in reforming the gas industry, possibly Russia's least reformed sector and undoubtedly one of its least efficient.[107] The four sectors differ in many important respects, and there is certainly no single model of reform that is applicable to all, but there are some common challenges.[108]

- In each case, one of the major aims of reform is to make resource allocation more efficient. In the banking sector, reform will foster the development of efficient financial intermediation. In the rail, power and gas sectors, it will put an end to the implicit subsidies and cross-subsidies achieved by charging prices that are below long-run cost-recovery levels. Such subsidies are value-destroying and they distort resource allocation and investment incentives.
- All four sectors will require a fair amount of regulation even after reform. For these sectors, the competence and probity of state institutions will matter a great deal, as will the state's ability to create strong, independent regulators and to produce high-quality regulation.
- The state is extensively involved in all four sectors, not only as a regulator but also as the owner of the monopolies that dominate each. In all four cases, the state's management of the monopolies has been characterised by a basic tension between the desire to make the monopolies more efficient and the habit of imposing unprofitable social obligations on them – obligations that are often "compensated" through fiscal or regulatory privileges.
- This, in turn, points to the desirability of separating regulatory and ownership functions more clearly and of reducing the state's ownership of banking, rail and energy sector assets. This has been a major element of rail reform, but the overlap between the two functions continues to be particularly marked in the gas sector.
- In each of the sectors, the state-controlled monopoly has acted at times in ways that distorted or simply suppressed competition. It is no accident that they are among the entities most often in conflict with the competition authority. However, attempts to challenge their behaviour have generally been unsuccessful, owing to the weakness of the competition authority and of the general framework of competition law and policy in Russia.
- Insider-managers within all the major state monopolies have often been able to divert cash flows from them in the interest of what is euphemistically described as "informal profit-seeking" at the state's expense.

- In each sector, questions of transparency are central to reform. Some progress has been achieved in recent years in increasing the transparency of Sberbank, Gazprom, RAO UES and the railways, but much still remains to be to done to enhance the transparency both of the companies themselves and of policy making and regulatory processes in the sectors they dominate. Nowhere is this more evident than in the gas sector. Gazprom stands out, even in Russia's highly secretive corporate culture, for its exceptional opacity.[109]

The reform of Russia's state-controlled monopolies is a multifaceted process, in which a number of the regulatory reform issues outlined above come together. Monopoly reform will be a particularly difficult test, but it could have significant spill-over effects, by establishing precedents and building state capacities.

The authorities need to tackle gas-sector reform

The reform of Russia's gas sector, however, has been repeatedly postponed, and it is not clear that any meaningful reform will be undertaken in the foreseeable future. Despite its enormous importance, the natural gas industry is the least reformed major sector in Russia. Upstream and downstream activities are both dominated by a state-controlled, vertically integrated monopoly, OAO Gazprom. Though organised as a joint-stock company, Gazprom operates as if it were an arm of the state. It combines commercial and regulatory functions and maintains tight control over the sector's infrastructure and over information flows within it. Gazprom's control over information is particularly problematic, as it renders opaque much of what happens in the sector. Underlying all this regulation and rationing is the unsustainable under-pricing of natural gas. The gas sector, in effect, subsidises the rest of the Russian economy. Most gas is sold at regulated prices that are below full cost-recovery levels. Regulated tariffs have been rising rapidly since 2000, outpacing both retail and wholesale inflation, and tariffs for all consumers except households are now approaching cost-recovery, but they have some way to go before they reach long-term sustainable levels.

The inefficiencies inherent in the gas sector's architecture are in themselves a compelling reason for reform. An economy that depends heavily on its resources sector can ill afford such inefficiencies in such an important resource industry. However, the case for reform becomes even more compelling when one considers the need to boost investment and output over the coming years to meet rising domestic demand and growing export commitments. The natural gas sector as currently constituted is hardly prepared to meet these challenges. Both Gazprom and the government acknowledge that non-Gazprom production must grow if the industry is to develop successfully, but Gazprom's current position within the sector is in itself an impediment to such growth. It restricts small producers' access to the market and it limits consumers' freedom to choose their suppliers. It is entirely possible to speed the growth of non-Gazprom production and to make gas supply in Russia more competitive. This potential will not be realised, however, until Gazprom's domestic rivals can be assured of equal treatment, and that will not happen so long as Gazprom controls both the industry's information flows and its infrastructure. It is not in Gazprom's interest to exclude smaller producers from the market altogether. Indeed, it wishes to see them play an increasing role in supplying domestic consumers. However, Gazprom's position allows it to ensure that the smaller producers market their gas on terms that suit Gazprom: the monopolist can discriminate against other producers and it has incentives to do so. The establishment of a regulated third-party

access regime for the sector's infrastructure will be absolutely crucial to the prospects for new investment by non-Gazprom producers.

It is vital to increase transparency in the gas sector and to transfer what are essentially regulatory functions from Gazprom to the state. Eventually, Gazprom's function as a supplier of natural-monopoly infrastructure should be separated from its potentially competitive activities. This will require unbundling Gazprom's transport and dispatch operations into separate entities, a long and complex process which should not be executed in haste. It is important, therefore, that restructuring be planned and started soon. Finally, tariff policy in the gas sector, needs to be more transparent and more consistent. The government is committed to raising gas prices to cost-recovery levels, and it has made considerable progress in that direction already, but the authorities are understandably reluctant to risk lower growth and higher inflation by raising prices too rapidly. A big-bang approach to this issue would hit households and industry extremely hard. Both will need time to adjust. But the obvious need for a gradual approach makes it all the more important that the authorities commit themselves to a firm and credible policy of increasing regulated tariffs and to clear, transparent methodologies for calculating them. Such a commitment would make it easier to introduce longer-term contracts into the sector. At present, prices are adjusted once or even twice a year, and the increases often look somewhat improvised, the product of bargaining between the government and Gazprom. Various drafts of the government's energy strategy and other official documents have outlined medium-term targets for gas prices, but price increases to date have consistently been smaller than needed to attain these targets. The targets for gas-price increases reportedly included in the May 2004 agreement with the European Union on Russia's entry into the World Trade Organisation should be seen as an important step forward, for they represent a binding commitment undertaken by the government in an international agreement.[110] At the same time, the authorities should consider ways of ensuring that the state captures a larger share of the rents resulting from current very high gas prices, or at least that these rents are directed towards the development of the gas sector. Gazprom has been using those profits to acquire all manner of assets, many of them unrelated to its core functions.

The absence of real progress on gas-sector reform must surely be counted as one of the government's major policy failures of recent years. Many structural reforms are politically difficult to implement precisely because they involve large up-front costs, while the benefits of reform will be realised only over the long term. Certainly, any fundamental restructuring of the gas sector would be a complex and lengthy process. However, there are a number of relatively modest steps that could be taken rather quickly and that would begin to pay tremendous dividends at an early stage. The establishment of effective, regulated third-party access to the trunk pipeline network and some access to export markets for non-Gazprom producers would give a tremendous boost to the industry. Once assured that they would be able to enter the market on fair terms, non-Gazprom producers could increase investment and output very rapidly indeed. At present, however, they remain constrained by the authorities' failure to break Gazprom's stranglehold on the industry. Non-reform in the gas sector also risks distorting the ongoing reform of the electricity sector, as well as attempts to press ahead with reform of the municipal utilities.[111]

Better regulation of the financial sector will help foster the development of real financial intermediation

The future of Russia's financial sector will depend to a great extent on the vigorous implementation of a range of regulatory reforms now in the works, as well as on wider economic developments. All the major financial sectors have been under-regulated, although they have often been subjected to quite onerous reporting requirements and other red tape. The banking sector exemplifies the problem: only in the last few years has there been a consistent effort by the authorities to regulate the substance of banking activity rather than merely the form. The challenges in regulating insurance and the financial markets are similar: first, to reduce the burden of red tape and the proliferation of formalistic regulatory requirements and, secondly, to establish regulatory systems that are stable, transparent and focused on substance rather than form.

Banking reform will test both the political will and the regulatory capacities of the authorities

After years of delay, the pace of banking reform accelerated in early 2002. The important reform initiatives of the past three years have included deposit-insurance legislation and a reform of the framework for prudential supervision. Steps have been taken to increase transparency in the sector, and measures have been adopted to facilitate the development of specific banking activities. Each of these actions is an important step in its own right, and the various strands of reform complement each other nicely, reflecting the coherence of the central bank's overall strategy. The emphasis on transparency is especially welcome, as greater openness will facilitate better monitoring of banks by private individuals and businesses. The real test of banking reform, however, will come with its implementation. The reforms challenge numerous vested interests. Their successful realisation will require considerable political will, as well as the development of regulatory capacities of a very high order. Unfortunately, the authorities' handling of turbulence in the banking sector in the summer of 2004 revived doubts about their ability and willingness to press ahead with difficult reforms. The CBR was slow to react to the crisis as it developed. When it did take action, some of its decisions were difficult to reconcile with its stated policies.[112] Even more worrying were mixed signals from the Kremlin and the government, which suggested that the authorities were not united in their approach to banking reform. It is no longer clear that the central bank can count on the political and administrative support it will need to press ahead with its planned reforms.

There is also a need for a clearer government strategy on the future of state-owned banks. Russia's largest banks continue to be controlled by the state. Regional authorities continue to intervene, sometimes quite heavy-handedly, in local banking sectors, suppressing competition and impeding the entry of new participants. The state's continuing dominance of the banking system is a serious problem. It distorts competition and credit allocation, and encourages expectations of a bailout. It can also prompt banks to pursue policies that reflect the non-commercial requirements of the authorities rather than good commercial sense. The short history of Russia's banking sector is studded with examples of all these problems. Official policy holds that state-owned banks should exist, if at all, to correct market failures. They should specialise in sectoral or other niche activities which the market is unlikely to provide on its own. In practice, however, the major state-owned banks have operated as universal banks, with Sberbank, in particular, exploiting its protected retail monopoly to extend its business in many directions.

Sberbank is now the dominant bank in a number of market segments other than retail banking. Vneshtorgbank, too, has become increasingly aggressive in its drive to expand in ways that contradict the government's stated policies. In some of these endeavours, Vneshtorgbank has appeared to enjoy the support of the regulatory authorities.

The Russian authorities are committed in principle to reducing both state ownership of commercial banks and the intervention of state institutions in the allocation of credit, but progress in these areas has been very slow. It is understandable that the government and the Bank of Russia should proceed cautiously in making major changes to the status of Sberbank and other large state-owned banks, but the *status quo* is nevertheless hindering the development of the banking sector. A major restructuring, including privatisation of most of the state's banking assets, is probably desirable over the long term. For the time being, though, priority should be given to reducing the distortions caused by the state's current position in the sector. The authorities should facilitate the growth and consolidation of private banks capable of competing with the state-owned banks. In particular, merger and acquisition procedures should be simplified, and branching should be made easier. Prudential norms should be rigorously applied to state-owned banks. Above all, the governance structures of the main state-owned banks should be revised to ensure competitive neutrality and to make possible a credible commitment by the authorities neither to extend special privileges to them nor to intervene in their commercial affairs.

Financial markets need better sector-specific regulation and better framework conditions

Russian financial markets are also under-governed. This is a matter of particular concern in view of their rapid growth, and new bills are being prepared to deal with problems such as insider trading and market manipulation, where there are currently gaps in the legislative framework. However, this task will take some time. Because of the courts' lack of experience with such issues, the language of the new statutes must be drafted with exceptional care. At present, a short list of permitted securities is set out by statute, and the list is considered to be exhaustive: new forms of securities cannot be created without new legislation. The securities laws must be made more open to financial innovation. A stronger legal basis is also needed for mortgage finance and asset securitisation. There is still no proper legislation governing derivatives. While small markets in such instruments as options and futures do exist, their legal position is uncertain.[113] Uncertainty also surrounds the practice of close-out netting, whereby all transactions of a given type are netted at market value in the event of one party's bankruptcy. Such debt offsets are not permitted in the event of bankruptcy in Russia, and this greatly increases the risk for derivatives providers. The authorities are well aware of these problems and are actively working on measures to address some of them. Hitherto, conflicts among competing regulatory authorities have bedevilled attempts to develop the non-bank financial sector. It is to be hoped that the creation of the new Federal Securities Market Agency will lead to an acceleration of reform and greater coherence in the regulation of different market segments.

The development of the financial markets, like that of the banking sector, is in many ways limited by problems in the wider contracting environment. The weakness of the rule of law is a particular problem here. Securities markets deal in legal claims and obligations, and they are only as sound as the legal system supporting them. Corporate governance issues are also important, including ownership transparency and requirements for

disclosure. A company that wants to raise new capital or increase its market capitalisation can be motivated by financial-market requirements to improve its governance practices and make fuller disclosure. At the same time, however, weaknesses in corporate governance can make it more difficult to police securities markets. There is thus an obvious complementarity between financial sector development and improved corporate governance. Finally, corruption and rent-seeking on the part of officials can undermine the effectiveness of even the most enlightened regulatory framework.

The financial sector would also benefit from the removal of the remaining barriers to foreign entry

Although Russia stands to gain considerable benefits from greater foreign participation in its financial sector, strong protectionist sentiments prevail in both banking and insurance circles. Russia does not, of course, need a financial sector dominated by foreign players, but it does need more foreign involvement in both banking and insurance, if only to acquire the skills and technology such exposure can bring. It would therefore be in Russia's interest to eliminate the remaining restrictions on foreign entry into these sectors – something it will probably have to do anyway when it accedes to the World Trade Organisation. While there is no longer any limit on the foreign capital share in the Russian banking system,[114] a number of lesser restrictions remain, including the requirement that the CBR approve any acquisition of shares in a Russian bank by non-residents. The CBR, however, is seeking to revise this provision and to subject foreign investors to the same percentage thresholds as domestic investors when it comes to requiring prior approval for share acquisitions. Other regulations, such as those governing the appointment of foreigners as top managers or board members of Russian banks, depend to a great extent upon the discretion of the CBR but are potentially quite restrictive.[115]

Formal barriers to foreign entry are far more extensive in the insurance sector. They include a 25% ceiling on the foreign capital share in the sector.[116] EU-based insurers enjoy a better position than do other foreign insurance companies, because they are exempt from many restrictions under Russia's Partnership and Co-operation Agreement with the European Union. EU insurers have recently gained the right to provide all types of insurance, including life insurance and "mandatory" forms of insurance, such as automobile insurance. Subsidiaries of foreign insurance companies from outside the EU, as well as Russian companies that are more than 49%-owned by non-EU foreigners, may not write mandatory insurance or life insurance.[117] There are special regulations on the role of foreign citizens in managing insurance companies, on the sale of shares in Russian insurance companies to non-residents and on increases in the charter capital of insurance companies paid from outside the Russian Federation.

Much remains to be done to create not only better regulation but a better regulatory system

Regulatory reform involves not only the revision of existing regulatory frameworks – including further deregulation in some areas, new regulation in others and revised regulation in nearly all – but also the creation of effective regulatory *processes* that can deliver high-quality regulation.[118] The experience of OECD countries suggests that such a regulatory process needs to rest on a comprehensive and coherent long-term framework

with clearly defined priorities and strategies. Such a framework could offer Russia substantial economic benefits in at least three ways:

- By levelling the playing field for Russian firms competing with foreign firms that benefit from good regulatory frameworks in their own countries.
- By harmonising regulatory policies that have hitherto been adopted and implemented in an unco-ordinated fashion by different state bodies and at different levels of government.
- By providing a more rigorous basis for assessing the impact of regulatory policies and, in particular, the trade-offs that sometimes arise between purely economic objectives and other social values.

There is, of course, no single blueprint for an effective regulatory framework. It is important to take into account the legal, institutional and economic environments in which regulatory systems are to be embedded. There are, however, a few basic principles suggested by the experience of OECD members and the work of OECD experts with non-member countries. These include:

- The need for institutions and procedures in all areas and at all levels of government for regulatory planning, co-ordination and accountability.
- The desirability of developing tools to evaluate the impact of proposed regulatory policies and the policy trade-offs they may involve.
- The importance of transparency in all aspects of the regulatory process.
- The need for strong enforcement mechanisms consistent with the rule of law.

The main aim of reform should be to shore up the fundamental institutions of the market economy

The foregoing discussion has addressed a wide range of disparate and often rather technical issues, but the analysis returns again and again to a small number of fundamental questions.

The first key idea is that reforms should be pursued across a broad front, in order to realise the complementarities that exist among various reforms. This is a critical point. While most international observers stress policy *coherence*, an idea that is often viewed as a political *constraint*, we stress the notion of policy *complementarity*, which points to the additional *benefits* that may stem from pursuing different strands of reform together. Policy complementarities arise when the returns generated by two or more reforms in tandem exceed the sum of the returns that would be realised if they were each pursued separately.[119] The benefits arising from such complementarities underscore the importance of the main recommendations set out in Chapter 2 of this study. It is essential to formulate a long-term regulatory reform strategy and have it adopted at the highest levels of government. That strategy needs to be explicit and coherent and to integrate the various reform efforts now underway. The experience of OECD member states shows that the adoption of regulatory policy reforms at the highest political levels can lend authority to the reform and ensure greater consistency of policy across a wide range of fields of activity.

The second theme that runs through the analysis above is the need to continue working to establish sound basic institutions and conditions for the market economy. The revision of formal laws and regulations will not do much to foster economic growth and development in the absence of a major improvement in the way the Russian state

functions. Such basic issues as strengthening the rule of law and securing property rights, increasing the transparency and accountability of state institutions, and combating corruption all remain major reform challenges. The state still has to learn to rely less on direct intervention in the economy and on its continuing control over assets and markets, and more on regulation. It must create a state administration that is able – and willing – to perform the role required of it in a functioning market economy. The core of that role is the provision of the public goods that people and businesses need in order to invest, produce and trade efficiently. Many of these goods – like the rule of law – are not even "economic" in the narrow sense of the word. Most are concerned in one way or another with the formulation, implementation and enforcement of rules and regulations.[120]

Consideration of these two themes helps clarify a final, crucial question facing the Russian authorities: the relative priority of different reforms. As is clear from the foregoing analysis, there is an enormous amount to do, and it would be both unrealistic and unfair to believe that any government could do it all at once. However, an emphasis on reform complementarities and on shoring up the basic institutions of the market economy suggests two lines of policy that might be considered the top priorities:

- "State reform" in a broad sense (*i.e.* judicial and administrative reform). The knock-on effects generated by real steps to strengthen the independence and probity of the judiciary and by even a moderately successful reform of the civil service would be tremendous. Prospects for the successful implementation of virtually every other major structural reform would be improved, while the reduction in official corruption and rent-seeking would of itself represent a major improvement in the business climate.
- Further reductions in barriers to entrepreneurship. This second priority is very closely related to the first, since many of the barriers in question stem not from formal regulation of new businesses but from informal – and often corrupt – practices on the part of officials. The potential complementarities between the two reforms are clear: further reductions in licensing and other regulatory burdens would *ipso facto* reduce bureaucrats' opportunities to intervene in the affairs of private businesses, while judicial and civil service reforms would improve the fairness, transparency and efficiency with which the remaining regulations were administered.

To judge from their programmatic statements, the Russian authorities understand and are committed to these priorities. Recent years have seen important steps towards realising them. But the actions of state bodies often contradict stated reform goals. There has been evidence recently of a drift towards more interventionist, less rule-governed – and sometimes predatory – state behaviour. Russia's long-term growth depends in no small measure on checking such tendencies and reinvigorating reforms that aim to create not merely a strong state, but one which is law-based, accountable and efficient.

Notes

1. OECD (2004a), p. 8.
2. Hydrocarbons form the backbone of the economy, but other sectors that rely heavily on natural resources are also extremely important, including ferrous and non-ferrous metals and timber, pulp and paper. Altogether, natural resources, electricity and food accounted for an estimated 84.4% of the country's industrial production in 2000. Machine-building and metalworking accounted for only about 9.2%.

   Here and elsewhere in this chapter, the data on Russia's economic structure and on the contribution of various sectors to growth differ from the official Russian data. The numbers given

here are based on the adjusted sectoral weights estimated by the World Bank in an effort to correct the distorted picture of Russia's economic structure that results from the widespread use of transfer pricing. For details, see OECD (2004a), pp. 28-29, and World Bank (2004).

3. EBRD (2003), p. 186. This is an EBRD estimate. The Russian authorities do not publish data on the private-sector share of GDP.
4. Indeed, almost the entire Russian transition could be subsumed under the rubric of "regulatory reform".
5. See Hausmann *et al*. (2004).
6. For details, see OECD (2004a), especially pp. 125-127.
7. On the outlook for natural gas, see Ahrend and Tompson (2004).
8. These included the Chernobyl nuclear accident, the collapse of international oil prices in 1986, and a sharp decline in the value of the dollar in 1986-1987. Chernobyl scuppered the Twelfth Five-Year Plan and the oil-price drop undermined the Soviet Union's terms of trade. The decline of the dollar aggravated this latter effect, since Soviet exports were generally priced in dollars, while most imports were invoiced in West European currencies, particularly the Deutschmark.
9. Sinel'nikov (1995), p. 20. The deficit reached 26% according to the IMF. See IMF (1992).
10. By late 1991, fewer than a dozen of the 130 goods considered by the statistical authorities to be basic necessities of everyday life were available through normal retail channels.
11. In many cases, these interests were precisely those which had gained from the first wave of reforms. For a detailed analysis, see Hellman (1998).
12. This overhang had begun to develop in the 1960s but grew extremely rapidly in the late 1980s. Wages jumped by around one-third during 1987-91, while output per worker actually *declined*.
13. In an economy with free prices, this excess rouble liquidity would have resulted in inflation. In the Soviet context, repressed inflationary pressures expressed themselves in chronic shortages, rationing and queues on the one hand, and the accumulation of excess rouble liquidity on the other.
14. It is not clear that any effective regime for governing the rouble zone *could* have been negotiated, given the political situation at the time.
15. The rouble zone developed into a classic "common pool problem".
16. It is especially significant that some other FSU countries started growing in 1995. Indeed, in 1996, a majority of these countries was recovering, while Russia was still declining.
17. The attractions of deficit-spending were limited so long as there was a fairly direct, short-term link between additional spending and inflation. Once it became possible to finance deficits without incurring immediate inflationary consequences, the incentives for deficit-spending increased.
18. For details, see Woodruff (1999) and Tompson (1999).
19. At the end of 1997, it stood at an apparently modest 55% (26% foreign, 28.4% domestic). Kharas, Pinto and Ulatov (2001) calculate that in 1996 alone, real exchange-rate appreciation lowered the debt-to-GDP ratio by 8%.
20. Yields on several short-term Treasury issues during the late spring and early summer exceeded 100%, rising to 130-150% for some series in early July, even though inflation was below 10%.
21. Industrial production, adjusted for both seasonal factors and workdays, rose by 5% from September to October and a further 2.2% from October to November. Seasonal adjustment of Russian data is notoriously difficult and such data should always be interpreted with caution. But the fact that the growth continued suggests that these data reflect neither a statistical aberration nor a "dead-cat bounce".
22. See Lambert-Mogiliansky, Sonin and Zhuravskaya (2000) for details. To some extent, the use of bankruptcy as a takeover mechanism reflected the absence of a well-functioning market, which would have enabled acquisitions to be executed in a more normal fashion.
23. Oil prices in 1994 were close to the levels of 1999 in real terms.
24. See Ahrend (2004a).
25. Clearly, high oil prices were another major factor.

26. In fact, cash revenues (and thus effective revenues) are substantially higher than they were before the crisis. Pre-crisis federal revenues amounting to 3.6-3.7% of GDP and regional revenues of the order of roughly 6% of GDP were non-cash revenues, consisting of bartered goods, offsets, bills of exchange and other money surrogates. Since the recorded value of these non-cash payments was often substantially greater than their real value, the shift to cash collections means that effective revenues have increased relative to GDP, even if nominal revenues have declined.

27. Large-scale, longer-term monetary sterilisation was until recently impossible, as the CBR was unable to issue its own debt until late 2004. While the statute providing for the issue of CBR bonds was adopted in the 1990s, it was long ineffective, because the corresponding regulation was never issued by the now-abolished securities commission. As a substitute, the CBR used government bonds from its portfolio in reverse repo operations, mainly for short-term sterilisation purposes. The question of short-term sterilisation became especially prominent in 2003, with a sharp increase in speculative short-term capital flows into and out of Russia.

28. For an excellent analysis of the authorities' attempts to pursue stabilisation without imposing budget constraints, see Pinto, Drebentsov and Morozov (2000).

29. Dynkin (2004).

30. See Dynkin (2004).

31. As a rule, the groups formed in the mid-1990s have rationalised their structures, abandoning some activities to concentrate on others.

32. Ericson (1998), p. 622.

33. The coal concern Kuzbassugol provides an excellent case in point. A medium-sized company in a not very promising sector, it fetched more than USD 180 million when it was privatised in the autumn of 2001. The price was driven up by rivalry between the steel concerns Severstal and Evrazkholding, each of which feared the consequences of allowing the other to control Kuzbassugol.

34. For more detail, see OECD (2004a), pp. 28-29, and World Bank (2004).

35. Gimpel'son and Kapelyushnikov (2004).

36. The data in this paragraph are taken from World Bank (2004), p. 51.

37. Employment in the natural gas sector rose dramatically, although there was no corresponding increase in output. See Ahrend (2004b) for details.

38. Data for 1993 are used for the first year of liberalised trade, partly because the 1992 data are incomplete and of poor quality but also because trade was so severely disrupted in the months following the Soviet collapse that the 1992 figures are clearly an aberration from trade patterns before or since.

39. *Izvestiya*, 19 August 1992.

40. For one of the few serious analyses of the impact of price liberalisation on centre-periphery relations, see Woodruff (1996).

41. Accustomed to very cheap energy prices and with little incentive to minimise costs, Soviet industrial enterprises were fantastically energy-inefficient.

42. There are, however, far fewer zero-free lines than would typically be found in an OECD economy.

43. OECD (2004b), p. 29.

44. For further discussion, see OECD (2001).

45. See Ahrend (2002).

46. Angelucci *et al.* (2002), using data from a large enterprise-level panel, find strong complementarities between these four factors in generating significant improvements in enterprise performance in Russia.

47. The exception was Norilsk Nickel. Oneksimbank, which bought the Norilsk stake, met fierce resistance within the company and had to fight a protracted battle to assert its rights as owner.

48. The exception was 1997, when a catastrophic shortfall in tax revenues was partially offset by a handful of large privatisation sales, amounting to 3.3% of gross revenues in that year.

49. Unrealised tax arrears and arrears on gas or electricity bills were among the most common forms of implicit subsidy.

50. On Romania, in particular, see Ahrend and Oliveira Martins (2003).

51. Indeed, in some cases, these rights already existed *de jure* (*e.g.* occupiers of flats who were allowed to privatise them for nominal sums).

52. Shleifer and Treisman (2000) report that they were "unable to find a single study that does *not* show positive effects of privatisation on restructuring in Russia".

53. See Tompson (2002) for an overview of some fifty studies of various aspects of Russian privatisation.

54. Ahrend (2004b).

55. See OECD (2004a), pp. 125-127.

56. See, *e.g.*, Claessens and Djankov (2002).

57. See OECD (2004a), Chapter 5, for details.

58. Hainsworth, Yeremenko and Tubin (2001).

59. *Vekselya* are also cheaper to issue than bonds, as the latter incur stamp duty, although this has recently been cut.

60. In theory, government debt, as the least risky investment available, should provide a baseline interest rate against which rates on other instruments could be assessed.

61. Rubin (2003), *Vedomosti*, 20 September 2004.

62. Tadesse (2001), cited in Berglof and Bolton (2001).

63. For more detail on the judicial reform package, see Tompson (2001). For the texts of the procedural codes, see GPK (2002) and APK (2002).

64. Courts of general jurisdiction are subordinate to the Supreme Court, but the arbitration courts are under their own Supreme Arbitration Court, over which the Supreme Court does not have authority.

65. For details, see OECD (2002a), pp. 80-104.

66. This is partly a result of the reduction in the number of licensed activities.

67. PBOYuL is the Russian acronym for *predprinimatel' bez obrazovania iuridicheskogo litsa* ("entrepreneurs without the formation of a legal person").

68. A great deal of activity that in other countries would be carried out by small companies is in fact done by PBOYuL in Russia.

69. It should be borne in mind that, owing to the limitations of the available data, these estimates are necessarily very rough.

70. We use the English term "civil service" to refer to the permanent bureaucracy. The Russian term, "*gosudarstvennaya sluzhba*" is more accurately translated as "state service". As will be argued below, this is not a purely linguistic point. The difference in terms is reflected in the culture of the service.

71. For details, see OECD (2004a), pp. 88-89, and Tompson (2001).

72. See Goetz (2001).

73. The *nomenklatura* system was perhaps the most potent tool used by the Communist Party of the Soviet Union to control the economy. The *nomenklatura* was a comprehensive list of appointments for all the important posts in the state, industry and army. Control over the *nomenklatura* was critical insofar as it was Communist Party nominees who became senior bureaucrats, enterprise managers and army generals. See Voslensky (1984).

74. In the Soviet period, violations of the rules were often tacitly condoned in the interests of fulfilling the task at hand. *Gosarbitrazh*, the state body charged with resolving inter-enterprise disputes, was expected to resolve them according to the law, *subject to the requirements of fulfilling the Plan*. If the law came into conflict with the need to fulfil Plan tasks, the latter tended to take precedence.

75. It is no accident that post-Soviet Russia has continued such practices. Highly personalised administrative systems often emerge in periods of political instability, because they enable political elites to shore up their positions. They enhance the administrative capabilities of new states fairly rapidly, but they limit the development of those capabilities beyond a certain point.

76. The central bank, the privatisation agencies and some regional governments fall into this category. However, the close ties of some of these bodies to specific private interests have sometimes raised questions about their autonomy.

77. The discussion in this paragraph draws on the analysis in Huskey and Obolonsky (2003).

78. The "greying" of the state bureaucracy is not unique to Russia; the US General Accounting Office reported in 2002 that more than 30% of people working for the FBI, the State Department and the Defense Department would be eligible to retire by 2006; *Wall Street Journal*, 19 September 2002.

79. Brym and Gimpelson (2004), pp. 108-110.

80. See Huskey and Obolonsky (2003).

81. See Brym and Gimpelson (2004), pp. 92-100, for details. It should be noted that comparisons across time and countries are complicated by problems of definition, including the creation of new types of officials and the reclassification of others in conjunction with the transition.

82. Little has been done to downsize the "traditional" bureaucracies left over from the Soviet era, such as the Ministry of Agriculture.

83. It is also noteworthy that western institutions involved in civil service reform efforts in Central Europe and Russia have also reinforced the tendency to focus on the classical model. See Nunberg (1999), p. 264, and Goetz (2001), pp. 1034-1035.

84. Arkhangel'skaya (2003).

85. Brunetti and Weder (2003); Ahrend (2002).

86. Schleifer and Vishny (1993).

87. See OECD (2004b), p. 62. Russia has applied to accede to the OECD Convention against Bribery of Foreign Public Officials in International Business Transactions and to become a full participant in the OECD Working Group on Bribery. Russia also signed the UN Convention against Corruption in 2003 and the Council of Europe's Criminal Law Convention on Corruption in 1999.

88. "O statuse" (2001).

89. "Ob arbitrazhnykh sudakh" (2003).

90. *Kommersant,* 11 June 2003.

91. See, for example, Greif (2005).

92. Russian law requires shareholder majorities of 75% or more for certain types of decisions; a stake of 25% plus one share gives an investor a veto in those areas.

93. It should be noted that the physical separation of the remaining regulatory functions currently undertaken by RAO UES is planned to take place in the near future.

94. See OECD (2004a), pp. 220-221and 236-240.

95. See, for example, OECD (2004c).

96. Data from the World Economic Forum; see Gurvich (2005).

97. The licensing law's provisions do not extend to such sectors as finance (banking, insurance and the operation of financial exchanges were all excluded), communications (including both terrestrial and satellite communications, as well as broadcasting), international transport, agriculture, natural resource-based industries, education, nuclear energy, arms production, foreign trade and the production of spirit and/or alcoholic beverages.

98. The Federal Tax Service reported that it collected Rb 470 bn in taxes for previous years during the first nine months of 2004, as compared with a figure of Rb 150 bn for the whole of 2003.

99. See OECD (2004c), pp. 3-6, for details on these two points.

100. For details, see Pittman (2001) and OECD (2004a), pp. 146-151, 155-161, and 191-192.

101. "Tamozhennyi kodeks" (2003).

102. See OECD (2004b), pp. 77-79, for details.

103. Discrimination in government procurement is not limited to foreigners. Regional and local authorities also discriminate against Russian companies based outside their jurisdictions.

104. See OECD (2004b), pp. 36-48, for details of the remaining regulations still in force in early 2004.

105. According to the Federal Law "On Foreign Exchange Regulation and Foreign Exchange Control" the control itself will exist but limitations on the opening of accounts by Russian organisations in foreign banks will be lifted.

106. On 19 February 2005 the CBR lowered the reserve requirements on the import of foreign currency in the Russian Federation from 3% to 2%, including for the purpose of borrowing credit means/loans from non residents with the principal repayment period up to 3 years and on the export of capital with the purpose of acquiring foreign securities from non residents – from 50% to 25% of sums credited to/debited from special accounts of the residents (Directive of the Bank of Russia of 29.12.2004, No. 1 540-Y "On the Integration of Amendments in the Direction of the Bank of Russia of 29.06.2004", No. 1 465-Y "On the Setting of Requirements on Reservation while Putting Monetary Means on Special Banking Accounts and while Crediting Monetary means from Special Banking Accounts").

107. See Ahrend (2004b) and Ahrend and Tompson (2004).

108. For detailed analyses of natural gas, electricity and banking, see OECD (2004a); on electricity, see also IEA (2005). On rail reform, see ECMT (2004).

109. See Ahrend and Tompson (2004).

110. The actual text of the agreement remains confidential and has never been published.

111. See OECD (2004a), Chapter 3.

112. The extension of a loan to state-owned Vneshtorgbank, enabling it to buy the threatened but still viable Guta-Bank, stands out as a particularly troubling precedent, as did the apparent attempt to use Sberbank as a lender of last resort on the inter-bank market.

113. In the late 1990s, a Russian court found that derivatives contracts fell under the "wagers" provisions of the Civil Code and so were not subject to enforcement by the courts.

114. In any case, the ceiling never actually had legal force nor did foreign banks ever come close to breaching it. At the beginning of 2004, non-residents owned stakes in only 128 Russian credit institutions, of which 32 were wholly foreign-owned.

115. See OECD (2004b), pp. 71-73, for further detail on these and other restrictions. There has been pressure from the banking lobby to establish a 25% ceiling on the foreign capital share, but the authorities have so far resisted the proposal, which runs counter to their overall policy of encouraging foreign participation in the sector.

116. This ceiling was raised from 15% under legislation adopted in December 2003. In fact, the finance ministry estimated the foreign capital share at just 2.7% as of 1 January 2004.

117. Allianz and AIG were in the life insurance business in Russia before this legislation was adopted in 1993 and so are exempt from the restriction.

118. This discussion draws on OECD (2002b), pp. 46-47.

119. See Braga de Macedo and Oliveira Martins (2005).

120. Frameworks of laws and rules are best viewed as abstract public goods. To the extent that they are consistently and impartially applied, they are "jointly consumed": both rivalry and excludability are low. If they are effectively enforced, then exit is low as well.

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PART II

Regulatory Policies and Outcomes

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PART II

Chapter 2

Regulatory Governance*

* For more information see: "Background report on Government Capacity to Produce High Quality Regulation" available at *www.oecd.org/regreform/backgroundreports*.

Introduction

Russia stands at a crossroads on its path to economic change. If it implements reform vigorously, the country can increase its growth rates, improve its social welfare and take a leading role in the global economy. In some areas, its performance could converge with that of OECD countries. But if Russia ignores the factors that have dogged it in the past, the future could bring only modest growth and continued marginalisation in the world economy.

In July 2001, the government began to implement its "Medium Term Programme of Social and Economic Development for 2002-to-2004", the document that underlay all its subsequent reform efforts. Until the launch of this programme, the notion of regulatory reform in Russia was fragmented and undefined. In the 1990s, the government had embarked on several reform initiatives under such headings as "deregulation" and "debureaucratisation". They had uneven impact and at times created more problems than they solved.

The medium-term programme set out the fundamental principles for regulatory reform and a timetable for its implementation. It defined a scenario that combines a measure of state oversight with economic liberalisation. State intervention was to occur only in cases where market forces could not do the job. The role envisioned for government was to reduce barriers to growth and to create a favourable entrepreneurship and investment climate. The model prescribed in the programme was based on an implicit social contract between the state and its economic subjects; the state was to provide an appropriate institutional and regulatory framework, while the economic subjects were to comply with the rule of law.

The government has gone a long way toward carrying out the principles laid out in the programme. But the state's withdrawal from the economy is still far from complete. It remains an important player in the market. This continues to breed *ad hoc* policy making and arbitrariness, and it has the potential seriously to distort markets. Rather than rely on law or regulation, the state continues to exert direct control over assets and to wield market power. This may have been a reasonable strategy for the early years of transition. But the time has now come for improving regulatory quality and promoting administrative and regulatory practices within the rule of law.

The regulatory environment

The Russian regulatory system presents a number of strongly marked characteristics. It is essentially prescriptive: it seeks to determine and control economic activity down to the smallest details. This stems from an underlying conviction by Russian regulators that the responsibility for ensuring regulatory compliance should reside with them. One problem with such a prescriptive approach is that it becomes easily outdated as technology or industry practices change. The costs of maintaining detailed prescriptive regulations that keep up with current practice are likely to be excessive. Prescriptive regulations also tend to stifle innovation, as they do not provide the flexibility that businesses need to use new technologies and practices.

The system can be inconsistent. The development of implementing regulations (secondary legislation) has been slower and even more inconsistent than the adoption of framework acts. Many Soviet regulatory documents are still in force. As a consequence, it is not always clear which regulations apply in a specific case, creating confusion for regulators and the regulated community alike.

It demands a high degree of information. Russian regulatory standards require those starting businesses or launching new business projects to provide regulators with a great deal of information. Under the current approval procedure, whenever design changes are made, project documentation must be re-submitted, re-reviewed and re-endorsed.

The Russian system is highly sequential. The requirement that one approval must be obtained before the request for another approval can be submitted adds considerably to the time it takes to secure all necessary approvals for a project. The sequential nature of the approvals process places a heavy financial burden on the investor and the state and increases the potential for costly delays. It can also be duplicative as regulatory bodies often duplicate each other's efforts by reviewing documents that are essentially the same.

Russia's complex regulatory framework is further complicated by weak enforcement and spotty compliance. A popular Russian saying holds that the severity of Russian laws is tempered only by their lack of enforcement, and the dictum could well be applied to the regulatory system of today. It can be difficult to know which laws and regulations are implemented and observed, although it is clear that many are not implemented at all, or only partially.

This difficult situation stems from a number of causes. First among them is a historical lack of respect for the rule of law. Administrative and judicial bodies are weak in both moral authority and financial resources. Moreover, the penalties and sanctions for failure to comply with regulations are not applied in a rational way. Some public officials engage in corruption through the discretionary enforcement of regulatory policy.

The government's approach to the regulatory process is changing. Under a new scheme described below, officials proposing legislation are required to take into account alternatives to regulation. A lead ministry is appointed to supervise each legislative initiative through the law-making process. It is obliged to consult with other government departments before a draft law is considered by the government. This practice is still new, but it is clearly a positive step toward better-quality regulation. Until this procedure was put in place, ministries had substantial freedom in taking regulatory initiatives, and there was a lack of co-ordination among ministries.

The regulatory environment in Russia, though improving, remains poor. New investments and economic diversification will remain limited unless significant bottlenecks are removed. The remaining reform agenda is extensive, particularly at the regional and local levels.

The administrative environment

Implementing a comprehensive regulatory reform agenda will depend crucially on the quality of Russia's public administration, especially at the regional level. Russia's public administration has not, in general, been up to such key tasks as increasing economic growth, reducing poverty and enabling the country to compete effectively in the global economy. It has not provided the Russian population with the service it has a right to expect.

Three key problems haunt the current system.

- The federal government is a product both of its Soviet past and of the tumultuous early years of Russia's transition. It is made up of competing and overlapping structures with unclear accountability. These structures include the government itself, with its ministries, agencies and services; the government *apparat* (attached to the prime minister's office and fulfilling functions similar to those of the cabinet office in the UK), and the President's administration (which resembles *pari passu* the White House staff in Washington). The Administration and the *apparat* often parallel and duplicate the policy-making role of line ministries. The parallel structures fragment decision making. This has led to the proliferation of inter-ministerial commissions to resolve inter-agency issues, a trend which has increased transaction costs and undermined the transparency of decision making.
- The quality of the public administration and the civil service is low. Civil-service salaries are not competitive with those in the private sector. It is hard to recruit and retain top staff, and low pay can encourage some officials to accept bribes.
- The fallout from federalism is a major problem for regulatory reform in Russia. The federal government has moved ahead rapidly in legislating reforms in many areas, but the implementation of most of them requires detailed action at the regional level. While some regions have actively implemented reforms, progress across the Federation has been very uneven. Constant vigilance will be needed to ensure that actions taken by the federal government are not countermanded or sabotaged at sub-national level.

The government has begun a major reform of the state and its public administration. Three sets of complementary and inter-linked reforms are being developed and implemented.

- The first reform concerns *the state administration*. On 9 March 2004, President Vladimir Putin initiated a radical plan to reorganise and streamline the federal government. It defined the different types of government bodies and their respective roles. The reform also sought to keep control of decision making and policy management at the centre and to improve overall government performance.
- Second, the *civil service* is being reformed. A Presidential decree to guide this reform over the period 2003-to-2005 calls for large pay hikes for civil servants. A code of conduct for the service has already been approved. A major aim of the reform is full transparency in the operation of the civil service. A new law on the state service system has been drafted, as has a law on the civil service, which emphasises the merit principle. Administrative processes are to be computerised to increase efficiency and to discourage corruption. Eventually, each of Russia's regions will have to be persuaded to reform its own civil service.
- Reform of the federal system was one of President Putin's early priorities. The aim was to strengthen the authority of the federal government and resume much of the power that the regions had grabbed during the 1990s.

Recent initiatives to improve the quality of public administration

By the end of the 1990s, the Russian authorities and many outside observers had come to regard the reform of the state institutions themselves as the most important item on the country's reform agenda. In recent years, attention has focused on reforming the courts, the civil service and the major regulatory institutions, and on recasting relations between

the federal centre and the sub-national governments. But progress in rebuilding state's administrative capacities has been very uneven.

Public administration reform

A much-anticipated reorganisation of federal executive bodies was undertaken in March 2004, after several years of debate. The federal executive is divided into three types of institutions, each with a specific role:

- Federal *ministries* are policy-making bodies. They conduct the analysis, development and evaluation of policies in their respective domains and they draft new legislation. They co-ordinate and monitor the activities of federal services and agencies within their jurisdictions. The reform reduced the number of ministries from 23 to 15.
- Federal *services* are supervisory and regulatory bodies. Funded from the state budget, they can issue individual regulations but not normative legal acts.
- Federal *agencies* are direct providers of public services to the state and private sectors. Their funding can come in part from charges and fees paid by their "customers".

Before the recent restructuring, the government *apparat* mirrored the structure of the government itself. It was widely criticised for unnecessary duplication and for weakening the role and status of line ministries. And the *apparat*'s active involvement in legislative and regulatory activities limited its time for focusing on more strategic issues. The recent reform radically restructured the *apparat*. Its staff was cut by 20%, from about 1 000 to about 800. The number of its departments will be cut from 23 to 12. Some will be merged, others handed over to the relevant ministries.

Under the reorganisation of federal executive bodies, the President retains a major role in managing the federal government. All five of the so-called "power ministries" (Interior, Emergency Situations, Foreign Affairs, Defence and Justice) report directly to him. Seven services and two agencies are also under the direct Presidential purview. The President's Administration (his Kremlin staff) sets and develops the main directions of reform.

The reorganisation appears to reflect the desire to separate the functions of policy making, service provision and regulation. In principle, such a separation would increase the efficiency of executive bodies while reducing the conflicts of interest that arise when these functions are combined. Unfortunately, there is little evidence that the reorganisation has achieved either aim. It disrupted the work of many government bodies for much of 2004, as officials concentrated on setting up the new structures and sorting out their respective roles. In many cases, regulators continue to be subordinated to the ministries they regulate. The Russian authorities have not yet demonstrated that they are committed to creating regulatory organs that are genuinely independent and properly shielded from outside pressure. The subordination of the new Federal Antimonopoly Service to the cabinet is a particularly striking instance, as this service is required to evaluate many of the government's own acts.

Civil service reform

Reform of the bureaucracy has been actively discussed for several years, but the strategic direction of reform is still far from clear. Whatever overall orientation is ultimately chosen, the Russian authorities face a number of specific choices on civil-service reform, including:

- The degree of unity or diversity to be achieved.

- The vertical integration of state administrative bodies.
- Recruitment and promotion, and
- Civil service pay.

Changes in the broader institutional environment

Civil-service reform in the narrow sense of reorganising structures and redefining roles will achieve little on its own. Its effects will depend on the wider institutional environment. Indeed, changes in that environment may matter more than the specific model of administrative reform. These include:

- Strengthening the rule of law.
- Increasing the transparency of state institutions.
- Buttressing the institutions of civil society.
- Reducing opportunities for corruption, and
- Supporting enforcement.

Co-ordination between levels of government

Co-ordination between levels of government is a key issue for regulatory reform. The federal authorities have laid down the principal features of that co-ordination, but the actual implementation of those principles will be critically dependent on the attitudes and actions of sub-federal administrations. And history is not particularly promising. During the first decade of Russia's transition, relations between the federal authorities and those in the regions were often contentious.

The Russian Federation is divided into 89 federal subjects: twenty-one republics, six *krai* (territories), forty-nine *oblasti* (regions), one autonomous *oblast* and ten autonomous *okruga* (districts), as well as the cities of Moscow and St. Petersburg. For the purpose of this report, the term "region" will be used to refer to any of the above-mentioned federal subjects.

According to the Constitution, all 89 regions are equal in their relation with the federal government.[1] The basic framework of federal-regional relations is defined in the Federation Treaty of 1992 and in a number of articles of the 1993 Constitution. Articles 71 and 72 of the treaty broadly define the division of authority between the federal government and the regions.[2] Where federal laws are lacking or are unspecific, as was the case in many regulatory areas during the earlier years of transition, regional legislation and the exercise of regional regulatory authority filled in the gaps.

Most of Russia's regions have signed separate bilateral agreements and treaties with the federal authorities. These are tailored to the needs of each region, and so they vary widely in content. Some regions negotiated individual taxation packages, while others gained additional rights over the extraction and distribution of natural resources. The treaty process was intended to provide some coherence and predictability to federal relations with the regions. In fact, however, the coherence of the central state's policies came under daily attack throughout the 1990s from almost all the regions of Russia – including, of course, those that had signed power-sharing treaties with the centre.

The devolution of central authority in the 1990s

During the 1990s, a persistent theme in the relationship between the national government and the regions was the non-compliance by regional government with federal authority – particularly concerning regulation of the national market. In those years, the federal authorities were unable to create the conditions for a nascent federal system.[3] Instead, Russia experienced a rapid decentralisation that left the Kremlin unable to carry out its policies on the periphery. The abuses of devolution can perhaps be traced back to President Boris Yeltsin's now infamous exhortation to regional leaders within Russia to "take as much autonomy as you can swallow".

Violations of the two relevant articles of the Constitution negatively affected economic policy at the regional level and the central government's ability to influence the development and regulation of markets. Many violations involved the ownership, use and distribution of natural resources, with the regions claiming ownership despite the fact that the federal government had legal jurisdiction. Some regions introduced unconstitutional laws on the administration and distribution of federal property located on their territories. Others imposed their own financial, credit and-hard currency regulations – exercising a prerogative theoretically reserved exclusively to the federal government. Some regions even legislated on the organisation and activities of the branches of federal ministries located on their territories.[4]

Regulatory capture of regional governments

The devolution for central authority can trace its roots to the regulatory capture of regional governments. The rapid privatisation of Russian industry in the early 1990s was creating a new class of private owners. These early beneficiaries from the transition had little interest in promoting effective regulatory policy. To consolidate their initial acquisition of state assets, they set out to capture parts of the state – particularly at the regional level – for their personal financial advantage. As a result, regional governments in Russia passed legislation that often contradicted the federal Constitution in ways that affected competition and market development. Illegal tariffs and non-tariff regulations were imposed on inter-regional trade as a way of favouring local products over those from outside the region. The residence-permit system that persisted in many regions was used to restrict freedom of movement and limit labour mobility. Regional claims to the ownership of natural resources and violations of federal privatisation policies were used by regional governments to benefit local economic interests. Local courts were restructured so that ownership disputes might be resolved in favour of regional interests.

Publications by the World Bank support the view that regional governments and businesses insiders had a vested interest in maintaining the *statu quo* and actively worked to undermine federal policies and regulation.[5] The Bank's studies characterise the situation as a "high-capture" economy. Both old and new firms engaged in attempts to influence and "capture" the state. They sought to limit competition and the entry of new firms into the market, to preserve rent-seeking opportunities and to limit federal oversight.

Regional governments willingly participated in the process of state capture. They sought to maintain their involvement in, and sometimes control over, key regional enterprises.[6] In the end, a system of intimate interdependence developed between regional business and local governments.[7]

Regional non-compliance with federal policies and regulations resulted in a deep erosion of central state authority. The government effectively lost the ability to maintain a common market and establish a single, federation-wide economic space. The country failed to reap the rewards associated with decentralised development. Efficient decentralisation requires more than just constraints on the central state. It also requires a central government that is strong enough to control its regions. In the absence of a central state strong enough to ensure capital and labour mobility, to eliminate internal trade barriers and to protect property rights, decentralisation during the 1990s proved to be market-stalling rather than market promoting.

Reform of the federal system under President Putin

One of President Putin's early priorities was to strengthen the authority of the federal government and resume much of the power that the regions had grabbed during the 1990s.[8] His reform of the federal system aimed to bring regional laws into line with federal legislation; to co-ordinate the operations of the regional branches of federal agencies; to improve the investment climate, especially for small and medium-sized businesses in the regions; to demarcate clearly the powers and competencies of federal, regional and local authorities; and to step up the war on corruption.

The main points of the programme, announced shortly after Putin's inauguration in May 2000, were:

- Restructure the Presidential Administration, replacing more than 80 presidential representatives to the 89 regions with seven envoys to greatly expanded federal territories.
- Change the composition of the Federation Council (the upper house of the Federal Assembly) so that regional governors and heads of regional legislatures no longer automatically hold seats in it.
- Enable the President to dismiss regional governors and legislatures when the courts rule that they have passed laws or decrees in violation of federal laws or the Constitution.

Five years on, the reform has weakened some of the institutions that flourished in the 1990s, notably the office of regional governor. They have sharply limited the role that regional elites played at the national level, particularly by removing the governors from the Federation Council. Federal authorities have gained greater control over the state budget. Financial transactions have been made more transparent through greater use of the federal treasury system. The reforms have also reduced the importance of political bargaining between the federal and regional governments.

Despite these gains, there are clear limits to what the reforms have been able do. Russia's governors remain powerful, especially within their home regions. The reform creating the seven federal districts lacked a clear definition of the functions that the envoys to them would perform, and the envoys were given few resources to carry out their duties. They do not have real executive powers. Their position within the federal executive branch is ambiguous and do not have the clout to influence federal bureaucrats or regional leaders. They have small staffs, usually numbering about 100. They have no say in the process of spending federal money, a task which is handled by the Finance Ministry. Governors and regional legislatures – not the envoys – are responsible for defining and executing regional budgets. Moreover, the envoys do not implement laws or prosecute legal violations, since other institutions already exist for these purposes. Unlike governors, the envoys are not elected by popular vote. Unlike the government ministries which they are

supposed to co-ordinate, the envoys do not have responsibilities defined in the Constitution. The impression is gaining ground that these presidential representatives are but another layer of state bureaucracy with poorly defined powers.

Russia's ability to make new high-quality regulation

Administrative transparency and predictability

Transparency is essential for regulatory quality. It encourages the development of better policy options, and helps reduce the incidence and impact of arbitrary decisions in regulatory implementation. Improved transparency will be particularly helpful to the Russian government in speeding up reforms, as it will weaken the resistance of insider groups. Transparency helps create a virtuous circle in the market. Consumers and investors trust competition more when they see that special interests have less power to manipulate government and markets. Transparency is also a sharp sword in the war against corruption.

The Russian Federation is a civil law jurisdiction with a written Constitution that lays down the fundamentals of its government and regulatory framework. The Constitution sets out the general procedures to be followed in promulgating federal laws and regulations.[9] Regulations can be initiated by the President, by either chamber of parliament or by the government.[10] Federal laws and regulations take effect only after they are signed by the President and published in a number of official publications.

In the past few years, several initiatives have been taken to formalise the system for making new regulations. The first was a resolution outlining a new administrative procedure for the drafting of laws by federal executive authorities.[11] It stipulates that government plans for law making must comply with the Medium Term Programme. While there has been slippage in the enactment of some parts of the programme, it is encouraging that the legislative framework outlined more than four years ago is largely being followed.

The resolution specifies that a federal agency drafting new regulations must:

1. Co-ordinate with other relevant federal agencies.
2. Report progress to the government *apparat* and submit proposals to it on issues that require specific resolution.
3. Set up working groups with representatives of public, academic and other relevant organisations to contribute to the drafting effort.

These procedures introduce a greater degree of transparency both within the government and for the public at large. Moreover, the resolution makes the head of the responsible federal agency personally responsible for ensuring the contents and the timely preparation of draft laws.

The Justice Ministry has laid out the following stages for law-drafting:

- Developing the concept of the draft law.
- Preparing the text of the draft law.
- Co-ordinating the draft's text with the federal executive authorities concerned.
- Obtaining a legal opinion from the Ministry of Justice on the draft's constitutionality.
- Revising the draft and accompanying documents, if necessary.
- Preparing explanatory notes, and financial and economic justifications, of the draft law.

- Sending the draft to the government.
- Supporting and explaining the draft law when it is deliberated by the Federal Assembly.
- Preparing and submitting to the government draft opinions, official comments and amendments for draft laws deliberated by the Federal Assembly.
- Collecting, recording and organising background and analytical materials related to the law drafting.

A second major initiative covers the drafting and introduction to parliament of bylaws that support the enforcement of federal laws.[12] It requires each federal body to name the unit responsible for compiling a list of bylaws as well as a timetable for their adoption. An efficient and effective mechanism for developing bylaws following the adoption of federal laws has been lacking for some time. As a result, many federal laws, once passed and promulgated, could not take effect at the planned date. It will be necessary to develop procedures to keep the regional authorities throughout Russia advised well in advance about what bylaws are being developed. This would avoid conflicts between bills written by a federal ministry or agency and bylaws written by regional authorities.

A third initiative is a new law on technical regulations,[13] which provides a system for the development, adoption, and application of technical standards and requirements. The law also creates procedures for the certification of such standards and the evaluation of compliance with them. The procedural element of this law could be just as important as its substantive component. It is an important attempt toward defining a new and improved regulatory process. The law will have far-reaching effects. All requirements and standards applicable to goods under other laws and regulations will be subject to compliance with it. Specific technical requirements and standards will be introduced by means of "technical statutes".

Transparency in decision criteria: proportionality

OECD member countries agree that regulations should be based on explicit quality criteria that identify when they are needed. Some governments stick strictly to the principle that benefits should justify costs. Others have adopted more general criteria based on proportionality. Those applying proportionality criteria ask whether the magnitude of the problem at hand is sufficient to justify action and, if so, whether the action proposed is the lowest-cost option available. Examining the issue of proportionality can act as a check the overuse of regulation. It can also help to ensure that standards of regulatory quality, such as its interfering as little as possible with trade, are protected.

Russian legislation requires that the government explain and defend its draft regulatory proposals. But there are no clear-cut guidelines for preparing the notes that accompany draft regulations along their path to adoption by the government or the Duma. Nevertheless, some consideration is given to proportionality at several stages of the law-making process and by different participants in the process.

The government's law-making plans are now formed within a broad legislative and economic framework. Moreover, the Ministry of Justice has the authority to reject regulatory proposals if it considers them unjustified or improperly substantiated. Secondary legislation must also be justified. The government's draft resolutions and directives need to be accompanied by explanatory notes justifying the regulatory actions they entail and projecting the economic and other effects of their implementation.

The Audit Chamber participates importantly in the vetting of legislation. It conducts its own assessments of income and expenditure items in the draft federal budget. It also analyses draft laws and other acts of the federal authorities that entail costs to be covered by the federal budget.

The Law on Technical Regulation stipulates that draft technical regulations submitted to the Duma be accompanied by a justifying note. The documentation should indicate any provisions that differ from international standards or from requirements currently in effect in Russia. It should also contain a cost-benefit analysis of the proposed regulation.

Requirements for the justification of proposed legislation are set by the Federation Council.[14] A draft submitted for the council's adoption must be accompanied by:

- A note justifying the regulatory action, including a detailed description of the draft, its objectives and key provisions.
- An explanation of the draft law's place in the system of legislation.
- A cost-benefit analysis (if the law entails new costs).
- A forecast of the political and economic effects of the law.[15]

The Ministry of Economic Development and Trade has proposed a law requiring that draft regulations be submitted to independent critiques based on a presumption of inexpediency. The need to regulate would have to be substantiated by the regulation's proponent.

Transparency through dialogue with affected groups

Consultations with the public give interested parties a chance actively to influence regulatory decisions. They may take place at every stage of the development of regulations, from the initial identification of a problem to the evaluation of regulations already in force. Consultation may be a one-time event or a continuing dialogue.

In Russia, the idea of public consultations has been receiving more and more attention, and some steps have been taken toward refining procedures for them. The general procedures on the matter of consultation for regulatory decision making are largely handled by individual ministries and agencies. More and more consultations with the public are taking place, especially with respect to major reform programmes. But such consultations largely remain voluntary. Moreover, these efforts may not be sufficiently ambitious to assure the kind of open and systematic dialogue that would lead to a shared "ownership" of reforms.

Current law makes the lead author of a regulation responsible for organising working groups to contribute to the drafting process and to prepare background material. It is up to the author whether to consult academic or other non-governmental bodies. He is obliged, however, to consult with regional governments when a draft law is in the joint domain of federal and regional authorities.

It is possible to set up permanent advisory boards including representatives of government agencies and of public associations and businesses. Several such boards have already been established, including the Advisory Board of the Russian State Customs Committee and an advisory board on foreign investments in Russia. These groups discuss draft regulations and reform programmes, offer opinions or make their own regulatory proposals. (On the other hand, a proliferation of "consultative commissions" is reported to have little real impact.)

The Law on Technical Regulation stipulates that the start of the drafting process for any technical regulation should be announced in the official press in printed as well as in electronic form. The procedures it establishes for developing new proposals for technical regulation will serve as a "pilot" for the use of consultation in regulatory decision making.

A recent government decision, on securing access to information, may pave the way to much greater use of consultation.[16] It specifies what information the government must publish, including on the Internet, and it makes the authorities responsible for ensuring public access to information about their activities. At the same time, the Presidential Administration has launched the E-Russia programme to provide information in electronic form about the activities of the executive and legislative branches, the judiciary and regional governments, including regulatory proposals and draft laws.[17] The public can e-mail its comments and suggestions on draft regulatory proposals to the site.

A new draft law on access to information has been prepared by the Ministry of Economic Development in Trade and was submitted to the government on 25 January 2005. This draft law describes the procedures and general conditions for citizens and organisations to access information about activities of government institutions. Consultation procedures will be greatly strengthened once the law is adopted and enforces.

In moving forward, a very flexible approach is needed in promoting transparency through dialogue with affected groups. Regulatory issues differ greatly in their impact and importance and in the number of groups they affect. The OECD has recommended that minimum standards for handling consultations are needed across the whole government to provide consistency and confidence. A consistent process is a key quality-control mechanism.

Communication

Transparency requires that the administration communicate the existence and content of all regulations to the public, and that enforcement policies be clear and equitable. Russian legal acts can be divided into: international treaties, laws, normative acts of the Government, normative acts of the President, normative acts of the judiciary, and normative acts of the constituent regions of the Russian Federation.

- *International treaties* are published when they enter into force (together with the federal law ratifying them) in the Code of Laws of the Russian Federation and the Bulletin of International Treaties, as well as in the official journals of the ministries whose areas of authority are covered by the treaty.
- *Federal laws* are published within seven days after they are signed by the President in *Parlamentskaya gazeta* (the parliamentary journal), in *Rossiiskaya gazeta* or in the Code of Laws of the Russian Federation. Federal laws are also entered into Sistema, a database run by the Science and Technology Centre of Legal Information.
- *Acts of the Federal Assembly* are published within ten days after their adoption in *Parlamentskaya gazeta, Rossiiskaya gazeta* or the Code of Laws of the Russian Federation.
- *Resolutions of the government*, unless they contain secret or confidential information,[18] are published within fifteen days after they are approved.
- *Acts of the President and acts of the government* are published in *Rossiiskaya gazeta* and in the Codes of Laws of the Russian Federation within ten days after they are signed.

Box 2.1. **OECD member countries use several major approaches to public consultation**

Informal consultation includes all forms of discretionary, *ad hoc* and non-scheduled contacts between regulators and interest groups. It takes many forms, from phone calls to letters to private meetings. This kind of consultation is carried out in virtually all OECD countries, but its acceptability varies tremendously. It can conceivably lead to "capture" and corruption, and it risks locking out important interests that are not a part of the ministry's network of contacts.

Circulation of regulatory proposals for public comment. A straightforward way to consult is to send regulatory proposals directly to affected parties and invite their comments. It is more systematic, structured and routine than are informal contacts. Groups on the circulation list expect to receive drafts of important regulations. Responses are usually in written form, but regulators may also accept oral statements. Circulation-for-comment is a widely used and fairly inexpensive way to solicit views from the public. Because the groups approached are selected in advance, it usually calls forth a good deal of relevant information. Its main weakness is that the lists of those to be solicited for comment are not always complete. This procedure is less satisfactory in situations where there are new and shifting interest groups.

Public notice-and-comment. The publication of draft legal texts for public scrutiny and comment is a more open and inclusive approach. Publication permits all interested parties to be aware of the regulatory proposal. Notice-and-comment was first adopted in the United States in 1946. By 1998, nineteen OECD countries were using the approach in some form. Policy makers who use the notice-and-comment method can be confident that most significant views have been heard. However, many countries have found that participation can be low when this approach is used. Participation depends on the breadth of publication, the time allowed for comment, the quality of the information provided in the published notice and the attitudes and responsiveness of regulators.

Public hearings. A hearing is a public meeting on a regulatory proposal for interested groups. A hearing usually supplements other consultation procedures. By 1998, sixteen OECD countries were using public meetings. Hearings are, in principle, open to the general public, but attendance depends on how widely the invitations are circulated, where and when the meeting is held and the size of the meeting room. Public meetings provide face-to-face contact in which a dialogue can take place. One disadvantage is that hearings are often one-off events, which some groups may be unable to attend.

Advisory bodies. The use of advisory bodies to give expert advice and information to regulators is the most widespread approach to public consultation in OECD countries. Advisory bodies are involved at all stages of the regulatory process, but they are typically called in early to define positions and options. There are many different types of advisory bodies – councils, committees, commissions and working parties. Their include members from outside the government. Their functions can vary from merely reacting to a regulator's proposals to acting as a full rulemaking body. Advisory bodies may carry out extensive consultative processes involving hearings or other methods.

Most countries combine different consultation tools throughout the regulatory process. Informal consultation and circulation-for-comment approaches are often used to test the views of a limited number of key players at an early stage, while an *ad hoc* group of experts may be created to gather reliable data before the process moves on to notice-and-comment or public hearings that allow wide input from the public.

- *Normative acts by ministries and departments* that bear on the rights, freedoms and interests of citizens must be registered with the Ministry of Justice. Official publication of ministerial normative acts should take place within ten days of such registration.

Regulations are now being made available on the Internet. The creation of an official government site[19] has facilitated this process. Laws signed by the President are published on the Duma site. Several commercial portals offer information about legislation; among the most popular are "Garant" and "Konsultant".

Throughout the OECD, concerns are being heard about the growing complexity of regulations; their fragmentation, inconsistency and unreadability; and the difficulty of finding the relevant regulation. As in Russia, the usual OECD response to these problems has been to publish new laws and regulations in official journals, while requiring ministries and parliaments to keep copies of current regulations available for public inspection. These mechanisms, while useful, have come to be seen inadequate. The increasing volume of regulation has increased the urgency of new efforts to make the complete set of regulatory requirements quickly available to the public.

Enforcement and compliance

Perhaps the greatest shortcoming of regulatory policy in Russia is the widespread uncertainty about which laws and regulations are implemented and observed. Improving regulatory enforcement is a multi-faceted, long-term task that goes beyond regulatory reforms to the consolidation of the rule of law. Nevertheless, useful progress could be made by certain legal and institutional reforms.

In addition to such larger issues as accountability and the role of special interest groups, which this paper does not address in detail, there are many transitional and structural reasons for unpredictable enforcement in Russia:

- Multiple layers of administration. Russia's regulatory enforcement system is highly decentralised and poses formidable problems of co-ordination and consistency. The degree of decentralisation in regulatory enforcement in Russia is, in fact, greater than that in any federal country in the OECD. Russia's *central* government is quite small by OECD standards. Almost all officials who inspect and enforce regulations are employed at the regional level, with little accountability to federal ministries.
- Regional governments have regulatory and enforcement powers in most policy areas, including the approval of investment projects, safety standards, tax compliance, labour codes and environmental regulations. Many local inspectorates are funded locally, and this fact further diminishes control from the centre. Even customs posts are financed by local governments or self-financed from fees. The flow of information between the levels of government is insufficient. Federal ministries usually do not know how vigorously the laws are being enforced, and have little authority to monitor or take corrective action. Local governments that do not implement the laws face few penalties.
- Local protectionism and "capture" of the enforcement process. Powerful, sometimes corrupt, local interests can have a strong influence on regulatory enforcement decisions taken against their competitors.
- Inadequate checks and balances on enforcement actions. One major problem is that regional and municipal administrations exercise very broad discretionary powers in the interpretation of regulatory requirements. Russia's administrative procedure laws do not

Box 2.2. **Communication regulations in OECD countries**

OECD countries use six main tools to make regulations easier to find and understand:

- *Codification.* The rationalisation and clarification of complex legal regimes that have accumulated haphazardly over the years often require comprehensive legal codification.
- *Centralised regulatory registers.* The counting and registering of regulations can serve as useful tools for internal management by improving the flow of information within the public administration. In most countries that have established central regulatory registers, the rule of "positive security" has been adopted. This means that only regulations that appear on the register can be enforced. For the user, this rule provides the certainty that, if he has complied with all regulations on the register, he has fully complied with the law.
- *Plain language drafting.* Legal texts must be understandable by non-experts. Several OECD countries have had plain language drafting policies in force for many years, and most of these provide training in this area.
- *Publication of future plans to regulate.* This is another strategy for improving transparency. Some twenty OECD countries currently have publicly accessible registers of forthcoming regulations.
- *Electronic dissemination of regulatory documents.* Advances in information technology, including improved data storage and the rapid development of the Internet, provide opportunities to improve the dissemination of regulatory material. One problem is that relevant information may be spread over different databases due to inadequate co-ordination between different levels of government. In some cases, "information overload" may actually diminish transparency. The fact that access to the Internet is not quite universal is also a limiting factor.
- *One-stop shops and regulatory streamlining.* The "one-stop shop" concept should be accompanied by a determined effort to eliminate unneeded and costly approvals, licenses, and permissions, of which there are many in Russia. The one-stop shop usually focuses on licenses, approvals and permits and provides a list of such requirements. It can also supply application forms and contact details.

require that the legal interpretations underlying regulatory decisions be disclosed in advance or that the decisions themselves be explained publicly.

- Inadequate judicial supervision. Despite recent reforms, judicial review of administrative actions is still very limited in Russia compared to that in OECD countries. Moreover, most Russian courts are subject to considerable pressure by regional governments. Judges are not tenured. They are usually appointed, promoted, compensated and removed by regional government officials. They often give more weight to local interests than to legal requirements. Sanctions can be risibly low compared to the profits to be made by violating the law and many court decisions are not enforced promptly – or at all.
- Intrusive and excessive regulation. Inspectors often intervene unduly in business decisions. Business licenses, for example, are given for very short periods, usually six months to a year. The frequent use of permissions and approvals rather than of general regulations exacerbates enforcement problems. The rapid expansion of regulation in

the 1990s made the problem worse. Contrary to what might be expected, more detailed regulations do not reduce the exercise of broad discretionary powers by regulators. On the contrary: it has been observed in OECD countries that an accumulation of procedures actually *increases* the arbitrary nature of administration. It becomes impossible to know or comply with all requirements; so administrators are left to decide which rules to enforce, and how. Paradoxically, the Russian legal system is characterised both by too much detail and by too much individual discretion.

A determined programme to eliminate unneeded and costly approvals, licenses, and permissions would go a long way toward resolving many enforcement problems. But eliminating the interlocked institutional and structural weaknesses that undermine enforcement will require reforms that go well beyond the scope of this paper. The experience of newer OECD countries which have overhauled their judicial systems and developed procedures for the independent review of administrative practices might be of interest to Russia at this juncture.

One tool that the Russian government might consider to control excessive administrative discretion, is the revision of its laws on administrative procedure. Administrative procedure acts are flexible tools. They can include requirements for:

- *Making regulation*: Requirements for consultation at various stages of the development of a regulation, for regulatory impact assessments; for consideration of alternative instruments; for publication; for setting dates of a regulation's entry into effect; for its duration (including automatic "sunsetting") and disallowance.
- *Implementation and enforcement*: Accessibility of regulations; rules on incorporated material, such as standards; general rules on the extent and exercise of administrative discretion, including the publication of the objective criteria for judging applications; time-limits for decision making; publication requirements for administrative decisions; and the obligation to give reasons for rejecting applications.
- *Revision and amendment*: Application of general procedural rules to amendments of existing regulation; rules on the updating of incorporated material, such as international standards.
- *Appeals and due process*. Procedures on hearings for disciplinary actions in the case of violation; the rights of regulated entities to appeal rules and administrative actions such as sanctions.

Many OECD countries are adopting or amending administrative procedure laws to improve the orderliness of their administrative decision making, to define the rights of their citizens more clearly and to define standard procedures for making, implementing, enforcing and revising regulations. When they are adopted in legislative form, these procedures become "rights" that the public can assert. By strengthening citizens' rights and controlling arbitrary regulatory actions, these reforms are fundamentally changing the relationship between the public administration and the citizen. Their effectiveness in improving predictability and reducing the perception of regulatory risk, while enhancing administrative accountability, can hardly be over-estimated.

Public redress and judicial review

The Russian Federation's judicial system consists of several types of courts, including the Constitutional Court, the civil courts or "courts of general jurisdiction" and the arbitration courts. Which court has jurisdiction over a particular dispute depends in part on the nature of the dispute. As a rule, economic and commercial disputes among legal

entities or individual entrepreneurs, foreign or Russian, are handled by arbitration courts. The civil courts hear non-commercial disputes among individuals and legal entities.

Overall, the judiciary's involvement in the law-making process is rather passive. The separation of powers in Russia drastically limits the judges' power to affect law making directly. But these limits carry some disadvantages. They may well result in the under-utilisation of valuable information. Judges who apply the law every day are well placed to know where laws conflict, where they are inadequate and where they are unfair. Yet, the only way a court can seek to quash regulation is to submit a law that has already been challenged to the Constitutional Court for a ruling on its constitutionality.

Other considerations limit the courts' ability to exercise regulatory oversight. Russia does not have enough judges, and those it does have are overworked. They do not have time even to meet the deadlines in their pending cases. Most civil cases last over a year, and some take two, three or even five years. Few judges want to see more delays in the process, and delays inevitably occur when a submission is made to the slow-moving Constitutional Court. Even if courts were allowed a more authority in overseeing law-making, few judges would be likely to exercise it.

The major remaining challenge in the field of judicial reform is to rid the courts of corruption and political influence – to eliminate the so-called "shadow justice" that President Putin decried in his 2001 message to the Federal Assembly. Some steps have been taken to strengthen judicial independence, including a new law on the status of judges which raises judicial pay and creates new mechanisms for punishing judicial malfeasance.[20] But it will be hard to implement the latter provision effectively and consistently. The federal government has also sought to improve the financing of the entire judicial system, so as to reduce the dependence of judges on regional authorities. More important will be the creation of a new tier of arbitration courts. They will be called arbitration appeals courts, and each of them will encompass a number of jurisdictions. Until now, appeals against arbitration-court decisions have been heard in the court of first instance, often with the judge who issued the contested decision presiding. By creating a higher-level tier of courts to hear appeals, the authorities hope to enhance the chances for a fair hearing for the appellant and to reduce the ability of regional bosses to meddle in judicial decision making.[21]

Regulatory Impact Analysis

A good regulator must be able to assess the probable impact of a regulation on the market before the regulation before it is adopted. RIA is a decision tool. It systematically examines the potential effects of a government action and communicates the information to decision makers.[22] The ability to assess the likely effects of regulation on markets is particularly relevant in Russia. In the current phase, when market needs are changing quickly and the regulatory reform agenda is particularly heavy, the risk of making bad regulatory decisions is high.

The Russian government has already acquired some mechanisms to assess potential regulatory impacts. Its rules on law drafting call for the developing of skills in evaluating the effects of new laws and regulations. Its Technical Regulation Law requires cost-benefit analysis of proposed technical regulations. The Audit Chamber may prepare financial analyses of draft federal laws and other normative acts that entail budgetary costs. Draft laws must be vetted by the government and notably by the Ministry of Finance if they incur

costs. A new initiative of the Ministry of Economic Development and Trade requires independent evaluation of draft regulations.

While this is a good starting point, Russia is still some way from making regulatory impact assessment a formal requirement. Russian policy makers are not yet in a position to base their decisions on a clear assessment of the costs and benefits of proposed regulations, such as their impact on economic activity. The Russian government should investigate implementing a more systematic approach to RIA.

But implementing a fully functioning RIA system is a long-term task, involving the progressive development and dissemination of much expertise and the refinement of implementation and control mechanisms. In Russia, it will also require a cultural change in the public administration, the political class and many groups outside government. On the other hand, the OECD has developed an extensive database of country experiences and good practices that Russia can consult.

Box 2.3. **Methods used in Regulatory Impact Analysis**

Benefit-cost analysis (BCA) is highly effective in dealing with efficiency issues preferences, and in comparing alternatives. Because it is usually the most expensive approach, BCA is often reserved for major regulations with large economic effects.

Cost effectiveness (or cost-output) analysis is a partial version of BCA. It does not attempt to convert benefits into monetary terms, but evaluates them using other measures, such as the degree of risk reduction or the number of lives saved. BCA is a less-than-ideal tool in judging a policy that may produce a number of different benefits, since it does not permit the analyst to make a cumulative evaluation. CEA is also of limited usefulness in answering the recurring "threshold" question: Is a given regulation necessary or desirable?

Compliance cost analysis is narrower still in scope; it does not attempt to quantify benefits at all. Rather, it focuses on costs, which are generally easier to estimate. Compliance-cost approaches are of particular value where the overriding concern is whether the cost of a proposed regulation is feasible or proportionate or reduced to the minimum.

Business (or small-business) impact analysis is a partial variant of compliance-cost analysis. It focuses on the costs to business generally or to small and medium-sized enterprises in particular. By far the largest cost of much regulation is borne by the business sector. This kind of analysis will identify most direct costs, but it will not capture costs to consumers, governments or other non-business groups.

Fiscal or budget analysis is still another variant of compliance cost analysis. It considers only the budgetary implications of the regulatory proposal for government, which is usually a very small part of total costs. This form of analysis can yield quite precise results. It may be particularly useful where a potentially high-cost strategy for compliance and enforcement is a key element of a proposal, or where different levels of government will share the costs.

Risk assessment attempts to quantify risks. This method is helpful in answering the "threshold" question of whether or not to regulate. It can be tricky to use because of the differences between "real risk" and "perceived risk," and because of society's complex reactions to risks of different kinds.

Risk-risk analysis considers risks as explicit trade-offs. It asks whether offsetting risk increases occur as an indirect result of a policy choice and whether these are significant to its effectiveness. This approach takes a wide view of consequences, but it requires a lot of data and very sophisticated analysis.

Building regulatory agencies

Russia has given high priority to restructuring a number of its infrastructure industries – electricity, the railways and telecommunications.[23] Substantial improvements in efficiency and service are possible in all these industries. But the fate of these reforms will be largely determined by the quality of the regulatory institutions set up to guide the reform process.

The regulatory structure being proposed for the Russian infrastructure industries is very complicated, especially for electricity and the railways. Institutionally, it is to consist of a web of government agencies at both national and regional level. Division of responsibility is further complicated by the fact that the different agencies involved will report to different parts of the government.

On top of the array of regulatory institutions concerned with economic and service issues, environmental, safety and technical issues will generate still another layer of regulatory institutions. This mass of different institutions is complex and loaded with the potential for contentious bureaucratic wrangling. It is not yet clear where some critical responsibilities will fall.

Infrastructure industries are inherently complicated. They require of the regulator a carefully calibrated mix of restraint and intervention. The regulatory regime needs to be simple, responsive, coherent, consistent, and transparent. This blend of characteristics is hard to achieve within a single institution. To assemble it in Russia, with its multiplicity of bureaucratic institutions, will be especially difficult.

It is a basic principle in most OECD countries that regulatory decisions in infrastructure industries should be taken on the basis of clear and transparent criteria, by entities which are fully independent of political influence and of private economic interests. Politics and private economic interests are always difficult to fully exclude from consideration. But if they are allowed to influence regulatory decisions, especially if they do so in a non-transparent manner, the result will be a loss of confidence for both consumers and investors.

Russian regulatory agencies appear to derive their authority from a variety of laws. These laws generally delegate power to the government, rather than directly to the regulator. While regulatory agencies in most OECD countries are empowered directly by law, those in Russia derive their authority by sub-delegation from the government. Powers that the government grants the government can also take away. This situation opens the door to political manipulation of the regulatory process. It also helps explains why the government appears to have the power to dictate methodology and to rescind regulatory decisions.[24] Direct vesting by law would give the regulatory authority more permanence and independence.

An extraordinary amount of work needs to be done in a very short time to prepare Russia's regulatory system for the new markets in the railway and electricity sectors. It will take very great efforts by the regulators and by officials at all levels of government. It will require radical changes and will call for voluminous research and robust negotiation. It will need much consulting, learning and writing. Russia would commit a costly error if it went forward half-prepared in the hope that mistakes or uncertainties could be remedied along the way. Reform programmes in too many OECD countries have faltered or failed due to poorly designed regulatory systems.

But designing independent regulatory agencies is very hard. As many countries have discovered to their chagrin, there is no singular institutional model for the independent regulator. Even the most independent, if they are under-equipped and unsupported, will be unable to carry out their assigned task. Governments have tended to rely too much on regulatory agencies that are underpaid and understaffed to carry out tasks that are beyond their capacities.

The design of regulatory agencies must fit the institutional and historical context, and that context is unique to each country. Since a regulatory regime is an interdependent system, redesigning it requires a systemic approach. The task of establishing a market-oriented regulatory regime should involve all institutions with significant influence on policy design and implementation. This will help avoid unhealthy focus on single components of the system, to the exclusion of others.

The Russian authorities will need to consider the concept that independence flows from a well-designed mix of incentives, authorities, and procedures involving a range of actors. The key question is whether the checks and balances built into the system are sufficient to prevent capture and ensure competitive neutrality.

Conclusions and recommendations for reform

Three main issues need to be addressed if Russia's regulatory environment is to be transformed:

- An improved and strengthened regulatory policy agenda must be adopted at the highest political level. It must contain explicit and measurable standards for regulatory performance. It must provide permanent institutions and procedures for regulatory management.
- Public-sector institutions will have to be revamped. Competing and overlapping structures will have to be eliminated. Internal and external accountability should be a top priority.
- Regulatory policy continues to be implemented inconsistently across the Russian regions. The federal reform strategy should create a rational and consistent regulatory environment throughout the country.

Outlined below are recommendations for improving regulation in Russia. They are based on an in-depth analysis of the Russian situation, on the concrete experience of OECD countries and on the recommendations of the 1997 *OECD Report to Ministers on Regulatory Reform*.

Adopt a clear policy on regulatory reform that establishes objectives, accountability and a framework for implementation.

A clear reform policy, adopted at the highest level of government, should integrate the various reform efforts now underway and establish a uniform set of quality standards. It should spell out the principle that regulations will be imposed only if its costs are justified by its benefits. A system needs to be developed to evaluate the impact of regulations once they are in place. Successful regulatory policy will require unambiguous accountability. Regulatory reform should be co-ordinated with competition policy, with efforts to ensure market openness and with the reform of the public administration.

Experience in OECD member countries has shown that the adoption of regulatory policy at a high political level lends it authority that it would not otherwise enjoy.[25]

Strengthen the principles of competition and market openness government-wide, perhaps through revised mission statements.

A sustained effort is needed to embed good regulatory practices into the culture of the public administration. The government should explicitly mandate all government bodies to support the principles of competition and market openness. All ministries should work to eliminate constraints on competition within their jurisdictions, to respect the principle of market openness and to reduce anti-competitive behaviour by the state itself. Ministries should co-ordinate regularly with the Federal Antimonopoly Service. That service's annual report should assess the consistency of ministerial actions with the principles of competition and market openness.

Russia's aspirations to enter the World Trade Organisation should catalyse the reform process. Sectors that fear being exposed to foreign competition will undoubtedly seek to remain protected by unduly prolonging the WTO transition periods. Experience in OECD countries, however, shows that adjustment is inevitable and that it should be pursued intentionally and early rather than be forced during times of crisis.

Restructure the government apparat to strengthen its capacity for strategic policy management.

The government *apparat* (the staff of the prime minister's office) will have to be reformed. The administrative reform plan foresees that the *apparat* will focus increasingly on government-wide strategic planning, policy evaluation and monitoring the implementation of the overall government programme. To prepare for those tasks, the *apparat* should eliminate its sectoral departments. It could transfer some policy responsibilities, and possibly staff, to sectoral ministries.

In most OECD countries, the main job of the cabinet office is to co-ordinate the diverse activities of individual ministries and agencies. Similarly, the new Russian *apparat* could:

- Co-ordinate preparation for meetings of the Council of Ministers, set the agenda and distribute background material to participants.
- Co-ordinate efforts to ensure that draft laws conform with the Constitution and with existing law.
- Co-ordinate preparation and approval of the government's strategic priorities and work programme, and ensure their budgetary back-up.
- Co-ordinate the preparation of proposals for decision by the Council of Ministers, oversee their development by individual ministries and groups of ministries and see to it that proposals fit with each other and with the government's priorities.
- Co-ordinate the government's communications.
- Co-ordinate the monitoring of the government's performance and ensure that it keeps its promises to the public.
- Co-ordinate relations between the government and other parts of the state, including the president and parliament.
- Co-ordinate work on strategic priorities involving several ministries – such as the reform of the public administration, regulatory reform and the government's relations with the regions.

Establish unit to promote regulatory quality and guide regulatory reform.

Reviews of OECD countries show that having a specific institution located as close as possible to the centre of government can be a valuable asset to promote regulatory quality and guide regulatory reform. The concept of regulatory quality needs to be integrated into the central policy making machinery of Russian government. The main aim of the new unit would be to ensure that government regulations contribute to the country's economic and social development. While individual ministries should adhere to regulatory quality principles in their areas of competence, overall regulatory oversight should remain at the centre of government.

The new unit should have:

- The authority to make recommendations to the centre of government.
- The ability to collect information and to co-ordinate regulatory reform programmes government-wide.
- The resources and analytical expertise to provide an independent opinion on regulatory matters.

In the short run, the unit could take the lead in promoting and developing Regulatory Impact Analysis (see below) and prepare periodic public reports on ministries' progress in improving regulatory quality. Eventually, the unit could develop and advocate specific reforms. Within two years, it should be in a position to set performance targets, timelines and evaluation requirements. It should review regulatory proposals from ministries on the basis of quality principles. It should advise the centre of government on reform proposals from regulatory bodies in the government.

Most OECD countries that have an effective regulatory policy also have a central oversight unit.[26] It would seem that a centrally located unit does more than simply improve co-ordination between existing agencies but is essential to ensure that regulatory quality principles are successfully applied. Such units serve as advocates for reform, as critics (when they review regulatory impact analyses) and as a source of practical and technical support for the use of regulatory tools.

Institute an effective practice of Regulatory Impact Analysis as a strategic tool to support regulatory policy.

In many OECD countries, the effective and systematic use of Regulatory Impact Analysis (RIA) is a key component in ensuring regulatory quality. While Russia is beginning to conduct budgetary assessments, it does not systematically take into account the overall costs and benefits of regulations from a social and economic perspective. This situation should be improved. RIA should be instituted as a systematic framework to rationalise existing practice and allow for a sounder *ex ante* decision-making process. To this end, RIA needs to be made a part of the legal framework governing the preparation of regulations.

Initially, RIA could be confined to significant proposals (perhaps a hundred a year). The regulatory quality unit should define precise criteria for identifying regulations subject to the assessment requirement. In addition, it could have the power to demand a RIA in certain cases. A key task for the regulatory quality unit will be developing a methodological guide and training materials for this purpose. The RIA process should also include prior consultations and results should be made public in a timely manner.

Pursue and extend administrative simplification.

The experience of many OECD countries shows that administrative simplification is key to minimising the cost of regulation. While the "de-bureaucratisation" package brought about much improvement, regulations and regulatory procedures continue to be more complicated than they need to be. Excessive red tape, however, is only part of the problem: businesses continue to face major problems because of the *instability* of the regulatory frameworks they confront.

The authorities should improve the clarity and simplicity of regulations through better and plainer drafting. The complexity of the existing regulatory regime and the incomprehensibility of some regulatory texts are serious problems. Where possible, the authorities should promote the adoption of alternatives to traditional regulation. Various alternatives to traditional command-and-control regulation can increase effectiveness and lower costs. Where rigid laws and an outdated legal culture inhibit innovation and experimentation, broader legal reforms may be necessary.

Licensing regimes merit attention. Scores of activities continue to be subject to licenses that would not be required in most OECD countries. Many of these licensing regimes should be scrapped. The principle must be established – in practice and not just on paper – that whatever is not forbidden is permitted. Where it is necessary to keep licensing regimes in place, they should be revised to increase transparency and limit official powers of discretion. Automatic sunset clauses are another tool that could be introduced. This would force the authorities into a systematic review, under threat of their expiry at a certain date.

Finally, a statistical effort to measure the economic burden of regulations – whether an individual measure or a whole complex set of regulations – could help steer the current simplification efforts towards maximising their economic benefits and fixing clear objectives for the future. The World Bank/CEFIR business survey shows that such an approach is feasible in Russia.

Fight corruption by improving transparency in applying regulations.

Greater transparency, the elimination of unnecessary regulation and the simplification of administrative procedures will be critical to fighting corruption. Several OECD countries have sought to reduce corruption in the application of regulations and administrative formalities. Mexico conducted a thorough review of its administrative formalities and procedures, particularly licenses, permits and concessions. In the light of this review, the Mexican government simplified, re-engineered or eliminated certain procedures. It thereby reduced the potential for abuse and contributed to a more transparent and efficient environment for businesses. Russia could follow Mexico's example by undertaking a thorough review of the regulatory regime and creating a single authoritative source for administrative procedures. Such an official registry, made available through the Internet, would significantly enhance the transparency of the regulatory regime.

Enhance the status of regulatory quality within sub-national government bodies, focusing on accountability, transparency and free-market orientation.

Russia has had only mixed success in transferring policy-making powers away from the central government to the regions. Such decentralisation can improve governmental responsiveness and local accountability, but experiences in several other countries

indicate that devolution must be accompanied by adequate safeguards. Very rapid devolution, like what happened in Russia in the 1990s, can impair the quality of governance. Regional governments may simply not be up to creating and administering good regulations.

In Russia, the safeguards needed to accompany devolution are not yet fully in place. Unless regulatory skills are improved in regional and local governments, further decentralisation could roll back the progress in regulatory quality that has been achieved so far at the national level. To date, it has been the courts that have sanctioned abusive regulatory practices after an action by a federal ministry or the competition authority. But even though the courts are becoming more efficient and responsive, recourse to them is still too costly for individuals and small businesses. The central authorities should accompany after-the-fact controls with accountability and transparency measures. Regional governments should be obliged to publish proposals for new regulations and hold consultations on them before they are adopted. This technique could reduce regulatory overlap and the exercise of undue political influence by special interest groups. Indirectly, it could discourage constraints on competition and even corruption. At a minimum, regional governments should be expected to apply the *1995 OECD Recommendation for Improving the Quality of Government Regulation* and its accompanying checklist. Publishing benchmarks of regulatory performance, such as the number and quality of business licenses granted, could also highlight best practices and shame laggards.

Continue to advance judicial reform.

Although it has figured only marginally in these recommendations, the Russian judiciary is a vital factor in the future of regulatory reform. It could well be the missing link in the overall structure of interlocking institutions that together can establish the incentives and pressures for high-quality regulation. In most OECD countries, the ultimate check on administrative abuses is the potential for review and reversal by the courts. But such deterrence has to be credible to be effective. It is particularly important in Russia that there be available an effective and practical infrastructure for dispute settlement. Once direct intervention by the government recedes, the role of the objective arbiter will become crucial.

Notes

1. This provision is somewhat awkward in the case of complex federal subjects like Truman and Krasnoyarsk, where one or more federal subjects exist inside another.
2. Article 71 of the Russian Constitution grants the federal government exclusive jurisdiction over important areas of economic policy, including establishment of the legal foundations of the market system; regulation of financial, currency, credit and customs matters; foreign policy and international treaties; and foreign economic relations. Article 72 lists matters under the joint jurisdiction of the central government and the regions, including the ownership and use of land, mineral resources, water and other natural resources; the delimitation of state property; environmental protection; public health; and taxation.
3. See North and Weingast (1989) and Weingast (1995).
4. Stoner-Weiss (2001) provides detailed examples of regions' legislating in direct opposition to federal law and the Constitution. In 1996, the Ministry of Justice reported that, of 44 000 regional legal acts it had reviewed, nearly half did not correspond with the Constitution.
5. See Desai and Goldberg (2000); Hellman, Jones, and Kaufmann, (2000) and Hellman, Jones, Kaufmann, and Schankerman (2000).
6. Stoner-Weiss (2001).

7. Desai and Goldberg (2000) report that in certain regions the interdependence between government officials and business managers gave the latter quasi-governmental powers, including influence over the law-enforcing apparatus.
8. See Orttung (2002).
9. In the hierarchy of federal legislation, a federal law is the highest form. Next come "normative acts," a catch-all Russian term which includes acts of the President and statutory acts issued by the government and governmental agencies. These acts specify more detailed rules and regulations than do federal laws. A federal law must be promulgated before the normative acts supporting it can be developed.
10. The Constitutional Court, Higher Commercial Court, and the Supreme Court of General Jurisdiction also have the right to initiate legislation in specific areas.
11. Government Resolution #347, "On improving law-drafting activities of the Government of the Russian Federation", 15 April 2000.
12. Regulation 803 "On Better Organisation of Enforcement of Federal Laws".
13. Law 184-FZ of 27 December 2002, On technical regulation.
14. Curiously, there is no such requirement for draft laws submitted to the Duma.
15. The description of the draft law, its objectives and key provisions should contain an extensive characterisation of the law, including a description of its structure, legal terminology, objectives and anticipated effects, as well as extracts of the draft regulation that clearly represent its purpose and concept. Plain-language drafting is required.
16. Government Decision 98, "On securing access to the information about the work of the Government of the Russian Federation and federal executive authorities", 12 February 2003.
17. See *www.government.gov.ru*. Another programme run by the President's Administration – the Reform Line – will provide an interactive platform for public dialogue on issues pertaining to state supervision. No data on implementation are yet available on the Reform Line. Nor is much information on implementation available on E-Russia, which is still fairly new.
18. Presidential Decree 188, of 6 March 1997, detailed the types of confidential information that are not subject to official publication and need not be promulgated to the general public.
19. *www.government.ru*, set up under the Electronic Russia programme.
20. "O statuse" (2001).
21. "Ob arbitrazhnykh sudakh" (2003).
22. Good RIA practices and case studies are available in OECD (1997), *Regulatory Impact Analysis: Best Practices in OECD Countries*, Paris.
23. The reform of the natural gas sector has been postponed repeatedly. It is not clear that any substantial reform will be undertaken in the foreseeable future, see OECD (2004).
24. For instance, under the recent government restructuring, the Economic Development and Trade Ministry can now order FTS to follow procedures and methodologies of the ministry's own making.
25. The following OECD countries have adopted government-wide regulatory quality policies: United States – 1981; United Kingdom – 1985; Canada – 1986; Denmark – 1993; Netherlands – 1994; Mexico – 1995; Hungary, Ireland, Finland – 1996; Italy – 1999; Japan, Korea – 1998; Czech Republic, Greece, Poland – 2000. See the Background reports on "Government Capacity to Assure High Quality Regulation", available at *www.oecd.org/regreform*.
26. Twenty of 22 OECD countries which have such units locate them either in the prime minister's department or the office of the president or else the budgeting agency. Fewer than half of the countries with dedicated reform bodies in 1996 did so. This rapid shift suggests an increasing recognition that the effectiveness of these bodies is enhanced by their being directly linked to the centers of political and administrative authority.

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Chapter 3

Competition Law and Policy*

* For more information see: "Background report on The Role of Competition Policy in Regulatory Reform" available at *www.oecd.org/regreform/backgroundreports*

Introduction

When the Russian Federation began its transition toward a market economy, competition emerged as a new and unfamiliar theme in policy making and law enforcement. In 1991, Russia created a competition authority and adopted a basic competition law. It enshrined the principle of competition in the new federal Constitution in 1993 and also in other fundamental legislation.

In 2003, the Organisation for Economic Co-operation and Development undertook a detailed assessment of Russia's decade of experience with competition law and policy. The OECD concluded that, despite the prompt passage of competition legislation and repeated expressions of support for the idea, the creation and protection of competition had *not* in fact become a policy priority in Russia. The country's rush to privatise state-owned industries had left little time for pre-privatisation efforts to restructure or divide enterprises to promote competition. Since then, the competition authority has been expected to serve not only as a general regulator of behaviour in the markets, but also to fill in legislative gaps and to combat a variety of undesirable practices.

The report found that serious structural and legal problems have also interfered with the competition authority's ability to do its job. The overly-broad responsibilities assigned to the authority, together with a lack of credible sanctions, have limited the impact of competition law. Additional problems include inadequate investigative authority, a lack of clarity in the applicable legal standards and a lack of substantive economic analysis to back up enforcement decisions.

Just a few weeks after the report's publication, the Russian government undertook a fundamental restructuring of federal executive bodies, including the creation of a Federal Antimonopoly Service with a narrower focus than that of the authority it replaced. Government sources describe a new competition law as a high priority for the near future. Work on drafting such a law is going ahead, and the government now has an excellent opportunity to address the problems identified in the OECD report, both in the institutional structure and the legal framework.

As Russia moves into a new phase of economic expansion, a strong and effective competition policy will be more important than ever. The government is committed to broadening economic growth to include more industries and geographic areas, to raising living standards and to creating new opportunities for business and investment. But these goals can hardly be achieved without the removal of existing impediments to fair and vigorous competition in an open and transparent environment – especially to the entry of new participants into the market.

Strengths and weaknesses of competition policy so far

Within little more than a decade, Russia has transformed a large number of its economic and legal institutions, replacing many of them with completely new structures. The creation of a competition-based market economy has been an explicit goal of this

process. Strong support for competition was expressed in both the Constitution and the Civil Code. A competition law was quickly passed and a competition authority created. In practice, however, the competition authority has had to operate in a shifting policy environment, where the creation of robust domestic competition and the enforcement of competition law have often been secondary concerns. The establishment of true competition has been crowded out by such matters as the rapid privatisations, the financial crisis and recovery of the late 1990s and the creation of internationally competitive companies.

Despite difficult circumstances, the authority *did* make important contributions, both through its enforcement activities and its participation in policy making and law-drafting. Among its achievements was a substantial reduction of direct barriers to the movement of goods and services within the country. The competition authority also took a leading role in creating the basic legislation on consumer protection and advertising regulation. It led the original drafting of the law on natural monopolies, which includes a narrow definition of such monopolies. Over time, the authority has continued to play an active part in natural monopoly reform, proposing models for the restructured industries and supervising the conduct of their newly-formed components to insure non-discriminatory access for competitors.

But the authority encountered serious structural and legal problems. Chief among them was the breadth of its own responsibilities. Its initial remit was to civilise markets while protecting the interests of weaker parties and of the public. But this concept led to overtasking. The authority was assigned duties in the areas of consumer protection and advertising regulation. It was expected to supervise commodity exchanges and protect small businesses. These and other duties required different sets of skills and a wide range of different procedures. The agency's resources were scattered and its focus blurred. The situation was further aggravated by the addition of new enforcement activities. In 2002, new language added to the Law on Competition assigned the competition authority the further task of enforcing rules on competitive state purchasing. In connection with the reform of the electricity sector, the competition authority is to supervise the dispatcher in the wholesale electricity market. Rules are currently being developed that require non-discriminatory purchasing by natural monopolies; the competition authority will enforce those rules, too.

The Law on Competition is fairly complete in its area of coverage, but it does not provide the authority the tools it needs to be effective. It contains no credible sanctions. For even the most serious and damaging violations of the law, the violator faces little more than the prospect of a cease-and-desist order. Fines are too small to have any deterrent effect; in any event, they are imposed only upon failure to obey a direct order or to file required information. Criminal sanctions for some violations are provided for in the Criminal Code, but none has ever been applied. Just as serious, the law fails to provide the authority with the power to carry out needed investigations. Procedures for obtaining information are cumbersome; they usually take the form of written requests. Failure by any party to comply with a request for information can be sanctioned by nothing more serious than a small administrative fine and a repeated request. The authority cannot compel anyone to testify. In theory, it can search premises, with the co-operation of local law enforcement officials; in practice, however, the procedures are complicated and searches rarely occur.

The lack of effective powers is compounded by an unreasonably large workload. The authority may not refuse cases brought to it. Some provisions of the competition law are much too broadly worded. The authority is required to examine and rule on very small mergers. And the regulations on the behaviour of monopolies are full of loopholes. Many cases that the competition authority must handle are repetitive, trivial and unlikely to have a meaningful effect on competition generally. Large sums have been spent on the full-dress handling of disputes between individual entrepreneurs and state bodies, and between monopoly utility providers and individual customers. The costly investigations and hearings generated by such cases do not appreciably enhance competition in general. They could be more efficiently performed by other bodies, or under more streamlined procedures. In 2002 alone, the authority was overwhelmed with 25 000 merger control matters; it was clearly impossible for the staff to carry out serious analyses of most cases within the legal time limits. This enormous caseload, together with difficulties in obtaining information and in recruiting trained staff, has resulted in a marked lack of economic analysis to underpin the authority's decisions. Deficiencies in analysis have, in turn, reduced confidence in those decisions, and in some cases led to reversals on appeal.

If the newly-created Federal Monopoly Service is to deal efficiently with the most serious competition issues and to perform its enforcement functions in recently deregulated sectors of the economy, these problems must be met and resolved. Solutions must be embodied in the design of the new service and in the provisions of the new competition law.

Priorities in drafting the new competition law

Credible sanctions for violators

The law must provide credible sanctions: substantial fines or other penalties that can be imposed directly upon a finding of violations, rather than after a failure to follow a cease-and-desist order. Fines must be high enough to provide serious deterrence. They will have to take account of the violator's size and economic importance. (One possibility is to express fines as a percentage of a company's turnover, a practice already followed in some other countries).

Private actions for damages should be encouraged, both as a supplementary sanction against violators and as a way of increasing awareness of competition issues in the business community. The continued existence of criminal penalties will provide clear evidence of the government's serious commitment to competition. It would also enhance deterrence, and it could be used as leverage in a leniency programme. But if criminal sanctions are to have any real effect, at least a few criminal prosecutions must be undertaken. This will require some changes in the law. It will also entail new arrangements for co-operation between the antimonopoly service and prosecutors. Criminal sanctions (which apply only to individuals) cannot, however, substitute for stiff monetary penalties imposed on enterprises through civil or administrative proceedings.

Sharply reduce merger control cases, improve economic analysis and structural remedies

The number of merger filings received each year now exceeds 25 000. It is far too large to allow any real economic analysis. The merger control threshold will have to be raised significantly to allow for something more than a brief review of each file. Consideration should be given to rules that would prevent a single, large company with an asset value

that meets the combined threshold from being required to notify – and the FAS not be required to review – every transaction it concludes. A minimum value for the second company participating in the transaction could serve this purpose. As Russian accounting practices move toward international standards, and as objective market valuations of transactions become more readily available, rules on mergers should be based less and less on asset values. They should be increasingly based on transaction values or other measures that more accurately reflect the economic activity of parties to a transaction, such as turnover.

Even with a vastly reduced overall caseload, it may be a good idea to set up a two-tier review system, under which mergers that are unlikely to affect competition to be dealt with quickly on the basis of summary information. A longer time-frame and a more thorough information-gathering procedure would be made available for the analysis of those cases that are of greatest concern. The law should provide explicitly for structural remedies, such as the requirement that certain assets be sold to unrelated parties to ensure competition in particular products or markets. Increased use of structural remedies, as opposed to behavioural remedies that impose restrictions on post-merger pricing or production and sales, would reduce the need for continuing detailed supervision of the business activities of companies. It would help the FAS to accommodate mergers aimed at enhancing international competitiveness without, by the same token, permitting monopolisation or inviting abuses in domestic markets. Parties to transactions should not be able to hide their true ownership or corporate structure behind straw men or offshore companies. The law should grant the FAS express authority to demand all necessary information from the parties. If its requirements are not met, it should have the right to refuse consent to the merger proposal or impose penalties.

Of equal importance, though nor a matter for specific legal texts, will be political support by the government for a strong regulatory stance in these areas. The desire to attract inward investment should not result in pressure being exercised on FAS to approve transactions where the parties fail to provide full information on their beneficial ownership and control.

In cases involving state actions, a new focus on protecting competition

Before 2002, the provisions of the competition law on anti-competitive actions by state bodies were interpreted far too broadly. In general, any action by the state that violated the rights of an individual entrepreneur or business was held to be a competition-law violation – even if the action had no effect on competition. An amendment to the law in 2002 appeared to resolve this problem. It requires the antimonopoly body to show both that a violation has occurred and that it had a restrictive effect on competition. But the amendment did not immediately reduce the number of state-action cases brought to the FAS.

Provisions of the competition law need to be even more tightly focused on the protection of competition, rather than on that of individual companies. Cases concerning denials of licenses, lease renewals, zoning disputes, land rents and similar matters should be referred to the courts or other dispute-settlement bodies. FAS should *not* be required to decide whether a given governmental action is "groundless" and therefore constitutes improper interference with a given individual or firm. In cases where a state action or policy *does* affect competition, a more complex standard of evaluation is needed. The effort should be made to balance the impact of an action on competition generally with the legitimate needs and responsibilities of the government. To achieve a clearer focus in this

area will require the elimination of vague legal prohibitions on "groundless" actions by the state – and their replacement by a clearer definition of what constitutes a violation.

Clear legal standards for agreements and effective enforcement against restrictive agreements

Investigating and prosecuting anti-competitive agreements has proved to be a challenging task for Russia's competition authority. Part of the difficulty lies with the authority's lack of investigative authority. But ambiguous legislation, and unhelpful amendment and unclear standards of proof have also complicated the task. The Law on Competition contains provisions on vertical agreements, on horizontal agreements and on "co-ordinated actions" or "concerted practices". But no definition of "concerted practices" has ever been adopted. Some courts, when reviewing questionable agreements, have resorted to extremely restrictive standards of proof. An amendment to the Law on Competition, adopted in 2002, contains the confusing requirement that the participants in an illegal vertical agreement must collectively hold 35% of the market in question. Another new provision forbids the competition authority to clear any horizontal agreement that has not been voluntarily submitted for prior approval. Clear legal provisions for both vertical and horizontal agreements are needed; drafting them should be a legislative priority. A specific description of what constitutes adequate proof in various kinds of cases is not a matter for legislation, but guidelines are needed on how to conduct investigations and how to apply the law in markets characterised by oligopoly and by high degrees of vertical integration.

What must be done to strengthen the FAS

Increasing FAS's investigative powers

The competition law requires police and other government bodies to assist the competition authority in gaining access to premises and other investigative tasks. But members of the FAS staff report that obtaining such assistance can be difficult and result in significant delays. The law also requires businesses and others to provide the authority with information it requests, but the enforcement of this obligation is also time-consuming, and the sanctions for non-co-operation are very weak. If this situation continues, the authority will remain inefficient and will probably never obtain evidence of the most serious violations. If it is to uncover cartels and other very serious violators, FAS must be empowered to obtain the kind of evidence that is likely to be destroyed if its owners are tipped off in advance. It must also be able to compel testimony from relevant witnesses. If the government does not wish to hand such powers to the FAS itself, it must provide more effective mechanisms than now exist for co-operation with the police, prosecutors and other authorities. Stiffer and more immediate sanctions must be imposed for a failure to provide information that is requested in writing. Penalties could be designed without increasing delays in compliance. The deliberate provision of false information should be defined as a separate violation, of a different order from mere delays, and should be subject to more severe penalties.

Allowing FAS to focus solely on competition issues

Till now, the competition authority's tasks have been too broad and too varied in nature for any single body to perform well. The creation of the new Federal Antimonopoly Service has gone a good way toward narrowing the authority's focus. Issues of consumer protection, the regulation of small businesses and tariff-setting have been assigned to

other bodies. Even now, however, care needs to be taken to ensure that the service can concentrate on the most serious competition problems. The new body is still responsible for enforcing advertising laws and some aspects of the law on natural monopolies. And it has been assigned some supervisory tasks related to the reform of natural-monopoly sectors. Some of these new tasks are indeed closely related to competition concerns, but others are not. It may be appropriate to shift some of the enforcement burden to other bodies. For example: some violations of the advertising law are clearly related to unfair competition, but rules limiting the advertisement of alcohol and tobacco and those governing the placement and duration of television ads are not primarily concerned with promoting or protecting competition. Enforcing the latter requires special skills, technical facilities and work patterns. The government should consider assigning those tasks to the federal bodies that routinely handle publishing and broadcasting matters.

Relieving FAS from the burden of settling disputes between monopolies and customers

Because there is no comprehensive regulation of Russia's natural monopolies, the competition authority has been burdened with the handling of a large number of abuse-of-dominance cases. These are essentially disputes between regulated monopolies and individual customers over service obligations, tariffs or contract terms. Till now, the resolution of these cases has entailed quasi-judicial proceedings, in which the antimonopoly body was required formally to prove the defendant's dominant position as well as the alleged abuse. The remedy applies only to the case in hand and is thoroughly inefficient. It leads to repetitive consideration of the same issues. It spawns lengthy appeals, in which all the issues may be re-argued. The authority's rulings are sometimes maintained on appeal, and sometimes overturned. A far more efficient procedure to resolve these problems would be by way of a detailed and comprehensive before-the-fact definition of permissible contract terms and service obligations. This should be done by independent sectoral regulators, who would also be responsible for resolving complaints and disputes in this area. They would use simplified proceedings, and their rulings would be binding on the regulated monopoly in similar situations in the future. The regulators could make decisions on such matters as the permissible contract terms that are consistent with the pricing models being used to set tariffs. For example, the acceptability of contract terms requiring customers to cover the costs of new lines or infrastructure upgrades is related to whether usage tariffs are calculated to include those costs as well. Such an approach would avoid the repetition and inconsistency inherent in the current system. The FAS would be relieved of having to serve as the forum for thousands of specific complaints. But it could continue to serve in a supervisory role. Through its authority over anticompetitive actions and decisions by state bodies, it could adjust any undue restriction on competition imposed by the regulator.

Unfortunately, the government's current plans do not seem to include strong and independent regulators of the kind we have just mentioned. Moreover, it is probably not appropriate to transfer dispute-resolution functions to a unified tariff-setting body. Nonetheless, there is still a need for clearer and more comprehensive regulation of natural monopolies. And the competition authority needs a separate, more streamlined procedure for the settlement of these types of disputes.

Reduction or elimination of the FAS role in overseeing public purchasing

The 2002 amendments to the Law on Competition introduced "antimonopoly requirements" for most state purchasing. The same amendments appear to vest the competition with the responsibility to supervise all such activities and void tenders when improper conduct is discovered. In the financial services sector, the authorities' responsibilities are even more extensive. Not only does the law require generally that all services provided to state bodies be subject to tender, but also that the terms of tender for all public purchases of financial services be submitted to the FAS for prior approval. The volume of state purchasing is enormous, and these provisions may well impose a limitless drain on FAS's resources. The service could find itself attempting to monitor public purchases at all levels. It could be drawn into endless disputes as to whether the specific requirements in a given tender are appropriate, or have been drawn to give an advantage to a certain supplier. The requirement that state bodies use competitive purchasing procedures may indeed stimulate competition in a variety of markets. But the enforcement of that requirement should be entrusted to financial or auditing bodies, and they should be backed up by a system allowing companies to make private complaints about exclusionary or unfair bidding processes and receive compensation for damages or review of the decision.

It has also been suggested that the competition authority take on the supervision of purchasing by natural monopolies with newly-formed regulatory structures, so as to ensure that such purchases do not favour related companies or otherwise restrict competition. In the Russian environment, such concerns are quite legitimate. Some infrastructure monopolies, notably the railroads, are selling off non-core holdings simultaneously with – rather than prior to – the other early steps toward structural reform, and so may continue to have an interest in benefiting related companies by directed purchasing and acceptance of higher purchase prices. Supervising these activities will, however, entail many of the same problems as supervising state purchasing. It would require FAS to become involved in the business activities of the relevant entities, in great detail and over a considerable period. This, too, is a task that would be more appropriately performed by sectoral regulators than by the competition authority.

Broadening responsibility for the support of competition

Assigning responsibility for all competition issues to the competition authority alone has resulted in an unrealistic multiplication of its tasks and responsibilities. It has also fostered counter-productive attitudes on the part of branch ministries, the privatisation authorities, tariff regulators and others. Many of these agencies are unaware of competition issues or fail to see the connection between their own primary responsibilities and that of promoting competition. The detailed investigation of violations and the enforcement of competition law may be an exclusive prerogative of the competition authority, but the *general promotion and support* of competition is a core value enshrined in the Constitution and a key element of the government's economic policy. Such promotion and support should be the responsibility of every public body.

Assigning more specific responsibility for promoting competition or removing barriers to ministries, regulators or other bodies would enhance their appreciation of the importance of competition in a healthy economy. Price regulation, licensing and other remaining restrictions on competition are currently administered by a variety of public bodies. Making those same bodies responsible for reviewing those restrictions and removing (or proposing the removal) of as many of them as possible would have a

significant government-wide impact. The bodies concerned would be obliged to consider the impact on competition of regulations in their sphere of responsibility and to evaluate alternatives to them. This process would develop new skills as well as advancing regulatory reform and promoting competition generally.

Improving the staff's information-gathering capabilities

Competition authority staff say they do not have time to conduct such standard tasks as telephone interviews of market participants or distributing questionnaires. They complain that they do not receive timely and accurate information. The steps already recommended – reducing the authority's enforcement burden and beefing up its investigative authority – will in themselves improve its quality of information. There will be more opportunities to do such work and better information will be available. But more can be done. Information held by the state statistics office and branch ministries should be made available to FAS when needed for investigations or analyses.

The gathering and circulation of information about specific companies is complicated by the lack of clear legal rules on confidential information. Many public bodies and individual officials fear that they could be held responsible for damages caused by the improper revelation of confidential information. In the absence of specific rules on what constitutes sufficient protection of such information, the fear of possible liability discourages information-sharing. A recently-passed law made some progress toward defining what information may be considered confidential and what steps must be taken by companies to identify and protect it. On the other hand, rules on sharing such information among public bodies and the procedures to be followed by public bodies in using and protecting it have not yet been defined.

Improving the staff's ability to do economic analysis

The lightening of workloads and an improved flow of information are necessary to improve the work of the competition authority's staff. But they may not suffice to remedy its obvious lack of in-depth economic analysis. In 2003, only half the employees of the Ministry for Antimonopoly Policy held a university degree in economics, law or management. Advanced degrees in economics were very rare. Turnover rates at the authority have run at up to 25% a year, partly because much higher salaries are available in the private sector. In these circumstances, the FAS needs to give high priority to the recruitment and retention of qualified staff members, and providing them with practical training in economic analysis. The service might consider creating a specialised department of economic analysis, which would assist other departments on economic issues. It might also prepare training manuals and give members of other departments practical training in case investigation and analysis.

Improving transparency and increasing public awareness of the benefits of competition

High priority should be given to the preparation of information for the business community and the general public. These materials would explain the provisions of the competition law and the benefits of competition generally. The Russian public is largely unaware of the meaning and merits of competition (as opposed to competitiveness). Knowledge of competition law is very limited. In this environment, actions to enforce the law often bring charges of unfairness. With an increased awareness of the benefits of

competition and the provisions of the law, the business community and the public generally will be much more supportive of FAS. Indeed, they will tend to act as partners with the authority in the promotion of competition and the discovery of violators. Priority should also be given to improving public access to the authority's written decisions. Care should be taken to see that public notices contain not only the fact that a specific act or decision has been taken, but also the reasoning behind it. This will allow interested parties to develop a better understanding of how the law is interpreted and enforced, and will allow them to conduct themselves accordingly. This kind of transparency will help to reassure the business community and the public about the quality of the authority's analyses and the fairness of its findings. In the absence of transparency, its decisions may appear to be random, accusations of favouritism may seem credible and an atmosphere of insecurity and mistrust could develop which would *not* be conducive to investment and growth.

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OECD Reviews of Regulatory Reform: Russia
Building Rules for the Market

Chapter 4

Enhancing Market Openness through Regulatory Reform*

* For more information see: "Background report on Enhancing Market Openness through Regulatory Reform" available at *www.oecd.org/regreform/backgroundreports*.

Economic forces unleashed after the break-up of the Soviet Union have opened Russia inexorably to the outside world. Booming foreign trade – and, to a lesser extent, inward foreign investment – has rendered a return to the country's previous state of isolation and autarky virtually unthinkable. For Russia, the issue is no longer how to open its economy, or how much, but how best to profit from its new exposure to the rest of the world. In this connection, trade policy and regulations are of decisive importance, as is the economic environment in which they are developed and applied.

Russia has already made considerable progress in reforming its regulatory practices, particularly in the area of transparency. In recent years, the reform process has been accelerated by Russia's dialogue with the World Trade Organisation (WTO). A rash of new laws has been passed, aimed at preparing Russia for WTO membership. Business leaders interviewed for this study confirm that the business climate has improved in many respects. But much remains to be done. Elements of discrimination hang on, especially due to the lack of uniform implementation of legal and regulatory measures throughout the Russian territory. Unnecessary trade restrictions persist, affecting market access and the operations of both foreign and domestic firms. New laws and regulations are applied vigorously for the first few months, and then are gradually neglected. Trade facilitation and problems with customs are the main impediments. They hamper not only foreign operators, but also Russian exporters and importers and, in the long run, Russian consumers. Regulatory reform is still very much a work in progress.

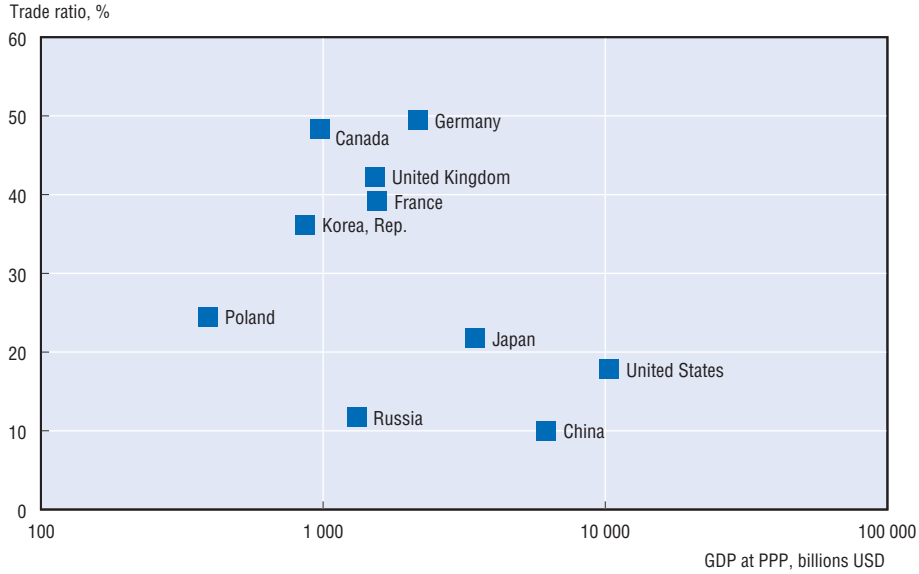
This chapter traces the path to date of Russian regulatory reform in the trade area and describes initiatives still in the planning stages. We pay special attention to the way in which rules are implemented. We use as our basic yardstick the six "efficient-regulation principles" developed by the OECD. We conclude with a series of policy options which the Russian authorities should consider as they move toward a fully open and efficient trading system.

The economic context: trade and investment

Russia's foreign trade has grown steadily over the past five years, from a total of USD 150 billion in 2000 to USD 280 billion in 2004. Fuelled by rising energy prices and dynamic domestic demand, trade turnover soared by some 30% in 2004 compared to the previous year. Russia registered a record trade surplus of almost USD 90 billion in 2004. Over the years since the break-up of the Soviet Union, Russia received a total of USD 26.1 billion in foreign direct investment inflows, a disappointing performance considering the country's huge investment needs, its vast natural resource endowments, its large and well-educated labour force and its potential domestic market.

Impressive as it has been, Russia's push toward openness has gone neither so far nor as fast as those of many other countries in transition. It has also been remarkably uneven across the Russian Federation. Some of Russia's regions resemble small land-locked countries. Others, which enjoy a wealth of exportable natural resources or a proximity to external markets, display a very large degree of trade openness. As a whole, however,

Figure 4.1. **Trade openness – selected economies, 2002**



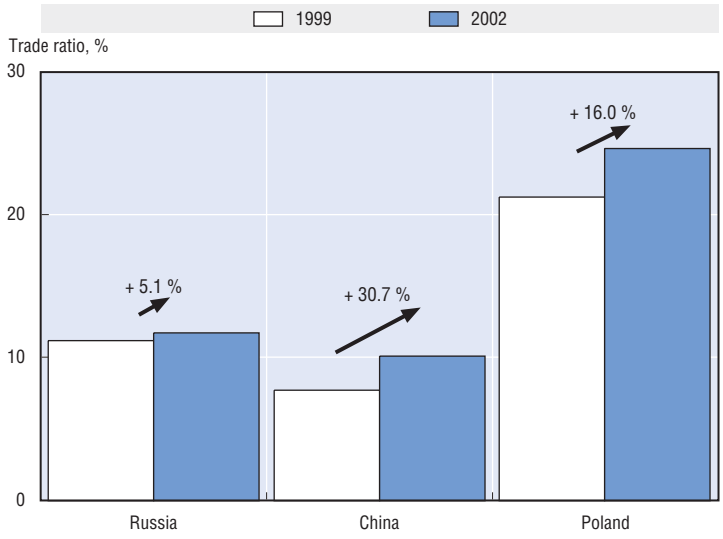
Note: Trade openness is the ratio of total imports and exports to Gross Domestic Product, calculated on the basis of purchasing-power-parity (PPP). Data for EU countries take into account intra-EU trade.

Source: IMF, World Economic Outlook Database, UN Commodity Trade Statistics Database (COMTRADE).

Russia has a long way to go to catch up with OECD countries and other transition economies (Figure 4.1). In 2003, Russia ranked 17th among world exporters, accounting for just 1.8% of total world exports. The increase in Russia's openness remains modest compared to that of other countries in transition, and especially to China's (Figure 4.2).

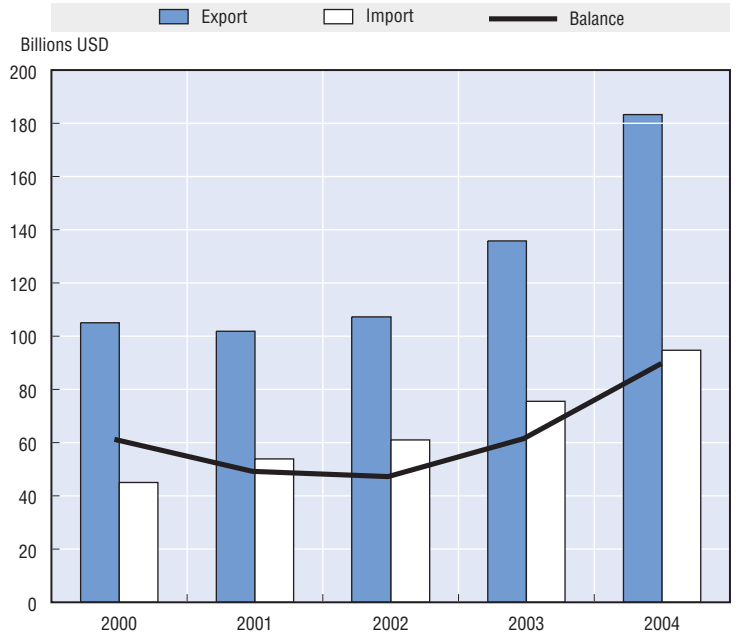
Energy products overwhelmingly dominate the Russian export mix, and that fact exposes the country to oscillations in external demand and in world commodity prices.

Figure 4.2. **Trade openness growth in China, Poland and Russia, 1999-2002**



Source: IMF, World Economic Outlook Database, UN Commodity Trade Statistics Database (COMTRADE).

Figure 4.3. **Russia's foreign trade balance, 2000-2004**



Source: UN Commodity Trade Statistics Database, COMTRADE.

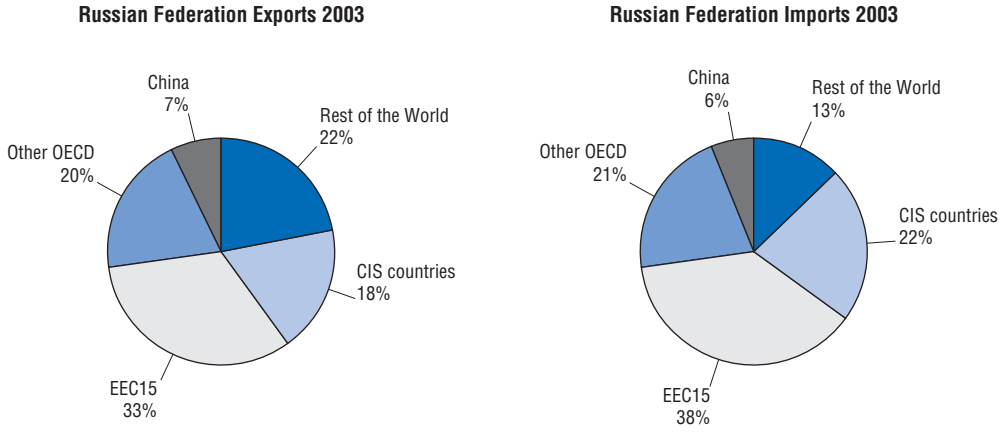
The share of oil and gas continues to rise, from 50% of total exports in 1999 to 61% in 2003, reflecting both greater volumes and higher world prices. At the same time, products with higher value-added content represent less than 10% of total exports. Growing Russian imports have in principle strengthened the exposure of its domestic market and enterprises to international competition, but not all product categories have been evenly concerned. Deliveries of consumer goods and transport equipment have increased, but the share of investment goods has stagnated and that of industrial inputs has even decreased.

OECD countries now provide half of Russian imports and take half of Russian exports. In 2003, member countries of the European Union accounted for over 60% of the OECD's trade share, and more than 30% of Russia's total trade. In the wake of the recent EU enlargement, Europe's position as Russia's leading trade partner is even stronger. A number of efforts have been made to boost trade with other members of the Commonwealth of Independent States, but in vain. It slid from 25% of Russia's total turnover in 1995 to 20% in 2003. Between them, Belarus and Ukraine account for three-quarter's of Russia's trade with successor states of the former Soviet Union. China's share is still small, but growing (Figure 4.4).

Russian trade in services is still well below its potential, reflecting a relatively slow growth of the service sector in the domestic economy.[1] In 2003, the country ranked 27th among service exporters with only 0.9% of the world total. As a share of overall Russian exports, services represent less than 11%, while the world average is 19.5%.[2] Russia's trade balance in services is negative and the deficit has been steadily increasing, reaching USD 10 billion in 2003. Traditional sectors still dominate Russia's trade in services. Some 40% of export service revenues are generated by transportation, while almost half of service expenditures are for travel.

Figure 4.4. **Geographical structure of Russian trade in 2003**

Per cent



Source: UN Commodity Trade Statistics Database, COMTRADE.

Russia's record in attracting inward foreign direct investment has been disappointing both in absolute and relative terms. According to statistics provided by the Federal Service of State Statistics,[3] FDI inflows more or less stagnated in 2001-2002 (USD 2.8 billion annually), then started to increase in 2003 and continued to grow in 2004, reaching a record level of USD 9.4 billion. This remains, modest compared in particular to China, which attracts some USD 50 billion annually. On a per capita basis, foreign direct investment inflows in 2002 represented USD 28 per head in Russia as against USD 818 in the Czech Republic. By the end of 2003, the stock of net inward FDI corresponded to 12% of GDP in Russia, compared for instance to 25% in Poland (UNCTAD, 2004).

According to Russian statistics, UK businesses were the major foreign investors in 2003 (with almost 16%), followed by Germans and Cypriots (each with more than 14%). The large amount of FDI originating from Cyprus (19% of cumulative FDI up to end-2003) indicates that a large share of FDI to Russia still consists of returning capital flights. The geographical distribution of FDI within Russia is uneven. The Central Federal District (Moscow and neighbouring Moscow oblast) absorbs more than half of the total. The industrial sector is traditionally the main beneficiary of foreign investment (almost 50% of the total in 2004), concentrated mainly in oil extraction, and followed by trade and catering activities. In 2004, foreign investment in the financial sector rose above 2% for the first time.

Russia's narrow export base and weak investment performance can be blamed to some extent on geography and on the legacy of the Soviet past. But delays in economic restructuring and shortcomings in the regulatory framework have been critical factors as well. High oil prices have permitted the country to finance its burgeoning import needs without taking the trouble to carry out a profound restructuring. The impact of Russia's increased external exposure has been muffled by an inappropriate legal and regulatory system, by flawed implementation of the rules and by corruption.[4] Russia's experience fully confirms earlier anecdotal and analytical evidence that highly regulated economies do not take full advantage of increased openness and that such exposure can even accentuate distortions.[5] Existing regulations prevent available financial and human resources from going to the most competitive sectors. They hamper the production of

Table 4.1. **Main Russian tariff indicators, 2002**

Tariff indicator	Per cent
Mean tariff	
All lines	10.8
In agriculture	11.4
In industry	10.7
International tariff peaks	
All lines	16.9
In agriculture	8.9
In industry	18.1
Tariff lines intervals (all lines)	
Duty free	0.6
0-5%	41.3
5-10%	16.9
10-15%	24.7
15-20%	15.8
20-50%	0.5
> 50%	0.1
Share of *ad valorem* duties	
All lines	85.4
In agriculture	66.3
In industry	90.5

Note: The calculations are made using the national tariff HS 6-digit level. International tariff peaks are the share of lines with tariff exceeding 15%.

Source: CCNM/TD(2002)4: Russia's tariff regime.

goods in areas and sectors where Russian firms could exploit their comparative advantage. Within sectors, barriers to entry and exit inhibit the expansion of efficient and innovative firms. If it is to enjoy the full benefits of liberalised trade and investment, Russia must adopt a full slate of pro-market and pro-competitive trade regulations.

Russia has gradually liberalised its trade regime over the past decade as part of the overall transformation of its economy. Trade policy has become more marketed-oriented. It has begun to foster domestic and external competition. The most important steps taken so far have been the liberalisation of prices and foreign exchange and the de-monopolisation of foreign-trade activities. Russia's decision to join the World Trade Organisation has speeded the liberalisation process and facilitated harmonisation of Russian trade legislation with international trading principles. At the same time, however, there has been strong and continuing resistance from some sectoral interest groups and elements of the administration that favours a strong state role in the economy and an import-substitution strategy.

A key development in Russia's trade regime has been the general switch from direct intervention based on non-tariff barriers to using tariffs as the main trade policy instrument. Mean tariff has fallen in recent years to 10.8% in 2002 (11.4% in agriculture and 10.7% in industry). By some measures, Russia's tariff structure is now close to that of OECD countries. The share of lines with tariffs above a 15% rate is relatively small, at just 17%. On the other hand, the proportion of duty-free tariffs is very low (less than 1% of total tariff lines) and well below the corresponding OECD average of 25%.

Table 4.2. **Foreign trade related revenues**

Types of tax	2000	2001
Total foreign trade related taxes (in million Rb)	358 808	539 851
Of which (in per cent)		
Export duties	45.8	41.6
Import duties	17.9	19.3
VAT	28.2	29.9
Excise taxes	2.8	2.5
Customs fees and other payments	5.1	6.2
Other	0.2	0.5

Source: The World Bank Customs Project in Russia, March 2002.

While Russia's tariffs have fallen in recent years, the tariff regime continues to suffer from relatively limited transparency and predictability. A third of Russian agricultural tariffs and 10% of industrial tariffs are not applied *ad valorem*, and this leaves wide discretion to individual customs officials to establish the tariff duty levels in individual cases. Another serious shortcoming is the absence of binding international commitments on tariff levels, which sharply reduces the regime's predictability. Tariff revisions have now been limited to twice a year, a useful step toward stability. Russia's accession to the WTO will be the decisive step in this area, and it will help the government to resist protectionist pressures from specific industries.

In Russia, customs reforms have a major impact on government revenues since foreign-trade-related duties play a more important fiscal role in Russia than in OECD countries. Export duties on raw materials and energy products amounted to 40% of total customs revenues in the year 2000-2001. Value-added-tax and import duties were the next largest categories (Table 4.2). Moreover, most customs duties are collected from a small number of firms. In 2001, 80% of all customs duties were paid by just 1 240 companies. If properly designed and pursued, however, customs reform can still yield higher collections, as it did from 1989 to 2001. During that period, better control of the use of exemptions and better collection of arrears increased customs revenues, despite a simultaneous decrease of import tariffs.

Russian policy on foreign investment has evolved in recent years. A 1998 federal law provides for the supremacy of international agreements in this area. National treatment for foreign investors has been integrated into the Civil Code and was confirmed in the 1999 law on foreign investment. Large foreign investors involved in "priority projects" have been given a legal guarantee against unfavourable legislative changes occurring after the start of their projects. But several limitations still apply to the entry and activity of foreign investors and to their participation in the privatisation process.

When Russia accedes to the WTO, it will have to conform to the Agreement on Trade-Related Investment Measures (TRIMs). This agreement prohibits local-content requirements, trade-balancing schemes and export restrictions based on the obligation to supply local markets. Several Russian laws and regulations are incompatible with the TRIMs regime. Among these are the federal law on Production-Sharing Agreements, which requires that certain equipment be bought in Russia. Current regulations on foreign investment in the automobile industry offer some import exemptions to investors.

Russia's progress in achieving trade openness and reforming its trade regime over the last decade has been driven by the country's overall liberalisation reforms and reinforced by the WTO negotiating process. Both have favoured a growing reliance on traditional trade policy instruments and international trading disciplines. WTO accession will anchor permanently these achievements into Russia's trade policy, but further efforts to reduce barriers to trade and investment are necessary at both the macro- and micro-economic levels. Success in this area will depend on the authorities' ability to integrate a market openness perspective in the domestic regulatory framework.

The policy framework: six basic principles

The general objective of regulatory reform is not deregulation or less regulation but better-quality regulations supported by adequately designed and functioning regulatory institutions. The OECD has developed six "efficient-regulation principles" to guide the development of trade-related policy and its institutional regulatory framework. The principles that can also serve to monitor the progress of individual countries are as follows:[6]

1. **Transparency and openness** of decision making. Information on new and revised trade-related regulations is necessary to foreign firms and investors so that they may accurately assess potential costs, risks and market opportunities.
2. **Non-discrimination** means equality of competitive opportunities between products and services irrespective of the country of origin.
3. **Avoidance of unnecessary trade restrictions**. To fulfil legitimate objective, governments should use regulations that are not more trade restrictive than necessary.
4. **Use of internationally harmonised measures**. To avoid the additional costs resulting from cross-country disparities in standards and technical regulations, countries should use internationally harmonised measures when appropriate and feasible.
5. **Streamlining conformity-assessment procedures**. The negative effects of duplicative conformity-assessment systems can be reduced by recognising the equivalence of regulatory measures and the results of conformity-assessments performed in other countries.
6. **Application of competition principles on an international scale**. Market access can be reduced by regulatory action that ignores anti-competitive conduct and by failure to correct anti-competitive practices.

In addition to general regulatory reform issues, Russia faces some specific problems in adapting its regional trade policy and regulations to comply with international commitments. The Russians have already taken significant steps toward defining more clearly the roles and responsibilities of central and regional authorities in trade policy. But these efforts have not always translated into concrete domestic regulations. The business community still faces uneven implementation of trade policy across the Russian territory.

Transparency: equal access to information

Russia has progressed considerably toward achieving a transparent legal framework. Procedures for publication of different categories of laws and the time limits for their entry into force are legally stipulated. Presidential and governmental acts, as well as legal measures by individual ministries, are published in the "*Parliamentary Gazetta*", the "*Rossiyskaya Gazetta*" or in the specialised review "*Collected Legislation of the Russian*

Box 4.1. **The regional dimension of Russian regulatory reform**

The Russian Federation consists of 89 "Subjects of the Federation": 21 ethnic republics, 49 *oblasts* (or provinces), six *krai* (territories), ten autonomous *okrugs* (districts) and one autonomous *oblast*. The cities of Moscow and St. Petersburg are also Subjects of the Federation.

The Constitution gives the central government pre-eminence in the direct regulation of foreign trade, including the legal framework of a single market; financial, currency and customs regulations; foreign policy; and foreign economic relations. But it assigns joint responsibility to the central and regional governments in many trade-related areas, such as ownership issues; land use and management; mineral resources; and establishing the general principles of taxes and levies.

In the year 2000, seeking to counter what were regarded as dangerous centrifugal forces in Russia, President Vladimir Putin created seven new federal districts, each headed by a presidential appointee. The districts have been criticised as adding still another overlapping layer to an already complex institutional and regulatory system. Also in the year 2000, the representation of the Subjects of the Federation in the upper house of Parliament was changed. Instead of the regional governors, who used to sit *ex officio*, there are now two permanent representatives for each of the 89 Subjects, one named by the regional legislature, the other by the executive branch. Moreover, the region's share of tax revenues has shrunk under the new tax system.

The strong decentralising trends before 2000 often undermined the central government's efforts. But the recent strengthening of federal prerogatives could inhibit regional initiatives and diminish the government's sensitivity to local conditions.

In spite of ongoing efforts to clarify the responsibilities of different government levels, regional policies do in fact frequently diverge from federal norms. Regulations are not always implemented uniformly across the country. The resulting lack of transparency and predictability is particularly disadvantageous to foreign suppliers.

Source: Trade Policies in Russia: The Role of Local and Regional Governments, OECD 2003.

Federation". International agreements are published in the *Bulletin of International Treaties*. A government resolution of February 2003 lists data which should be made publicly available in a regular and timely fashion. The registration of existing legal texts in the Federal Register for Legal Acts has also enhanced the availability of regulations applied at local and regional level.

Russian authorities have made wide use of the Internet as a tool for transparency. The main government portal (*www.government.ru*) provides general information on government action and draft legislation. The Web site of the Scientific and Technological Centre for Legal Information (*www.systema.ru*) carries the texts of federal laws and other legal actions. The legislative assembly's site (*www.duma.ru*) publishes draft laws and accounts of debates in the Duma. Several on-line databases, such as GARANT, disseminate laws and regulations in English, but they are usually available on a commercial basis and not free of charge. Foreigners in the Russian federation have the same right of access to draft legislation and regulations as do Russian citizens.

Businessmen have noted marked improvement in the availability of information. More than 40% of respondents to a 2004 OECD business survey[7] described access to

information as "no problem" or only a "minor problem". Respondents working outside of Moscow were, however, more critical.

A key factor in legislative transparency is the extent to which interested parties inside and outside government are involved in the law-making process. In Russia, participation of the private sector in the law-making process – let alone that of foreign firms – is not yet a common practice. (The private sector, including, foreign investors, were, however, involved in the preparations of the new Foreign Exchange Law.) But the lack of institutionalised consultations between the administration and interested parties does not mean that specific firms and sectors cannot influence the shape of laws affecting them. Backroom discussions, the exercise of political influence and even bribery can be used to modify proposed laws and regulations. The risk that politically connected groups or firms could be minimised by establishing formal and standard prior consultation procedures involving representative and significant players. In Russia this will require a radical change in the mindset of the administration, which has not yet abandoned the habits of secrecy and mistrust of outsiders.

At present, the only federal legislative act which establishes a detailed mechanism for mandatory and systematic public consultations prior to the introduction of new regulations is the Federal Law "On Technical Regulation" It prescribes that draft technical regulations be made available to interested parties and publicly discussed. The drafter is to compile a summary of comments received and to make them available on request to the State Duma or whatever other body that has final say in the matter. The period for public discussion is to be not less than two months.

The federal law No. 164-FZ "On the Fundamental Principles of State Regulations of Foreign Trade Activity", adopted in December 2003, also recommends holding consultations with interested parties whose economic interests may be affected by proposed legislation. The methods and forms of such consultations have to be decided by relevant executive authorities. The recent Customs Law mentions preliminary consultations of proposed changes in customs regulations with different stakeholders. It remains that at present the principle of prior consultations of proposed legislation and regulations is not systematically applied and concrete modalities of such consultations are generally left the discretion of the authorities. The draft implementation plan of the federal programme of administrative reform for 2005 envisages reinforcing the consultation procedures by the authorities.

Russia's negotiations with the WTO have helped to improve transparency and consultation procedures. WTO rules have prompted Russian authorities to codify the procedures for publishing and registering current legislation. They have also motivated efforts to develop consultations with all interested parties and to set up a regular policy dialogue between the executive and the legislature. Evidence of the WTO's decisive influence in these areas is the fact that the Ministry of Economic Development and Trade (MEDT) has become a leading force for the institution of consultations at various levels. This was notably the case during the preparation of the "Electronic Russia" programme.

The ambiguities and loopholes that still mar Russia's legal and regulatory framework make appropriate effective appeals procedures even more important than they otherwise would be. Administrative guidelines are often non-existent. Where they do exist, they are frequently so complex that they breed varying interpretations, poor enforcement and time-wasting red tape.

Foreign organisations and citizens can appeal any action by Russian authorities, including violations of their rights due to a lack of transparency or access to the text of regulations. The Civil Procedural Code, which entered into force in February 2003, foresees a wide-ranging appeal process to the Supreme Court from legal acts by the President, the Chambers of the Federal Assembly and other federal bodies. Grounds include the violation of the rights, freedoms and lawful interests of persons and organisations. Cases may be brought in connection with customs regulations and with alleged protectionism. A special federal law provides that commercial disputes involving a foreign party should be settled by an international arbitration court.

Nevertheless, almost half the 307 firms responding to the OECD's 2004 business survey rated appeal and arbitration procedures in Russia as a "serious" or "very serious" problem. Now that provisions for resolving disputes between the administration and private entities are on the law books, they must be made to work in practice. This will depend in large measure on providing the relevant agencies with adequate human and technical resources.

Transparency is also a key requirement in public procurement procedures. Foreign companies are especially interested in transparency regarding their possible access to government procurement contracts, sectoral limitations, applicable thresholds and provisions related to local content. The relevant legislation (Federal Law No. 97-FZ of 6 May 1999) requires transparency obligations in the publication of tender offers. Results of tenders are to be published no later than 20 days after the declaration of the winner. The tender organiser must explain its decision within 30 days after receiving a request to do so. The law also foresees the possibility of appeals. Nonetheless, more than 40% of respondents to the OECD's 2004 business survey found information on tenders to be "inadequate" and "untimely." Access to relevant information appears even harder to come by outside of Moscow.

Non-discrimination: a core concept

Non-discrimination is the idea underlying the two core obligations of the world trading system: the Most Favoured Nation principle, which holds that goods and services from all countries are to be treated equally, and national treatment, in which foreign goods and services are to be treated on an equal footing with their domestic equivalents. WTO members must comply with both rules. But the regulatory principle of non-discrimination goes still further. It seeks to ensure that domestic regulations give equal opportunity to similar goods and services from all sources.

Russia maintains a number of restrictions on foreign ownership and participation, especially in mineral extraction and such service industries as banking, insurance, media, aviation, domestic transportation and telecommunications. The restrictions include ceilings on foreign ownership, separate licensing requirements, prohibitions on providing certain services and special criteria for determining the credit-worthiness of foreign investors.

In addition to specific sectoral restrictions, foreign firms may be directly or indirectly affected by certain general laws. Under the new Land Code foreigners may purchase non-agricultural land in Russia but are unable to own agricultural land. They can lease farmland for no longer than 49 years. Some other laws, though they do not explicitly target foreign firms, can make their operations more difficult. For instance, the recently adopted Foreign Exchange Law brought significant liberalisation and most remaining controls apply irrespective of

domestic or foreign origin of the firms. The recent reduction in mandatory surrendering requirements for foreign-currency export earnings, from 25% to 10% introduced in December 2004 is also a welcomed measure for foreign operators. Other measures, ostensibly aimed at controlling capital fight, could also be particularly burdensome for foreign traders, such as the so-called "reserve system", under which residents must in some cases deposit as much as 100% of the value of certain transactions up to a year. Tough bankruptcy laws and the inefficiency of courts dealing with debt issues can also hinder the activity of foreign firms in Russia. In general, foreign investors often observe that they are hindered less by explicitly discriminatory measures than by the complexity of regulations, and their frequently inconsistent application by regional and local officials.

Like many other governments, the Russian authorities, at different administrative levels and to a varying degree, support domestic firms. This practice results in discrimination among producers of similar products. Discriminatory measures include subsidies to some domestic producers, often industries in the course of restructuring. Coal mining, for example, has been a major beneficiary. Subsidies take various forms: direct cash transfers from national and regional budgets; credits; special tax rates; tax deferrals and tax credits; and subsidised energy supplies. The government is, however, preparing a new State Aid Law, which it says will be fully compatible with the WTO Agreement on Subsidies and Countervailing Measures.

Many informal government practices and regulations promulgated by sub-national bodies also discriminate against foreign companies, and sometimes among domestic firms. Regional customs agents, for example, exercise very wide discretion in determining customs classifications and valuations. As a result, different customs rates are levied for the same product in different locations. Vaguely worded licensing laws allow well-connected and politically powerful firms to interpret them to the detriment of smaller, weaker competitors.

The government has launched a major effort to harmonies national, regional and local laws and to prevent sub-national officials from applying them in a discriminatory manner. Foreign parties now have the right to appeal against decisions taken by the Ministry of Economic Development and Trade and the Federal Anti-Monopoly Service, the two principal bodies charged with ensuring the uniform application of economic policy across the Russian territory.

Current Russian legislation discriminates against foreign suppliers in the area of public procurement. Foreign firms may tender bids only if production of the goods or services needed by the state is "absent or is economically inefficient" in Russia. In the case of foreign and Russian firms bidding against one another, the domestic companies enjoy a "price preference" of 25%. As in other areas, the main challenge in public procurement is to bring local and regional law into line with national legislation. Many regional governments discriminate not only against foreign firms but also against those of other regions. To win a supply contract with the city of Moscow, a non-Muscovite firm must underbid the lowest bid from a local company by at least 10%.[8] A new federal law "On the Placement of Orders for Delivery of Goods, Performance of Works and Provision of Services for State and Municipal Needs", currently under preparation is expected to improve the compliance of Russian law and practices with the WTO Agreement on Government Procurement.

In principle, preferential trade agreements represent a departure from most-favoured-nation treatment, but WTO members may enter into such agreements if they comply with

Table 4.3. **Russia's main regional trade agreements and treaties**

Treaty	Signatories	Date
Bilateral Free Trade agreements	Russia, all CIS members, former Yugoslav Republic.	April 1994
Customs Union Agreements (CU), later transformed into a single Agreement on the Establishment of the Eurasian Economic Community (EEC)	Russia, Belarus, Kazakhstan Kyrgyz Republic, Tajikistan.	January 1995 (CU) October 2000 (EEC)
Economic Union	Russia, Belarus	January 1995
Bilateral Investment Treaties (BIT)	Up to 2004, Russia has signed the BIT with 56 countries, including 24 OECD countries, 6 Southeast European countries, 5 CIS, several developing countries and China. Only about half of these BITs have been ratified.	
Partnership and Co-operation Agreement	Russia, all EU member states, including new entrants.	June 1994
Energy Charter Treaty	51 countries. Russia signed in 1994 but has not yet ratified.	
Shanghai Co-operation Organisation	Russia, China, Kazakhstan, Kyrgyz Republic, Tajikistan, Uzbekistan.	June 2001

relevant WTO provisions. Specifically, the WTO requires countries entering a trade agreement to provide information on it to third countries whose commercial interests might be affected.

Russia has concluded a variety of preferential trade agreements and treaties. Preferential tariff treatment is accorded to Russia's CIS partners and to the former Federal Republic of Yugoslavia. The previously existing Customs Union with Belarus, Kazakhstan, Tajikistan and the Kyrgyz Republic was transformed in 2000 into a Eurasian Economic Community. Parallel ongoing negotiations between Russia and Belarus target the establishment of an economic union between the two countries. Russia also grants preferential tariff treatment to some developing countries under its national system of preferences. Russian officials negotiating with the WTO have undertaken to make these agreements consistent with the General Agreement on Tariffs and Trade and with the General Agreement on Trade in Services.

Preferential trade agreements between Russia and its CIS partners, with their overlapping memberships and unclear provisions, have failed to boost, or even maintain, regional trade and investment flows. At the same time, regional trade has suffered from numerous trade obstacles and infrastructure problems which could have been better dealt with through regional co-operation, trade facilitation efforts and regulatory harmonisation.

Unnecessary trade restrictions: an avoidable evil

In spite of its undisputable efforts to tackle business and administrative barriers, Russia's record on avoiding unnecessary trade restrictions is still unsatisfactory. Domestic and foreign companies frequently complain about the unnecessary complexity of business-related regulations. Over-strict and widely varying application of the rules is endemic at the regional and local levels. Customs and sanitary regulations entail long and burdensome controls and inspections. At the same time, in areas, such as intellectual property rights, existing legislation is insufficient and its enforcement weak.

Improvements in customs and trade facilitation regulations are critical for enhancing trade and investment environment in Russia.

Initiatives to reduce administrative and trade barriers

The government has explicitly confronted regulatory-reform issues in its de-bureaucratisation programme and in the Medium-Term Programme of Social and Economic Development for 2002-2004. New laws on inspection, licensing, registration and technical regulations were introduced as part of the de-bureaucratisation package. The long-awaited federal law on foreign trade and the reform of the public administration also have important implications for the business climate.

A 2001 federal law on the Protection of Legal Entities and Individual Entrepreneurs limits planned inspections of companies to one every two years. Although the law imposes no limit on unplanned inspections, it does specify procedures for initiating them. It limits the length of inspections to one month (two months in special cases). A survey by the Russian Centre for Economic and Financial Research (CEFIR) in co-operation with the World Bank shows that the number of inspections declined by 21% after the law was introduced.[9] But large disparities persisted among regions. In the Moscow and St. Petersburg *oblasts*, Primorsky *krai* and Samara, the number of inspections actually increased.

The 2002 law on Licensing of Certain Activities reduced the number of activities requiring licenses and lengthened the term of licenses from three to five years. The law also reduced licensing fees. The CEFIR/WB survey has shown an improvement in the area of licensing. While the situation on the ground has improved, there are still reports of authorities issuing "illegitimate" licenses – permissions no longer required by law. Average fees charged were also higher than stipulated in the new law. As in nearly every other area, progress varied widely from region to region.

A new registration law came into effect in July 2002, setting up a "single window" for the registration of new businesses and shortening the length of the procedure from one month to five days. CEFIR/WB surveys show that registration procedures have indeed become simpler and faster – but also more expensive. A new, simplified tax system for small and medium-size companies was introduced in January 2003, and appears to be working well. But, here as elsewhere, the impact of new laws gradually fades, and regional differences remain considerable.

Three rounds of CEFIR/WB surveys have shown that perception of the business climate has improved. One telling indicator of this improvement is that respondents are beginning to see competition as a growing problem. "For the first time in Russia's transition history", the CEFIR noted in its evaluation, "firms started to perceive competition as a more serious problem than government regulations".

Two OECD business surveys carried out in 1995 and 2004[10] confirm these general trends and provide some additional interesting insights. Transparency, predictability and access to information were shown to have improved in 2004 compared to the previous survey in 1995. Infrastructure for business operations, especially in telecommunications, became more readily available. But the situation was found to be less favourable in the regions – especially in terms of the accessibility of bank credit and transportation facilities. Of the firms responding in 2004, 72% still consider excessive red tape to be a "serious" or "very serious" problem, while 62% regarded support programs for small and medium-sized businesses as insufficient and ineffective.

Customs related issue

"Grey" practices abound in Russian foreign trade and are clearly at the source of some capital flight. But they are extremely hard to quantify. To try to estimate the extent of customs-related malpractices, Russian customs data, from the State Customs Committee were compared with trade statistics from the OECD and Belarus, Kazakhstan, Moldova and China. Quantities and values for 35 export categories and 89 import categories were examined over the period 1995-2000. The major findings include:[11]

- Discrepancies were much larger for Russian imports than for Russian exports. In the period 1996-2001, Russia reported cumulative imports of USD 124 billion from 15 major trading partners, while its partner countries reported exporting USD 175 billion. In absolute terms, the largest discrepancies were between Russian and German figures, a difference of USD 14 billion over five years. There were also wide discrepancies with Turkey, Belgium, China and Korea.
- Overall divergences on the export side were just USD 5.5 billion for the whole period 1996-2001, but that figure conceals large differences over the full period and among countries.
- Russian under-reporting of imports was largest for food, followed by clothing – especially from Turkey and China – and pharmaceuticals.
- Analysing Russian export data is harder because of the special conditions of energy trade and available statistics (that exclude transit or temporarily imported goods). Nonetheless, the statistical analysis turned up systematic under-reporting of the value of several categories of exports, especially nickel and copper and frozen fish. In the last category, Russia reported just 18% of the value reported by its partners.

This study suggests that Russian traders have been quite successful in avoiding payment of customs duties. In some cases, the motivations may simply be to avoid very long customs delays. It is estimated that only 20% of Russian imports are accurately registered, while some 10% are smuggled, and 70% fall into a "grey" area. The two main ways used to reduce the customs fees are to understate quantity or price or both and to declare the imported product in a product category subject to lower customs duties. The "consent" of customs authorities is often necessary and usually duly remunerated.

The common practice of declaring imported products in the wrong category could be reduced if Russia relied more on statutory *ad valorem* customs duties rather than on a mix of *ad valorem* and goods-specific rates. Fraudulent exports and shady VAT refunds could be cut if there were better exchange of information between customs and fiscal authorities. Existing problems must be addressed by more far-reaching reform. Sanctions for corruption need to be increased; as do salaries and training opportunities for customs officials.

The new Customs Code, which came into force in January 2003, made considerable progress in harmonising Russian customs procedures with international practices, in particular WTO disciplines and the principles of the International Convention on Simplification and Harmonisation of Customs Procedures under the standards of the revised Kyoto Convention. The new Code clarifies existing rules and practices and defines the prerogatives of different administrations. In the past, the State Customs Committee issued a number of *ad hoc* Orders, Instructions and Directives to compensate for many legal ambiguities or loopholes in the general legislation. This prerogative of the Federal Customs

Service to interpret the laws was abolished and relevant bylaws may now be issued only by the government.

The Code addresses several of the OECD's "efficient-regulation" principles:

- **Transparency and openness of decision making.** The Code requires customs officials to facilitate public access to information about changes in regulations that have not yet come into effect. Officials are to respond to information requests from importers and exporters, including foreign operators.
- **Non-discrimination.** The Code mandates senior customs officials to ensure that the decisions of lower officials comply with the law. It prohibits regional and local government bodies from interfering in customs affairs, and it spells out procedures for appeals from customs-related decisions.
- **Avoidance of unnecessary trade restrictions.** The Code simplifies and streamlines customs-clearance procedures and reduces the clearance period from ten to three days. It forbids official requests for additional documentation not envisaged by the Code. It allows traders to provide certain information after clearance is complete**.**
- **Use of internationally harmonised measures.** The Code calls for the use of internationally accepted commodity classifications.
- **Mutual recognition of regulatory methods.** The Code invites customs officials to complete agreements with foreign bodies on the mutual recognition of customs documents. Procedures for customs controls should be based on international norms and practices, such as the application of risk analysis.

The new Customs Code and related regulations address the previous inconsistencies of Russian customs procedures with corresponding WTO requirements. In particular, the application of unduly high customs fees that do not reflect the true cost of services provided and the use of arbitrary methods for customs valuation procedures have been tackled. The new legal framework, which is now in conformity with Article VII of the GATT Treaty, thus brings major improvements in Russia's customs regime. But its ultimate success will depend on its effective implementation.

To improve customs collection, illegal and grey practices must be reduced. Import exemptions, which applied to 9% of total imports in 2000, should be closely scrutinised, especially in Kalinigrad *oblast*. Efforts to collect customs arrears should be pursued, and ways should be sought to deal better with claims for VAT refunds and drawbacks. Long and unpredictable delays need to be eliminated. Required documentation is too detailed, and all shipments are still inspected individually. Better risk analysis and risk management would allow inspectors to concentrate on high-risk cases.

Regulatory reform must be accompanied by institutional reform. The Russian customs administration is not a single body, but a conglomerate of legally independent entities. Its headquarters staff in 2003 was 2 150, with more than 60 000 officers in seven regional directorates, 141 offices and 670 customs posts. The whole structure needs streamlining, and the functions of the various hierarchical levels need to be better defined. A thorough review should be made of salaries and incentives, as well as education and training activities. Russia should adopt the guidelines of the Arusha Declaration of the Customs Co-operation Council concerning the Integrity in Customs.

The Russian customs administration has yet to develop a "service" culture. The first step in this direction would be to improve consultations with traders, especially prior

consultations on new customs regulations. These could be carried on in existing institutions such as the Advisory Council on Customs Policy or the Foreign Investment Advisory Council (FIAC), which has a working group on Improvements of Customs Procedures. The adoption of efficient dispute-settlement procedures and appeal mechanisms for customs-related matters is also indispensable.

Trade facilitation issues

Russia's accession to the WTO will only partly integrate it into world markets so long as it lacks the transport and logistics to support trade growth. The relevance of trade-facilitation issues for governments and business has increased considerably both in the national context and internationally. In a broad sense, trade facilitation covers customs procedures, transport and other logistics aspects of foreign trade transactions. A number of recent analyses have sought to determine the general costs and benefits of trade facilitation.[12] Some other studies go beyond the issues expressly addressed in the WTO negotiating context and adopt a broader business perspective to assess the performance of individual countries, using different "logistic indexes", which have also been developed for Russia.[13]

Market surveys carried out in Russia and other selected countries in 1997 and 2003 measured the lead time between the day of an order and its delivery, as well as the' costs of warehousing and distribution for food products, pharmaceuticals and high-technology goods. In 1997, Russian costs were highest in all categories among the nine surveyed countries. Not only did Russia under-perform all OECD countries, it also finished way behind the three Baltic states. Russia's inadequacy was due to bottlenecks in every component of the logistics index. For example, its warehouse costs were six times higher than those of Denmark, the best performer, and double those of the Baltic countries. By 2003, Russia's relative performance had deteriorated even further, reflecting its high transport costs, longer and unpredictable lead time, higher inventory levels and warehousing costs.

Similar methods can be used by firms in their selection of commercial partners that measure various elements of the final price of a product, including duties, taxes, and transport and inventory costs. An example of such an index, analysing the final cost of machinery and parts delivered to Denmark from Russia, Poland, Italy and Estonia, shows that even where a Russian product was initially cheapest, it has become the most expensive for the consumer when all additional costs have been taken into account. In this case, transport costs represented almost a third of the initial costs of the Russian product compared with 11-14% observed in the other surveyed countries. Although this example could be a specific case, it shows that transport and other logistical costs can considerably reduce the competitiveness of Russian goods, which have already more difficulties to meet customer specifications.

Lengthy, unpredictable and costly trade procedures hamper Russian exporters and consumers as well as foreign traders. Transport and logistical costs become hard to anticipate. Capital costs and inventory levels rise, and companies are induced to adopt various alternative arrangements to face unpredictable delays and losses, which make imported goods more expensive for Russian consumers.

In light of the successful reforms accomplished in other countries, Russia could consider several policy options to improve its trade facilitation framework:

- Increase public and business awareness of the importance of trade facilitation through the establishment of a strategic plan for trade-supporting infrastructure and services.
- Develop a set of trade-facilitation and logistical indicators; conduct bench-marking exercises to assess current conditions in Russia; establish a timetable and numerical targets for improving the country's performance.
- Encourage public-private co-operation by creating a National Trade and Transportation Facilitation Committee including government officials and business representatives. Foreign firms operating in Russia should be represented. This group would be consulted before the introduction of laws and regulations and could propose specific initiatives to improve transport and trade facilitation environment.

Russia should also consider adopting the practice of regulatory impact analysis (RIA) that is used in a number of countries. RIA is a systematic process designed to quantify the expectable benefits and costs of a given regulation. It also provides information on possible alternative action which would do the job without introducing unnecessary trade restrictions. It can be used to weigh the impact of regulations on market openness – whether a proposed regulation would not restrict market entry, business activities or competition. Assessments of the potential trade restrictiveness of new measures through RIA are carried out regularly by Denmark, Hungary, Korea, Mexico, the Netherlands and the United States.[14]

Internationally-harmonised measures and conformity assessment procedures

The WTO's agreement on Technical Barriers to Trade (TBT) and the Sanitary and Phyto-sanitary Agreement (SPS) recognise that technical and sanitary standards can unnecessarily hinder trade and urge countries not to use them as disguised forms of protection. The TBT calls on countries to rely, as appropriate and feasible, on internationally harmonised standards. In Russia's accession talks, its WTO partners have urged the country to reform its domestic standards and bring them into line with the TBT Agreement and the Code of Good Practices it contains.

Several regional agreements go further than rather general recommendations referred to in the multilateral agreements. For example, for a number of Central European countries, the adoption of EU technical regulations, standards and conformity assessment procedures have significantly facilitated and accelerated their abandonment of domestic technical regulations and standards in favour of international equivalents. The APEC initiative also represents an innovative approach to tackle the problem of specific technical standards and regulations in different countries. Russia might examine these experiences and consider strengthening co-operation on standard issues with its main trading partners.

Russia's new federal law on Technical Regulations is a meaningful step away from the past pattern of mandatory norms and a very limited tolerance for international standards. The law moves toward a much more flexible and market-oriented system that complies with international practices. Interested parties were consulted on the preparation of the law; among others, IBM, Siemens and the US Chamber of Commerce took part. Because the law allows for a seven-year implementation period, it will take some time before its effect can be assessed.

Box 4.2. **The Law on Technical Regulations and the OECD Principles**

The law, which came into effect on 1 July 2003, reflects a number of the OECD's "efficient regulation" principles:

- On transparency, the law introduces a detailed mechanism for public discussion of draft technical regulations. The draft's sponsor must publish it and allow access to it by all interested parties, pass on any written comments to the national standards body and organise a public discussion. The national standards body must publish a notification of approval or explain its reasons for failing to do so. Technical regulations that are accepted in this way come into effect no sooner than six months after official publication.
- On non-discrimination, Article 7 stipulates that technical rules are to be applied regardless of the country or place of origin of the product. The law does not restrict the participation of foreign companies in prior consultations on new technical regulations and standards.
- On avoidance of unnecessary trade restrictions, the law states that technical regulations shall not serve as an obstacle to entrepreneurial activity beyond the minimum degree required to attain the law's purpose.
- On using internationally-recognised standards, the law states that international standards are to be used fully or partially in drafting technical regulations. Article 12 says that international standards are to be used in developing national standards, except where international standards fail to account for specific Russian peculiarities – climatic, geographical, technical or otherwise.
- On recognising other countries' regulatory measures, Article 30 provides that conformity-assurance documents and marks of conformity, as well as tests and measurements obtained in other countries may be recognised according to Russia's international treaties.
- On applying competition principles, Article 3 states that one of the principles of technical regulation is to avoid restricting competitiveness in accreditation and certification. According to Article 18, the purpose of conformity assessment is to permit the free transport of goods throughout Russia, as well as to bolster international co-operation and trade.

According to information provided by Russian authorities, the Russian Federation was applying in 2003 about 40% of the international standards developed by the International Standards Organisation. The best sectoral coverage is in automobiles (100%), machine-tools (74%), shipbuilding industry (65%) and informatics (60%). In a few sectors, such as aviation and space technology, international standards are applied only for five or less per cent.

Although Russian laws clearly assert the desirability to adopting international standards, the implementation of these targets is rather slow and patchy in practice. The main impetus for changing the situation will probably come from the private sector, especially as it commercial interests are likely to be directly affected by the EU enlargement – which has extended compliance with a single set of standards to the country's main trading partners. Mandatory consultations on new standards and technical regulations are the best guarantee that these business interest will be taken into account.

Some policy options for the future

Russia is still negotiating its accession to the WTO and is still in process of fully integrating into its trade regime the fundamental multilateral disciplines which underpin efficient regulatory principles for market openness. Russia's first and overriding goal is thus to complete its WTO negotiations successfully. Once the country is a WTO member, it can consider further policy options to integrate the OECD principles of efficient-regulation into its regulatory framework.

To enhance the transparency of the domestic regulatory framework, Russian authorities should consider:

- Continuing to disseminate information on the regulatory framework, making maximum use of the Internet. Using business associations, including foreign chambers of commerce in Russia as a relay to companies. Bringing concerned parties – including foreign traders and investors – into the regulation-making process at an early stage.
- Creating consultative and advisory bodies, to be managed by federal ministries, services or agencies and to include other parts of the administration as well as representatives of business associations and individual companies. Consulting these bodies before the introduction of new regulations and possibly involving them in gauging the effect of such regulations.

To eliminate discriminatory aspects of the regulatory environment, Russian authorities should consider:

- Eliminating the remaining restrictions on foreign traders and investors, including limitations on foreign ownership in some sectors, special permit procedures applying only to foreigners and restrictions on the employment of foreigners by foreign-owned firms.
- Further harmonising federal and regional trade policy and ensuring its unified application across the territory of the Russian Federation. Formulating regulatory measures in a clear and straightforward way so as to eliminate the possibility of varying interpretations. Making regulations available at different government levels in a timely way.
- Evaluating existing preferential trade agreements, especially those with member countries of the CIS. Focusing on developing regional co-operation in the areas of technical standards, regulatory requirements and trade facilitation matters.

To reduce unnecessary restrictions on trade, Russian authorities should consider:

- Making Regulatory Impact Analysis a routine component of the process of preparing new regulations. Using such analysis to assess the regulations' impact on trade and to consider alternative approaches.
- Regularly monitoring the impact of regulatory measures on the business climate. Ensuring that regulations are thoroughly applied, not only in the weeks and months after their introduction but also in the longer term.
- Maintaining the momentum of the de-bureaucratisation programme and further reducing red tape.
- Completing the harmonisation of customs-valuation procedures with WTO rules. Streamlining and simplifying customs regulations to avoid divergent interpretations by local officials. Ensuring adequate financing and technical support for the customs administration. Promoting a "service to the client" attitude in the custom administration.

Communicating regularly with users of the service through consultative and advisory boards.

- Increasing public awareness of the importance of trade facilitation issues. Launching target programmes to improve trade-related infrastructure and services. Developing a series of trade and logistic indicators, and then setting specific targets for improved performance.

To promote the use of international standards and the recognition of equivalent measures adopted by other countries, Russian authorities should consider:

- Ensuring that the new federal law on technical regulation is fully enforced, especially the requirements for mandatory public consultations before the adoption of new standards and for increased reliance on international standards.
- Reinforcing the staffing and technical resources of the national standardisation body. Relying more heavily on international standards in the development of national standards. Strengthening co-operation on standards and technical regulations with Russia's main trading partners.
- Reducing the complexity and cost of conformity assessment procedure. Developing domestic capacities for accreditation. Promoting the recognition of the equivalence of the results of conformity assessment procedures performed in other countries.

In order to apply competition principles on an international scale, Russian authorities should consider:

- Integrating the principle of openness into the procedures of the Federal Anti-monopoly Service. Increasing the participation of anti-monopoly authorities in elaborating trade policy, especially in the areas of tariffs and anti-dumping activities.

There is room to improve Russia's disappointing performance in attracting foreign direct investment. Although the main role of the authorities is to enhance general economic and business environment, it is also important to streamline the efforts and address more specifically the interests and concerns of existing and potential foreign investors in Russia. In addition to traditional tasks such as a policy advocacy role and promoting a positive perception of the country as foreign investment destination, the authorities should centralise information on foreign investment opportunities and procedures for establishment. Like in many other countries, these services could, together with the assistance in approval procedures, be offered in a "one-stop" facility.

At present, Russia has established only a limited number of national regulatory agencies to supervise activities in specific sectors or activities. In designing such agencies and defining their functions, it is important to ensure their independence from both the government and the sectors under their supervision. From the trade-policy perspective, it is essential to develop close and regular co-operation among regulators, competition authorities and trade policy makers. This co-operation could go a long way to ensure the mutual coherence of different policies and to promote the trade-friendliness of regulations and of their implementation.

Notes

1. According to the Russian official statistics, services represent almost 60% of GDP *i.e.* the level relatively close to OECD countries. However, taking into account transfer pricing practices used especially by Russian oil and gas companies (that sell their production cheaply to their trading

subsidiaries, mainly for tax purposes) changes considerably Russia's GDP sectoral distribution. The share of services drops to 38% of GDP while the contribution of the energy sector and industry to GDP increases correspondingly. See *Russian Economic Report*, The World Bank, February 2004.

2. WTO *International Trade Statistics 2004*, November 2004.

3. There are important divergences in Russia's FDI statistics. The figures reported by the Central Bank of Russia, based on the balance of payments, are usually lower than the figures provided by the Federal Service for State Statistics, using customs statistics and special questionnaires. In 2003, statistical gap was particularly important: according to the Central Bank, inward FDI amounted to USD 1.1 billion *versus* USD 6.7 billion recorded by the Federal Service for State Statistics *(OECD Investment Policy Review of the Russian Federation: Progress and Reform Challenges*, OECD, 2004).

4. Babetskii I., O. Babetskaia-Kukharchuk and M. Raiser (2003), *How deep is your trade? Transition and international integration in Eastern Europe and the former Soviet Union*, the EBRD Working Paper No. 83, November.

5. Bolaky B., C. Freund (2004), *Trade, Regulations and Growth*, the World Bank Working Paper No. 3 255, March.

6. The OECD efficient regulation principles for market openness have been identified by trade policy makers as key to market-oriented trade and investment-friendly regulations. They reflect the basic principles underpinning the multilateral trading system (see TD/TC/WP(2002)25/FINAL: Integrating Market Openness into the Regulatory Process: Emerging Patterns in OECD Countries).

7. The business survey of business environment in Russia, committed by the OECD, was conducted at the beginning of 2004 by Mr. Tibor Opela (Moscow State Institute of International Relations). Detailed results of this survey are provided in the OECD document TD/TC/NME(2004)8: Recent developments in the business environment in Russia.

8. OECD (2003), *Trade Policies in Russia: The Role of Local and Regional Governments*, pp. 65-66.

9. Results of the three rounds of Monitoring of administrative barriers to small business development in Russia are available at the Web site of the Centre for Economic and Financial Research (CEFIR): *www.cefir.ru*

10. The OECD business surveys of trade barriers in Russia were conducted in 1995 and 2004 using a similar questionnaire. More details on the sample and the results of the 2004 survey are presented in TD/TC/NME(2004)8: Recent developments in the business environment in Russia.

11. V.M. Zhukovskaya, I.N. Trofimova, N.T. Chertko (2003), Export/Import flows of the Russian Federation – Comparison of data from the Russian Federation Customs Statistics and the OECD trade statistics. Mimeo (in Russian) prepared for the OECD by the Institute of World Economy and International Relations, Russian Academy of Sciences (IMEMO), Moscow.

12. See for example: Wilson John S., Catherine L. Mann and Otsuki Tsunehiro (2004), *Assessing the Potential Benefits of Trade Facilitation: A Global Perspective*, The World Bank Policy Research Working Paper 3 224, February. TD/TC/WP(2004)4: Trade Facilitation Reforms in the Service of Development: Country Case Studies.

13. More details on the methodology used and estimates for Russia and other countries are provided in TD/TC/NME(2004)7: Trade Facilitation Issues in Russia: A Business Perspective.

14. OECD Trade Policy Working Paper No. 9: Regulatory Reform and Market Openness: Understanding the Links to Enhance Economic Performance; TD/TC/WP(2002)21/FINAL: Trade and Regulatory Reform: Insights from the OECD Countries Reviews and Other Analyses.

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Building Rules for the Market

Chapter 5

Railways Reform*

* For more information see: *Regulatory Reform of Railways in Russia* available at *www.oecd.org/regreform/backgroundreports*.

The report *Regulatory Reform of Railways in Russia*[1] was undertaken by the European Conference of Ministers of Transport as part of the OECD regulatory review programme. It provides a detailed analysis of the development of the Russian government's regulatory reform programme for the rail sector. The conclusions and recommendations of that report, updated in early 2005, are reproduced here together with introductory sections on Russian rail markets, the government's railway reform plan and key regulatory challenges. Readers are referred to the full report for further details.

Introduction

Russia has the second largest rail system in the world, after the United States, and one of the most intensively used. Its total length is 85 800 kilometres. Of these, 32 000 km are double track; 41 600 are electrified; and 11 400 are spurs owned by shippers. Russia ranks third in ton-kilometres, after the US and China, and fourth in passenger-kilometres, after China, India and Japan. It is second in traffic density, after China, and second in the average length of freight movements, after the US and tied with Canada. Russian railways' share of freight transport in its own market is the largest of any railway anywhere. The share of passenger traffic in Russia is low by international standards. The ratio of passenger-kilometres to total kilometres is 10%; the equivalent ratio in the US is 1%; in China, 20%; and in the European Union, 50%.

The Russian rail system is world-class by any measure, including managerial and technical capacity. It is an enormously important asset to the Russian economy. Both Soviet and Russian authorities have relied on the railway system to underpin regional development, especially the development of primary industry in Siberia. Over the years, "bringing Vladivostok closer to Moscow" has become a prime mission for the system.

The railways are particularly vital in Russia because of the very large distances between cities and the harsh climate, which makes all-weather road connections impossible over large parts of the country. The European and Asian halves of the system are quite different. Road transport is becoming increasingly competitive with trains in European Russia, but this is unlikely to happen in the sparsely populated Asian part.

The national railway is the largest of the country's state-owned monopolies. It has 1.2 million employees, and its net assets equal EUR 50 billion (or approximately an 8% share of the total net assets for Russia). In 1999, the railways produced 5% of federal government income. They probably accounted for a similar share of regional and local government income. This was the largest contribution of any industry – including the gigantic gas monopoly Gazprom. Freight operations make a book profit, which covers the losses made on passenger services.

The railways have traditionally been used as an important tool of regional development policy, supporting the development of primary industries in Siberia for example. The railways have also played a leading role in Russian industrial policy. Advantageous freight prices are charged to factories that process materials with low value

Table 5.1. **Contributions to government income from the railways**

Million roubles

	1998	1999	2000	2001	2002
Federal budget income	302 386	611 710	1 056 000	1 593 978	2 204 726
of which: tax	*235 984*	*509 507*	*915 552*	*1 460 398*	*2 035 598*
Regional and local budget income	n.a.	n.a.	789 888	1 512 850	1 896 943
of which: tax	*311 300*	*493 100*	*647 295*	*884 568*	*1 088 980*
Total government budget income	n.a.	n.a.	1 845 888	3 106 828	3 921 669
Total payments to government from railways	**42 932**	**62 268**	**60 534**	**74 205**	**95 843**
Payments to federal budget	8 273	15 486	17 238	27 372	26 196
Share of federal budget income	*3%*	*3%*	*2%*	*2%*	*1%*
Additional off budget transfers to federal Government	10 892	14 546	n.a.	n.a.	n.a.
Payments to regional budgets	11 048	14 168	19 194	22 712	31 421
Share of regional and local budget income	*n.a.*	*n.a.*	*2%*	*2%*	*2%*
Additional off budget transfers to regional government	1 827	3 520	n.a.	n.a.	n.a.

Source: Ministry of Finance and communication from MPS.

but high transport costs. The weight of these subsidies is borne by producers of goods with higher added value, especially imported goods and goods and raw materials for export. The railway pricing system also protects lower-income passengers, including pensioners and students. Half of all suburban rail passengers enjoy some kind of discount. Thus railway reform is intimately linked with reform in other key areas of government policy.

The railways of the Russian Federation are for the most part owned and operated by the State-owned joint stock company Russian Railways, RZhD OAO (РЖД ОАО). The company is vertically integrated, managing its infrastructure and operating freight- and passenger-train services. The assets of the railway, valued at EUR 50 billion, were transferred from the Ministry of Railways, MPS (МПС), to RZhD in September 2003 and RZhD began operations on 1 October 2003. The president and management board of RZhD report to a board of directors chaired by the vice prime minister and comprised of senior representatives from the Ministries of Finance, Transport and Economic Development and Trade; the Federal Antimonopoly Service; the Federal Property Management Agency, as well as representatives of the government's and president's administrative offices.[2] Under the company's charter, no more than a quarter of the directors can be drawn from the management board. Currently only the president of RZhD sits on the board of directors. The Ministry of Railways was combined with the Ministry of Transport in March 2004.

The system is divided into 17 regional railways, whose directors report to the president of RZhD. From 1975 to 1992, the railways ran Russia's metro system, but since 1992 the subways have been run by municipal governments.

In addition to the federal railways, around 8 000 km of branch lines are owned by industrial railway entities separated from MPS between 1992 and 1995 and subsequently sold off, usually to the industrial plants served by the lines. These enterprises, which number 100 to 120, own locomotives and wagons and carry freight to and from main railway lines for around 5 000 clients. A small number of other large industrial concerns have built their own branch lines.[3] An increasing part of the freight wagon fleet is owned by such concerns and by some other large rail customers (14% in 2003). In most cases the

Figure 5.1. **Russian railways in 2003**

Source: Louis S. Thompson, World Bank.

Table 5.2. **Headline financial indicators**

		Euro	Share of total for Russia	Source
Employment in core business, 2001	1.2 million		2%	Russian Statistics
Investment, 2001	Rb 123.9 billion	5 billion		Arthur Andersen
RZhD net assets (replacement value of fixed assets), 2003	Rb 1.5 trillion	50 billion	8%	RZhD

Source: *Transport and Communication 2002* and *Russian Statistical Year Book 2002*, Russian Statistics Office; Audit Report, Arthur Anderson, 2002.

rail operations are run as a division of the industrial concern for its own transport needs rather than as a rail company marketing freight services to clients on the open market.

Transport markets

Although Russian trucks haul six times as much tonnage as do the railways, rail accounts for *80% of total freight ton-kilometres* in the inland transit market. East of the Urals, rail holds a virtual monopoly on freight transport. In European Russia, however, road haulage accounted for 40% of ton-kilometres in 2001, and the trucking share appears to be growing as the highway network improves. Inland waterways account for only 5% of ton-kilometres and are not likely to increase their share. Rail freight is important to international trade, as it serves the country's ports.

Nationwide, trains and metros account for about the same number of passenger kilometres as do buses and trams. Rail services are an indispensable part of mass transport in the major cities, but rail does not really dominate the market, except in a few urban areas, notably Moscow. In urban and suburban markets, the railways account for a third of

Figure 5.2*a*. **Freight transport in billion t/km**

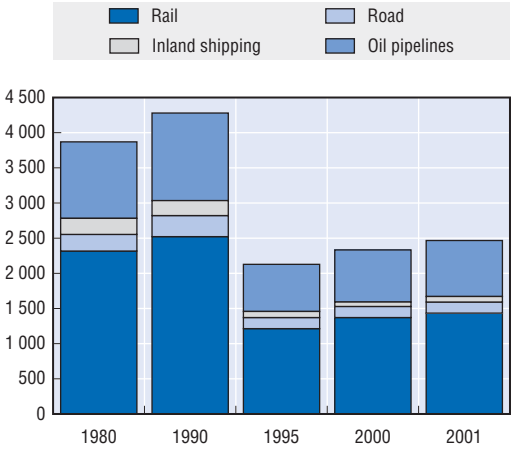
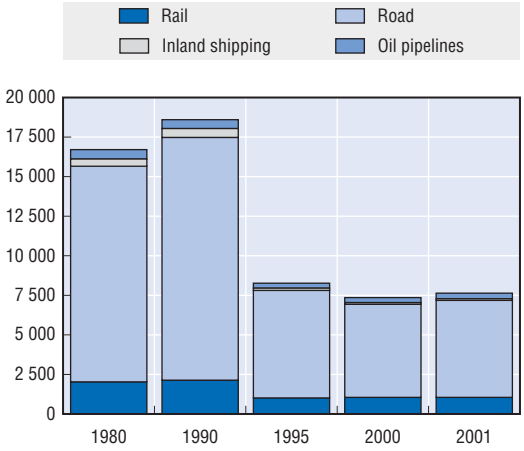
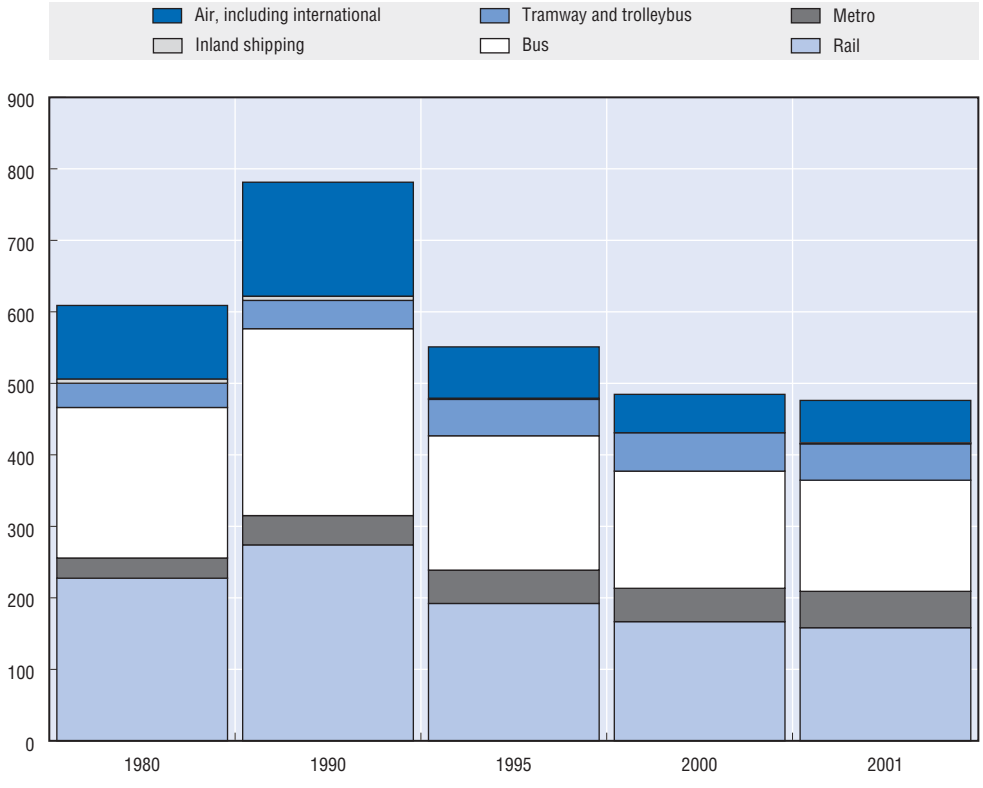


Figure 5.2*b*. **Freight transport in million tonnes**



Source: Transport in Russia 2002, Russian Statistics Office.

Figure 5.3. **Passenger transport in billion passenger kilometres**



Source: Transport in Russia 2002, Russian Statistics Office.

Figure 5.4*a*. **Inter-city services**
Billion pkm

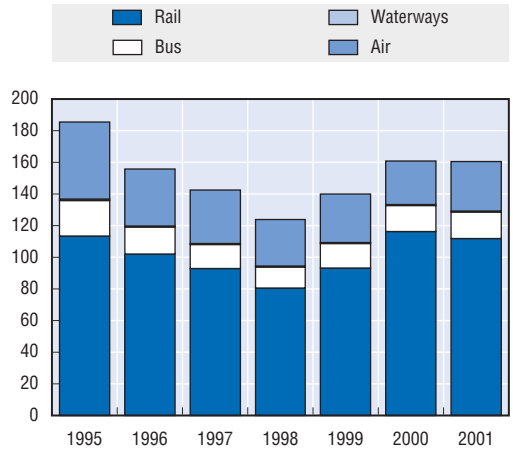
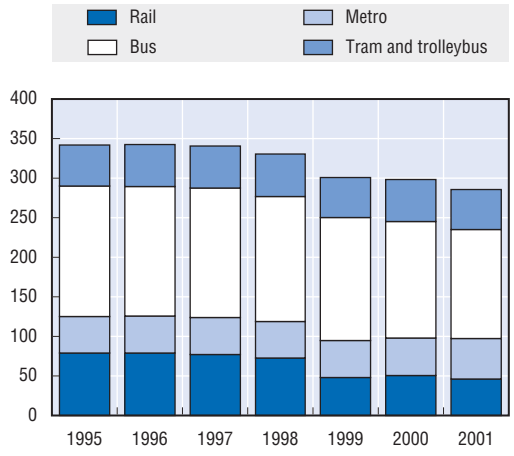


Figure 5.4*b*. **Urban and suburban services**
Billion pkm



Source: Transport in Russia 2002, Russian Statistics Office.

passenger-kilometres, although they carry only 3% of all passengers. Buses hold the largest share in both cases.

On inter-city and long-distance domestic runs, rail accounts for 70% of passenger-kilometres. A series of crises in the airline industry has limited its ability to compete, but airfares have fallen steeply in proportion to average incomes. Airlines are expected to increase their share of the air-and-rail market from the current figure of 20%.

There are no official figures on automobile usage. But car *ownership* is rising by a significant 9% per year. There are now about 170 cars per 1 000 population – a third of the ratio in Western Europe. Cars in circulation are expected to increase by 65% in the next decade.[4]

Forecasts of future developments in transport markets are notoriously difficult, especially in an environment where regulatory reform is in full swing. The behaviour of firms in responding to the emerging opportunities and pressures of a new market is likely to be considerably different from that of government. With that caveat in mind, a number of scenarios are outlined below.

In freight markets, the Ministry of Transport sees the medium-to-long-distance transport of raw materials and bulk flows of industrial goods between factories and ports as the markets where rail offers the highest efficiencies. Freight flows are heavily influenced by the regulated tariffs structure, which makes the long-distance transport of raw materials much cheaper than the transport of higher-value manufactured goods. RZhD calculates that the current low tariffs on bulk traffic are just high enough to cover its marginal costs. It is not sure, however, that the company will still hold this view when its costing tools are refined to deal better with a market-orientated environment and are based on international accounting standards. The development of more sophisticated freight-traffic costing models deserves high priority in Russia, for both freight-management and regulatory purposes. As road haulage competes harder for the more profitable freight traffic, the cross-subsidies which the railway provides to passenger services will come under pressure. The ability of the railways to adapt to these pressures

will in large part determine how rail-freight transport markets will develop over the medium and longer term.

In passenger markets, competition from airlines is expected to strengthen in the long distance markets as already noted. In shorter distance markets the dominant presence of rail is conditioned by subsidies to mainly loss-making suburban services. Cross-subsidies

Table 5.3. **Road network of the Russian Federation, 2002**

Total highway network	902 000 km
of which:	
Company roads (gas, logging, etc.)	330 000 km
Federal roads	47 000 km
2 x 2 lane roads	3 000 km
Motorway standard roads	1 000 km

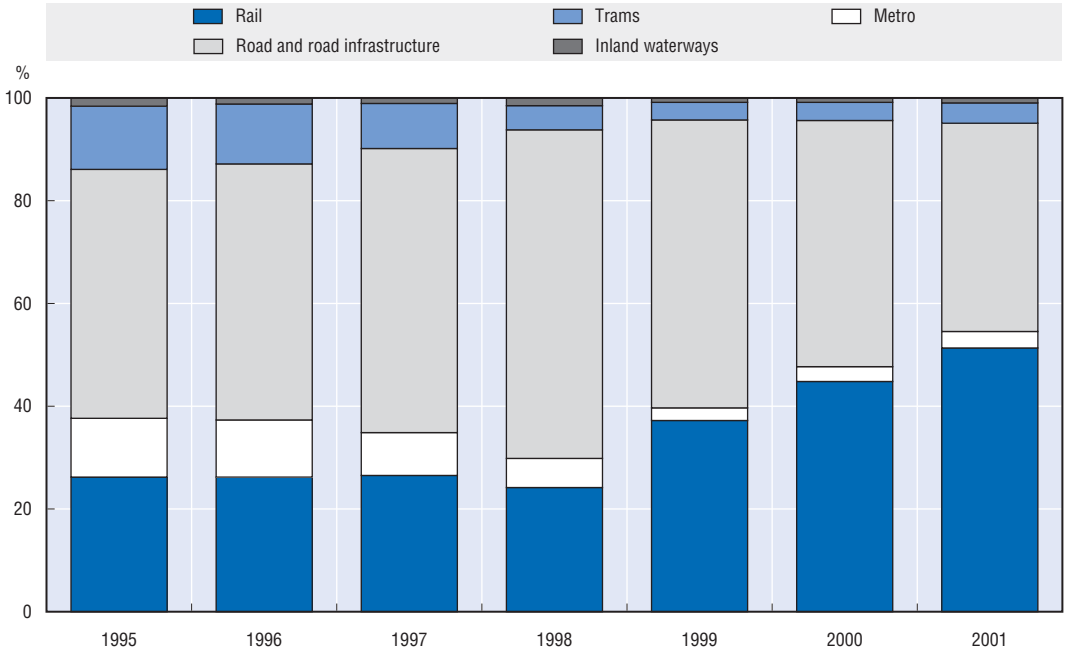
Source: Ministry of Transport, interview.

Table 5.4. **Rail network of the Russian Federation, 2001**

Total rail network	85 800 km
of which:	
Double track	36 200 km
Electrified	41 600 km
Spurs owned by shippers	11 400 km

Source: *Transport in Russia 2002*, Russian Statistics Office.

Figure 5.5. **Modal shares of fixed total capital investment in inland transport**



Source: *Transport in Russia 2002*, Russian Statistics Office.

from freight revenues have supported these services to date. As competition from road haulage reduces the income available, there will be increasing pressure to cut services unless government finds ways to channel resources through taxes and explicit financial transfers.[5] In some, though not all circumstances, buses may provide these services at lower cost. Rising car ownerships levels will have a major impact on this market along with urban planning policies and the way in which motorists pay for the use of the roads.

Investment in roads will be an increasingly important factor in shaping competition for the railways in both freight haulage and in short- and medium-distance inter-city passenger markets. Highway investments averaged USD 7 billion per year between 1995 and 2000 and were valued at 1.5% of GDP in 2002, but they have been outstripped by growth in the number of vehicles. Investments are most urgent for ring roads around cities. The biggest single investment in recent years went to complete the trans-Siberian highway.

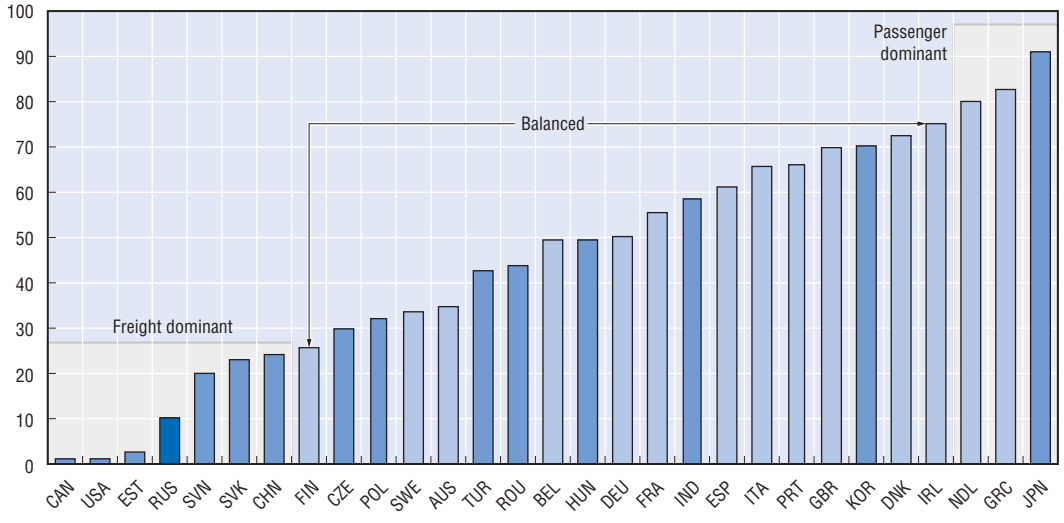
Railway performance

The Russian rail system is one of the largest and most intensively operated in the world. The importance of the railway is reinforced by the geography of the country (cities separated by large distances) and the harsh climate that makes all-weather road connections impossible over large parts of the territory. Population density and settlement patterns make the European and Asian parts of the system very different. Unlike European Russia, competition from road transport is unlikely to become significant for the Asian part of the system.

Rail-traffic trends in Russia have followed the course of economic restructuring. After peaking in the late 1980s, freight volumes halved by 1994. Volumes fell further during the unstable mid-1990s, then started to grow again as GDP expanded after 1999. Freight volumes are now at about 60% of their historical peak. There is, therefore, spare capacity in the

Figure 5.6. **Per cent of rail passenger traffic to total rail traffic**

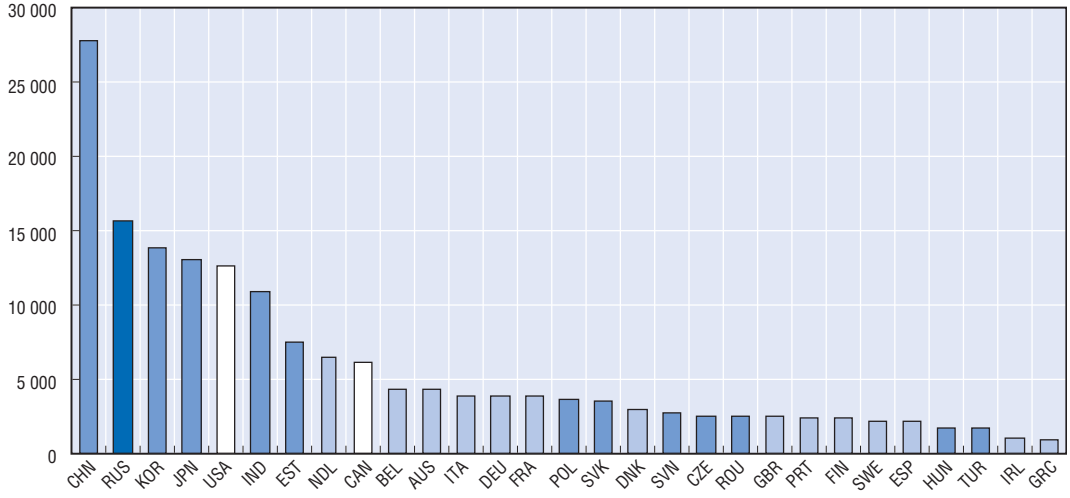
P-km/(p-km + t-km)%



Note: Light blue shading indicates EU railways.

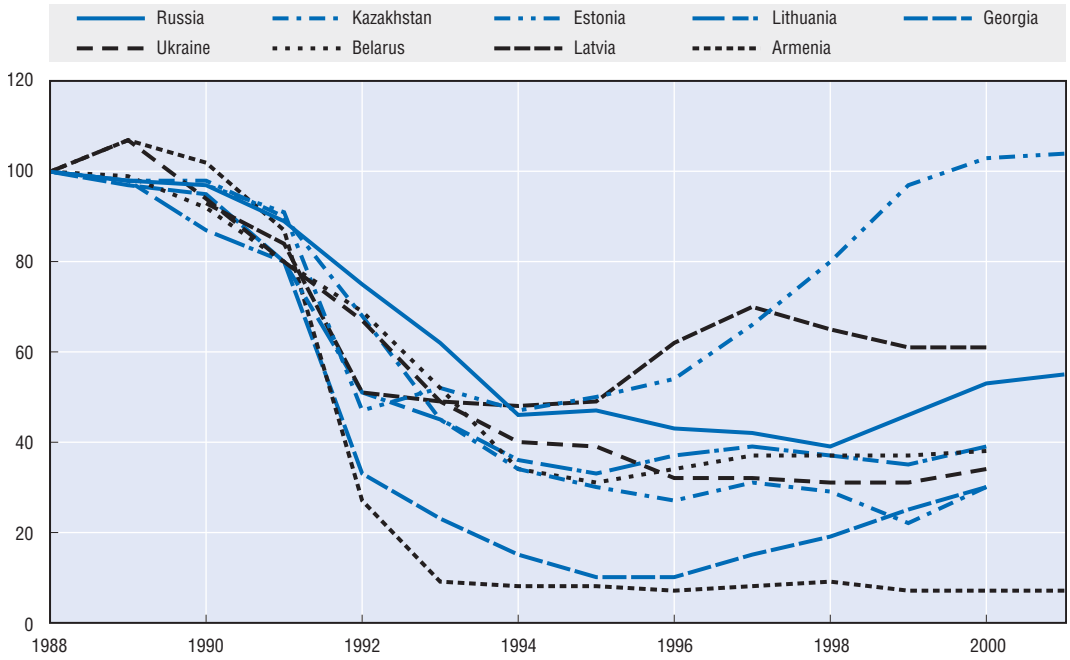
Source: Louis S. Thompson, World Bank.

Figure 5.7. **Rail traffic density, 1999**
(T-km + p-km)/km



Source: Louis S. Thompson, World Bank.

Figure 5.8. **Freight t-km trends on CIS railways**



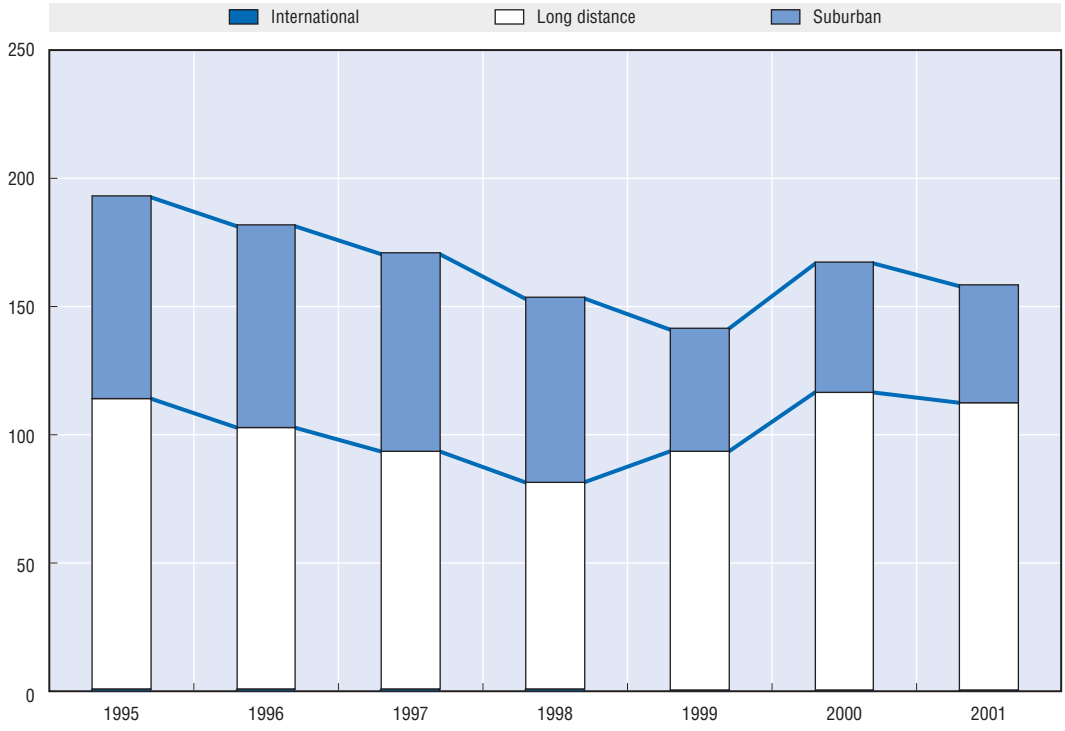
Source: Louis S. Thompson, World Bank.

system. Passenger traffic has followed a similar pattern, but the recent turnaround has been less marked than for freight – probably because of the simultaneous growth in car traffic.

Coal is the main commodity carried on the rail system. It accounts for 24% of tonnage and 29% of ton-kilometres (see Figures 5.11 and 5.10). Oil and oil products are the next-

Figure 5.9. **Rail passenger traffic in the Russian Federation**

Billion p-km



Source: Transport in Russia 2002, Russian Statistics Office.

largest commodities carried. A fifth of coal tonnage is transported less than 100 km, and half of it travels less than 550 km. But a fifth travels over distances from 3 000 to 5 000 kilometres. Ferrous metals are carried an average of 2 000 km, as are those goods in the "miscellaneous" category, which includes higher-value manufactured goods and containers. Containers accounted for just 1% of net t-km transported in 2001.

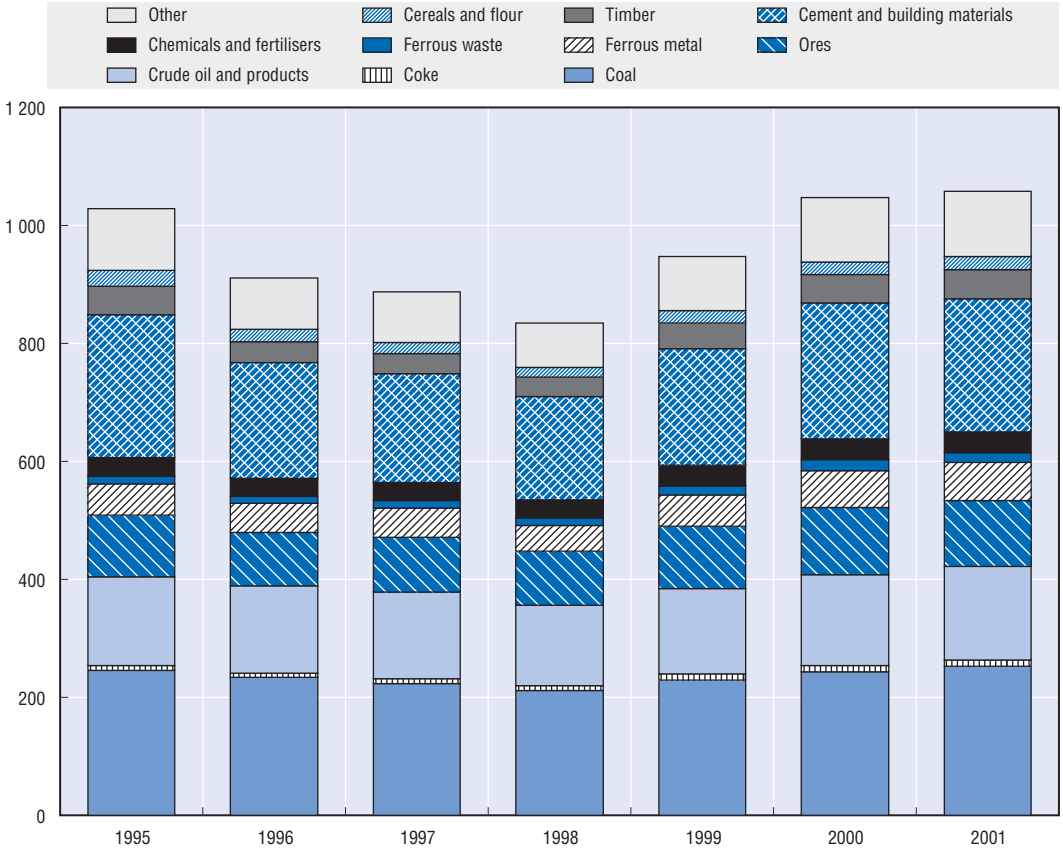
Some smaller-volume categories of freight transport have shown particular buoyancy in recent years. New investments on Siberian lines and interconnections with Asian rail networks, together with a general increase in trade between Asia and Europe, could attract new traffic. But security against theft would have to be improved, and very long delays at border crossings would have to be shortened.

Figure 5.12 gives an indication of traffic flows.[6] Nearly two-thirds of all railway traffic in Russia originates and terminates in what can loosely be called European Russia. A quarter originates and terminates in the eastern half of Russia. Only 11% travels between the two halves of the country. Coal accounts for the very dense traffic on the West Siberian Railway. Over half the coal transported within Russia is mined in that region's Kemerovo Oblast. A large majority of this coal is transported westwards, about 15% is carried eastward and a fifth goes to destinations within the Western Siberian Railway region.

The Trans-Siberian line carried 375 million tons of cargo along its 10 000 km in 2003. Of this amount, 55 million tons was international freight, the great majority of which was for import or export, with only 1.6 million tons of transit traffic (70% of which was movements from the Far East to Europe).

The map of traffic density also highlights the concentration of passenger traffic on the western networks and especially the Moscow Railway.

Figure 5.10. **Rail freight traffic by commodity in million tonnes**



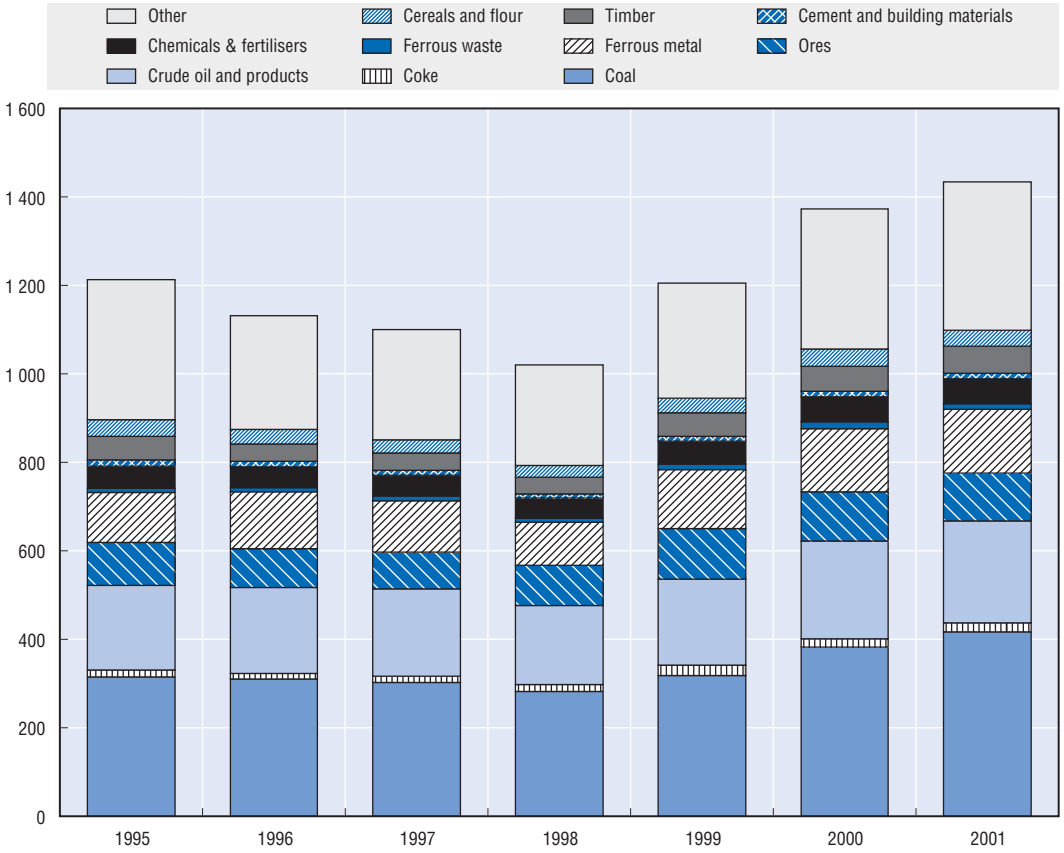
Source: Transport in Russia 2002, Russian Statistics Office.

Table 5.5. **Average length of haul by freight category in 2001**

	Share of ton km	Share of tons carried	Average haul length (km)
Hard coal	29%	24%	1 451
Coke	1%	1%	1 711
Oil and oil products	16%	15%	1 320
Ore	8%	11%	874
Ferrous metal	10%	6%	1 989
Scrap iron	1%	2%	761
Chemicals and fertilisers	4%	3%	1 506
Cement	1%	21%	532
Lumber	4%	5%	1 217
Grain and flour	3%	2%	1 441

Source: Transport in Russia 2002, Russian Statistics Office.

Figure 5.11. **Rail freight traffic by commodity in billion t-km**



Source: *Transport in Russia 2002*, Russian Statistics Office.

The government's railway reform plan

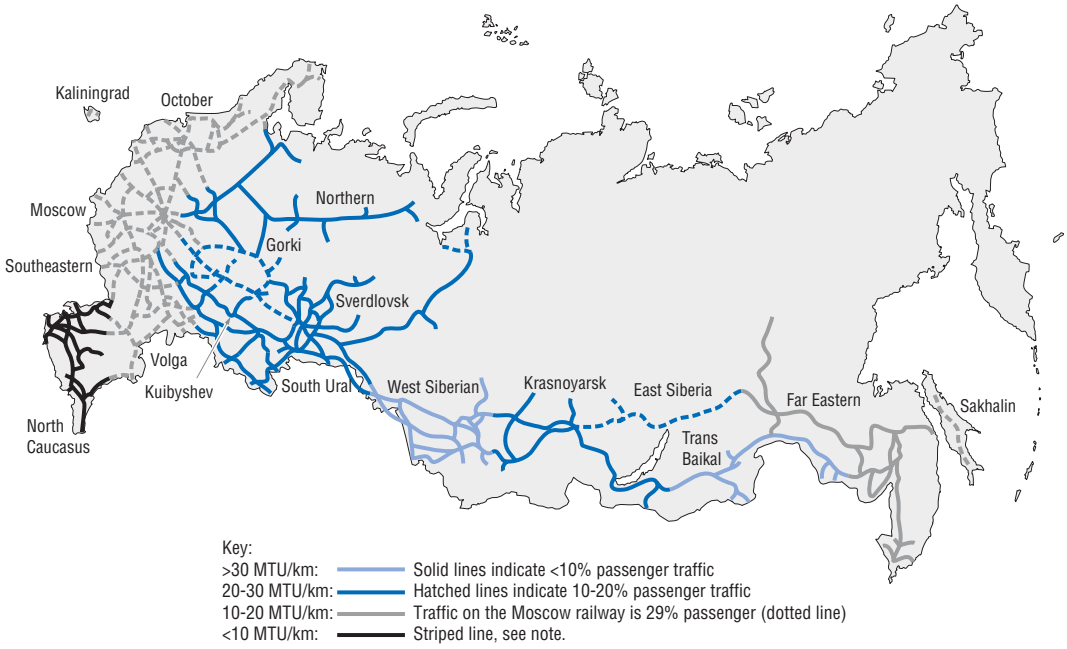
Despite their outward prosperity, the railways face a number of serious problems, the effects of which could become apparent in the next five to ten years. More than Rb 700 billion in new investment will be required to maintain the railways' existing stock of fixed assets. But several barriers to investment exist. The system as a whole is losing money – seven billion roubles in 1999. Resources are regularly transferred from the profitable freight service to the loss-making passenger service. Until recently the Russian legal system did not provide incentives for private investment in the railways. Because of lagging investment, the supply of serviceable locomotives and wagons dwindled. The government believes it has exhausted the possibilities of improving cost-effectiveness through administrative reform. Without structural reform to stimulate efficiency, the system may be unable to meet growing demand. If this were to be the case, there would be serious negative consequences for the Russian economy as a whole.

The reforms have had a long gestation period. Time was needed to provide greater transparency in financial flows and to determine asset values before restructuring. Much work was required to set up a procedure for regulating tariffs for those services that would remain in government hands after the establishment of the joint-stock company Russian Railways.

The restructuring approach is centred on separating the ownership of railway infrastructure from the operation of freight and passenger services. The reform plan puts

Figure 5.12. **Average traffic density on the regional railways**

Million TU/km of line



Notes: The Baikal-Amur Magistral line operated by the East Siberia and Far Eastern Railways, running parallel and to the north of the Trans-Siberian railway line, carries little traffic, much less than the average traffic density of the two regional railways that operate it. This is due mainly to steep gradients. It is in poor condition and carries only local traffic.

the emphasis on creating competition in freight services through competing carriers operating on RZhD tracks, but it also mentions the possibility of competition between *vertically-integrated entities* in European Russia. The plan also encourages private ownership of freight wagons and locomotives. It calls for the termination of cross-subsidies from freight to passenger services.

Decree 384 of 2001 sets out a three-step reform programme with these objectives:

- Stabilising the quality of rail service and safety performance.
- Preserving a single economic space across the Russian Federation and developing the national economy.
- Ensuring nationwide inter-operability of the transport system.
- Cutting the cost of the rail system.
- Meeting growing demand for transport services.

The key step in the first stage of reform was the creation of the joint stock company Russian Railways to take over day-to-day operations from the Ministry of Railways. It began operations on 1 October 2003. RZhD is fully state-owned. It retains the entire infrastructure formerly owned by the ministry. It maintains centralised supervision of train dispatching. Other main aspects of the first stage include:

- Phasing out freight-to-passenger cross-subsidies.
- Phasing out differences between tariffs for import/export freight traffic and those for domestic traffic.
- Refining tariff policy.

- Providing non-discriminatory access to the rail infrastructure for independent transport companies and independent owners of rolling stock.
- Separating out such non-core social services as schools and hospitals for employees.
- Improving financial incentives and social security coverage for rail employees.

During stage two of the reform, currently in progress, federal, regional and municipal governments are to take over the funding of loss-making passenger services, as well as that of railway expenditures ascribed to national security. Freight operations will remain integrated with track management in RZhD, but private entities will own half the wagon fleet and some locomotives. RZhD will establish subsidiaries for:

- Suburban passenger services.
- Some long-distance services.
- Maintenance and construction of rolling stock and track.
- Freight transit operations.
- Inter-modal operations.
- Refrigerated containers.

Some of these companies could be privatised. Consideration will also be given to the establishment of a wholly-owned freight subsidiary within Russian Railways.

Stage three, from 2006 to 2010, will focus on the gradual development of competition in freight and long-distance passenger operations, as well as some computer services. Competition in rolling-stock maintenance is to be encouraged. By 2010, 60% of freight wagons will be owned privately, as well as a growing share of locomotives. Investment cash is to be raised through loans, bonds and the sale of shares in some RZhD subsidiaries. The possibility will be assessed of separating RZhD into vertically integrated companies that would compete with each other for freight.

Key regulatory challenges

Accounting

Progress has been made in improving the accounts of the national railways. Income and expenditure are now recorded in separate accounts for freight, long-distance passenger transport, suburban passenger services and non-transport activities. Financial planning on the basis of budgets is now carried out with a central account-settlement system. Late payment and non-payment of accounts have been reduced.

If non-discriminatory access to rail infrastructure is to be provided for new operators, then separate accounts will have to be provided for infrastructure and for each of the company's train operations. The railway ministry developed a classification for accounting income and expenditure by type of activity, and RZhD put it into operation in October 2003.

Costs for the production of rail services are often hard to allocate because many costs are joint. It is not easy, for example, to allocate infrastructure costs between passenger trains and freight trains that use the same line. In Russia, the distribution of labour costs is used as the basis for allocating many other costs. Elsewhere, various economic and engineering models have been developed to make more accurate cost allocations. Russian Railways and the country's regulatory authorities will have to develop their own models or adapt models available on the market. More accurate cost allocation will help ensure non-discrimination in track access and will facilitate setting tariffs charged to shippers which

transport their goods in their own freight cars. Most important, it will help set charges for the use of rail infrastructure in such a way that train operators do not choose locomotive and other equipment that expose the track to excessive wear and tear.

It is important that accurate information on cost structures be made available to shippers and to potential train operators, in detail sufficient for them to write business plans. (Many railways and regulatory groups in other countries charge a small fee to cover the cost of providing such data).

Competition policy and the reform's goals for freight

The initial approach to introducing competition to rail transport has been to separate infrastructure management from train operations and to encourage new operators to run their trains on Russian Railways tracks. RZhD continues to own the infrastructure and operate the majority of freight trains, but passenger operations will be separated into subsidiaries that could eventually be spun off to regional or local governments or even privatised. As already noted, the reform plan also contemplates the possibility of creating competition between vertically-integrated railways.

Regulatory arrangements for the initial approach to competition

Whatever structure is chosen, regulation will be required. The specific arrangements will depend on the structure that is chosen and particularly on the relationship between the organisation that manages the infrastructure and those that conduct freight operations. The structure envisaged by the plan foresees new carriers competing with RZhD, which will still be the country's largest freight operator and also the infrastructure monopolist. This structure will require very active and very detailed regulation.

The government has encouraged large industrial rail users to build up their own freight-car fleets, in part to compensate for a national shortage of cars. The average age of Russian freight wagons is 19.5 years, and it is rising as the fleet deteriorates. The locomotive fleet is also aging alarmingly. The government believes that industrial customers are better placed to evaluate the investment risks in this area because they know the markets for their products better than the railways do. The railway has introduced new tariff schedules for private operators with their own wagons and locomotives.

"Competition" from large companies hauling their own commodities may be motivated more by incentives built into the tariff structure than by any real desire to compete with RZhD. This kind of competition is very different from that of "common carriers," which could compete with RZhD for all commodities across the entire rail network. It could, however, be a starting point.

The Federal Law on Railway Transport provides specifically for common carriers. It requires that they obtain a license from the government, that they enter into a contract with RZhD for the use of national rail infrastructure and that they own or lease locomotives. They must present a business plan and demonstrate that they have the skilled personnel to run trains. Train drivers are licensed under a separate procedure. By November 2003, nine carriers had obtained licenses.

Where there is free rail infrastructure, the law stipulates that access to it is guaranteed for license holders. But the procedures for determining whether capacity is available have not yet been tested. A separate decree defines non-discrimination and lays out the priorities to be followed when capacity is limited. As in most European Union countries,

the highest priority is given to international and express passenger services, and the lowest to domestic freight trains. Because the Russian system is very different from that in Western Europe, it might be well for Russian regulators to consider whether this approach will continue to be valid. Freight traffic in Russia is only half as heavy as it was in 1988, so capacity problems should be resolvable. More important for the future of competition will be the arrangement for access to *facilities other than track*, especially stations, freight yards and train marshalling services.

If the approach set out in Russia's current plan is to work, a number of practical measures will have to be taken to ensure that new carriers are encouraged to enter the market.

The key requirement is that access to, and charges for the use of, infrastructure be regulated in such a way that new carriers can, in fact, compete with RZhD. In essence, this means that the rules on access and charging must be set and implemented by a body independent of RZhD. Charges for using infrastructure must be free of discrimination between different carriers performing similar services. But non-discrimination will not suffice to achieve the full benefits of competition. Carriers must have control of as many of their costs as possible. They must be free to find more efficient ways of organising their operations and sourcing their supplies – including the procurement of services over and above access to essential fixed services. The existing tariff system permits them to contract separately with RZhD for a limited number of separate services, but the system may not go far enough to allow new carriers fully to control their costs.

An economic regulator will be needed to protect the public interest. This body should be a government agency entirely independent from the infrastructure manager or any carrier. The main duty of the regulator under the proposed structure will be to ensure that access to the infrastructure is fair and that the charges for it are appropriate. This will be a highly complex task. In the course of assigning access and determining charges, the regulator may have to take into consideration a number of *other* government policy goals, such as reducing subsidies to the railways, encouraging industrial production in certain regions or developing the rail network. The weight given to these different objectives will inevitably affect access policy.

Any carrier should have the right to appeal to the regulatory body if it feels it has been unfairly treated. In particular, carriers should be able to appeal against decisions adopted by the infrastructure manager in the areas of transparency, capacity allocation, infrastructure fees, safety certifications and the enforcement and monitoring of safety standards. The regulatory body should have the power to demand relevant information from the infrastructure manager, carriers and any third party involved. Current legislation authorises appeals to the Antimonopoly Service in disputes over access to rail infrastructure. In Russia's current institutional framework, this is an appropriate provision. But the Federal Antimonopoly Service already bears a crushing caseload. A sector-specific regulator for the railways may well be necessary if competition is to develop while RZhD continues to operate trains and also to manage the public railway infrastructure.

The economic regulator may have to take these other measures to reduce barriers to entry:

- Ensure that surplus rolling stock belonging to RZhD is not unreasonably withheld from potential new entrants.

- Ensure that potential new entrants can obtain locomotive drivers or training for new drivers.
- Provide assistance to potential new operators in meeting licensing and safety requirements.

By law, all train operators must be licensed by the government. Should the institutional framework change, licensing should remain the task of a public body. Ideally it should be handled by the regulator. Safety certificates should be issued by a safety regulator that is entirely independent from any infrastructure manager or carrier.

To encourage competition, infrastructure management and transportation operations should be separated to the greatest extent possible. The two functions should be vested in separated divisions of RZhD with their own profit-and-loss accounts, balance sheets and management teams.

Setting up the regulatory arrangements for the proposed interim structure will be a formidable task for the government. It will require the creation of both an economic regulator and a safety regulator. The two regulators would have to co-operate. They could be established under a common umbrella organisation. Both must be independent of the industry, and they *could* be independent of government. They must be given the legal powers to perform their duties. They would require substantial staff.[7]

Before it embarks on the major task of establishing a regulatory regime to cope with the structure that has been proposed, the Russian government should give further thought to reducing the regulatory burden. This could be achieved either by creating a vertically-separated structure in which no single train operator was dominant or by separating the railways horizontally and creating vertically-integrated companies that would compete with one another.

Horizontal separation into competing vertically-integrated operators

The second of these approaches – competition between vertically-integrated railways – would be less demanding on the regulatory authorities. Freight tariffs to customers who are served by two or more railway companies could be determined by competition, usually without any regulatory intervention. Alternatively, the companies might agree to use each other's tracks under voluntarily negotiated access terms. The Russian reform plan allows for the creation of competing vertically-integrated railways in European Russia during the third phase of restructuring.

There are at least two advantages to this kind of competition which should be taken into account in any cost-benefit analysis of different reform models. First are the simple economies of scale and "economies of co-ordination" that arise when the administration of a track system and the running of trains are combined. When a rail system is vertically *separated*, many decisions and transactions that once were made within the integrated company must now take place between independent companies. The chance for honest misunderstandings increases exponentially, as does that for strategic behaviour. In the rail sector, as in electricity, many experts consider that a vertically separated "grid" company is unlikely to receive the right incentives for investment, either in maintenance or in capacity expansion. (Many of the problems in the UK rail system and the US electricity system have been attributed to a lack of investment in the grid.) This in turn has been attributed to the fact that it is in the running of trains, or the generating of electricity, that money is to be

made – not in the operation of a regulated network enterprise. Maintaining vertical integration in the railways might avoid these problems.

Both models for competition could coexist in Russia. Competing, vertically-integrated railways could well be created in western Russia. East of Omsk, however, there is only one trunk rail line. In this area, therefore, regulated open access to state-owned infrastructure completely separated from all train operators would still be the more appropriate model.

Tariff regulation and charges for the use of infrastructure

Acting responsibly, the government has taken pains to avoid shocks to the system. It has preferred so far to preserve tariffs and to modify them gradually, rather than introduce a whole new system of tariff regulation in the midst of all the other reforms. But there are risks to this approach as well.

Within the regulatory framework, the Russian Railways must be given the freedom to price their services according to the market. If they do not get this freedom, they will lose their most profitable business to competition from road haulers and from industrial customers who decide to run their own trains. Within a few years, the railway will see its revenues decline, and the railway pricing system's ability to contribute to regional development will disappear. It will become increasingly hard just to cover the railway's own costs, even if the cost of supporting suburban passenger service is transferred to regional and local government budgets.

The Three Class commodity tariff system should be replaced by a much more flexible system of regulation adapted to the new market environment. Like RZhD, the private railway companies will need the flexibility to set tariffs that cover their costs and also allow them to respond to competitive conditions and hold onto their high-value cargoes. (This flexibility would, of course, be subject to broad regulatory constraints in those parts of the market where they were necessary.)

Once the decision is taken to move to more flexible pricing, the government will have to decide which, if any, of its goals should continue to be pursued through modifications of the railway tariff system. This judgment needs to be made before a new approach to regulation is formulated and adopted. The financial incentives that will result from the new layers of differentiation in the tariff system are hard to gauge. Even harder to predict are the responses of different parts of the rail sector as it undergoes legal and structural reforms, with some parts of the industry gaining unfamiliar new freedoms. Some of the changes could accelerate the railways' loss of traffic. Others may have unforeseen effects on the allocation of resources to investments that are essential to maintaining the system's asset value. Budgets for maintenance and renewal are often vulnerable during periods of change and uncertainty. The overarching risk is that, when the time finally comes to reform the tariff regulations, the railways will have been overtaken by financial crisis.

The regulatory task of overseeing freight rates would be greatly reduced if competition between vertically-integrated freight railways were to be established. The universal prescription of freight rates would be replaced by rates established through competition, with general regulatory oversight. There would be few cases in which active oversight of access charges would, in fact, be needed. Such charges would mainly be set, internally and implicitly, by the vertically-integrated railway companies themselves.

It will be important for the regulator to have both adequate information and economic expertise. The regulator should make economic assessments – not simply oversee the

application of the letter of the law. Even without competition between vertically-integrated railways, competition from road haulers will limit the market power of the railways in many markets. This will reduce the need for detailed prescriptive regulation and will allow the use of negotiated freight rates rather than pre-set tariffs in some cases.

The way in which charges for the use of infrastructure are set will depend in part on the model that is adopted. In one case, new carriers would operate on track owned by Russian Railways in competition with Russian Railways' own freight division. In the other, vertically-integrated railways would be established over parts of the network. Where vertical separation is chosen, a two-part tariff is probably indicated. There might even be a *menu* of two-part tariffs aimed at achieving cost recovery while allowing small companies to afford access. Since the system is expected to cover its full costs, the charges will have to be determined to a large extent by the customer's ability to pay. This would be assigned to the fixed part of the tariff. The variable part would be based on the marginal costs of running particular trains. It is vital that infrastructure charges be structured so as to provide very strong incentives to manage the infrastructure efficiently and to favour trains that do not impose excessive wear on the tracks.

Public service obligations and concessionary fares

Russian rail passenger services, like those in OECD countries, break down into two categories – suburban/regional and long-haul/inter-city. In 2002, the system carried about 1.15 billion suburban/regional passengers and 121 million inter-city passengers. Most long-haul passenger services can be commercially viable and should not receive state support.

In the European Union, however, the authorities have the right to conclude **public-service contracts** with a private transport firm in order to ensure adequate service that take into account social, environmental and regional-development factors. The Russian reform plan and its supporting legislation clearly foresee the adoption of a similar approach. State support for passenger services would be provided through a contract with the rail carrier. At least part of the support would come from local or regional governments. But the balance between the shares of national and local governments is a complex issue and needs to be discussed case-by-case.

Suburban/regional services are concentrated in a few regional railways, with more than half of suburban activity – and suburban losses – in Moscow and St. Petersburg. Total suburban losses for 2001 are estimated, very roughly, at Rb 16 billion. That is a large sum, and it plainly cuts into resources for badly needed investment.[8] High priority should be given to separating out the suburban/regional services financially, and later operationally.

Both types of passenger service suffer revenue losses because of widespread reduced fares. Suburban services are also plagued with fare evasion. An estimated 43% of suburban passengers travel free or on reduced-fare tickets, while another 10% are stile-jumpers. Resulting losses amount to Rb 6.8 billion a year – almost a half of overall estimated losses. (Long-haul services are less affected; only 14% of their passengers ride on reduced-price tickets, and fare evasion is rare.) If Russia were to adopt the European Union's model, in which public service contracts are required for each service, decisions on ticket privileges would start to be made in the right place.

The western part of Russia seems to constitute a fairly distinct set of passenger flows from those of Eastern Russia. About 61% of long-haul passengers start and finish their journeys within the western group of railways; another 29% start and finish within the

eastern group; and only 10% of passengers interchange between the two groups. It might, therefore, be feasible for Russia to have *two* long-haul passenger companies, each focusing on its own region and interchanging passengers at their boundary. If the eastern company were given the right to operate into Moscow, another 5% of passengers could travel without changing company.

This regrouping would not, of course, introduce competition into the passenger market. But, since the passenger carriers would be totally separated from infrastructure, there would be no reason not to introduce competitive operating rights, particularly in Moscow and St. Petersburg and on international routes to the West. If track access fees are properly set, if fares are deregulated and if the passenger carriers are directly compensated for their losses on reduced-fare tickets, Russia could have long-haul passenger companies that operate without major public support. Some, indeed, might become fully commercially viable.

At any event, the current Russian model, in which income from freight subsidises passenger services, will not survive the advent of intra-rail competition and growing competition from road transport. A new financing approach will be needed to support passenger services. A likely model is one in which passenger infrastructure would receive direct support form the federal government (which will continue to own the infrastructure) and the operating losses of local services would be borne by local governments (which are the primary beneficiaries of the services).

Summary and conclusions

The Russian railway system is in the process of rapid legal, organisational and regulatory reform. This paper is based on a series of discussions with the Russian government on the reforms and its progress in implementing reform. The conclusions are not intended to be interpreted as requirements or instructions on the next steps in the process. Rather, they aim to suggest further refinements that might facilitate the progress of regulatory reform – and in some cases avoid costly mistakes made in other countries. Only the Russian authorities are in a position to judge what the best course of action will be. It is they who will have to make the trade-offs between valid, but competing, objectives.

Progress

Good progress has been made in developing a comprehensive programme of reform for the Russian railways. Incorporation of the Russian Railways as RZhD OAO[9] on 1 October 2003 marked the first milestone in the implementation of the programme. In October 2004 RZhD was assessed by Standard and Poor's and issued with a BB+ credit rating, sufficient to enable it to issue bonds. The laws adopted set out a firm direction for reform while acknowledging the need to retain flexibility in the structural changes to be made as the market develops and responds to reform. The programme has been designed to avoid economic shocks to this key section of the economy. Progress is favourable compared with the planning and speed of reform in most railways world-wide. Some results are already evident – notably the fact that private operators have made significant investment in rolling stock the creation of the necessary legal framework and the modifications to rail tariffs.

The team believes it is critical that the momentum for change developed so far be continued and strengthened. First, to implement policy decisions already taken, gaps in the legal and regulatory frameworks must be filled as quickly as possible. And second,

more emphasis now needs to be placed on clarifying the stated objective of enhancing *competition* (both intra-rail and inter-modal) and its relation to *regulation* (both of infrastructure-access charges and of end-user rail tariffs) and the *structure* of the rail industry in Russia. The objectives, and the linkages between them, must be developed in a coherent way, or they will conflict with each other and defeat the overall goals of reform.

A major spurs to reform, clearly identified by the government, is the severe under-investment in infrastructure and rolling stock since 1990. This, coupled with the cost of supporting passenger services, may begin to limit the railway's ability to meet transport demand and threaten its financial performance. These issues have begun to be successfully addressed. But the rapid pace of change in the structure of Russia's economy, and growing competition from road transport to carry higher value freight, make it essential that the agreed reform plan be completed. It must not be allowed to stall at an intermediate phase. The team also foresees that competition from road haulage will increasingly limit the railway's ability to contribute to the government's regional and national economic development policies.

The government's response to financial weakness has been a determination to improve cost effectiveness by separating government from railway enterprise roles, separating non-core activities from the railway, contracting for public service requirements and creating legal and tariff frameworks for shippers and industrial customers of the railways to invest in private wagons. This has been the focus of stage one of the three-part reform plan. The later stages foresee the creation of competition in rail freight transport. Stage two provides for the creation of conditions for new general freight carriers to develop to compete with the existing, state-owned freight carrier, paying fees to RZhD for the use of infrastructure. Stage three evokes the possibility of splitting out businesses from RZhD as vertically integrated units (managing both infrastructure and train operations) that would be able to compete with each other to serve the main markets. A decision on whether to introduce this kind of competition will be taken at some point in the future.

In the meantime, further measures will be required to promote the competition foreseen for stage two of the reform plan. The team believes that the implementation of enhanced competition should now occupy a more central place among the government's priorities for reform of the sector. The initial phase of private investment in rolling stock may be reaching its end. Further scope for private investment needs to be created if investment is to continue on this scale. More fundamentally, experience in other countries shows that monopolies rarely maximise efficiency and are slow to innovate and provide the service that customers require. It is also significant that the Standard and Poor's rating analysis generally accepted the reform programme but focused on the need for improved implementation, especially transparency in financial reporting and in tariff regulation.

Fundamental points based on OECD experience with rail reform

The regulatory framework adopted for the railways will be critical in determining the performance of the system both financially and in terms of quality of service. The railways could sustain damage from *tariff regulation* that continues to limit its scope for adapting to market pressures (responding to competition from road haulage especially) and pricing its services according to its customers' ability to pay. And while geographically uniform tariffs may appear to promote regional development objectives, they place the railways at a severe disadvantage in competition with other freight carriers, such as trucks, that have the flexibility to charge tariffs specific to each commodity and local market.

Similarly, unless the *prices charged by RZhD to other carriers*[10] for using state owned infrastructure are regulated in a way that helps those licensed carriers control their costs, the competition envisaged in stage two of the reforms will not develop fully.

An effective mechanism for rapidly resolving cases of alleged discrimination in the provision of access to infrastructure is also essential for this kind of competition. Capacity is not generally constrained on the network; so RZhD is likely to have a general incentive to sell infrastructure services to other train operators. Nevertheless, maximising income for RZhD will not always be consistent with promoting the development of new train operators, especially when they compete with RZhD for higher-value cargoes. The Federal Antimonopoly Service will need additional resources to cope with an increase in its already heavy caseload. Alternatively, it might be more effective to establish a *specific regulatory agency for rail competition* to manage the increasingly complicated regulatory issues that are likely to arise. Markets where competition fails to develop are likely to see quality of service decline and traffic fall.

About 30 independent carriers now[11] successfully carry freight in niche markets for own-account transport. These are in relatively high-value bulk markets, especially oil products. RZhD is losing this potentially profitable business as it is not able to offer negotiated contract tariffs. At the same time the independent carriers are not able to offer transport services to other companies, because the regulations that will enable RZhD to sell its infrastructure services are not yet in place. Moreover there is no appropriate regulatory framework for licensing or setting charges for the use of infrastructure or leasing locomotives from RZhD. In these circumstances, although RZhD is losing income, shippers do not benefit from the reduction in tariffs that would be expected from effective competition. (Only own-account carriers gain, through better access to and control of wagons.) Until the licensing and regulatory framework for competition under stage two is completed, the income of RZhD will be undermined without delivering the benefits of competition to the economy. Moreover, freight tariffs in potentially competitive markets need to be liberalised. End user tariff regulation should be phased out or at least become more flexible, so that RZhD can compete with own-account carriers and with trucks.

The government's regulatory burden – in terms of financial resources, expertise and institutional capacity – will vary greatly with the type of regulatory framework adopted. Regulatory systems have been most successful when they both reduced the scope of prescriptive regulation and reduced the need for intervention by regulatory authorities. Such systems rely on *competition in place of regulation*. The more complicated and prescriptive frameworks – where competition depends primarily on operational regulation rather than the competitive structure of the industry – have often been adopted where government-financed passenger services dominated the rail system. They have also been chosen where external constraints limited the government's freedom to choose a new industry structure. This was the case, for example, when regulations were adopted to promote the development of a single market in rail services in the European Union. Because of the limited public resources available in Russia, there is a strong case for adopting a structure for the rail industry that reduces the need for regulatory intervention and minimises the burden on Government. This consideration, in turn, strengthens the argument argue for creating competition between vertically-integrated freight rail companies where feasible.

The coexistence of profitable freight services with unprofitable passenger services creates incentives that make it difficult for RZhD, as the infrastructure provider, to make the necessary infrastructure investments to sustain the largely government funded passenger train operations. Instead, RZhD may well direct investment resources to support revenue-generating freight services. Particular regulatory attention will need to be given to investment incentives and also to ensuring sufficient priority in the dispatching of passenger trains to meet the levels of service required. The system should give the public value for money in exchange for the public support provided for passenger train operations. Innovation will be required in defining the ownership of integrated railways. It will not be enough for Russia simply to adopt one model among those in force in OECD countries. The solution might perhaps involve a mix of public and private ownership, including leasing concessions rather than simply ceding ownership of infrastructure to the private sector. And Russia may prefer European-style public-service obligations to a North American-style system of competing integrated railways.

Whatever approach is adopted, the key regulatory task will be to encourage both investment and efficient operation of the railways, in line with the government's prime objective of reducing costs. To this end it will be important that the regulators have both adequate information and economic expertise to make judgments on issues such as tariff structures and access charges that are fundamental to efficiency. The *regulatory authorities should be making economic assessments*, not simply overseeing the application of the letter of the law.

The rail-competition regulator, in whichever institution it is housed, should be charged with protecting the public interest from an economic and commercial viewpoint. This body should be independent in its organisation, funding, legal structure and decision making from the infrastructure manager or any carrier. Experience in OECD countries suggests it will be most effective if it is an independent agency of the government. It should be free of the potential conflicts of interest that might arise were it also be responsible for regulating the prices of goods that have a large impact on rail costs, such as electricity. The principle role of this regulator would be to ensure that infrastructure access is fair and charges for the use of infrastructure appropriate. This is a complex task, given the conflicting objectives encompassed in government policy.

The results of government decisions, discussions and negotiations can only be as good as the *quality of the information* on which they are based. Whatever the objectives of reform for the Russian railways, it is vital that more accurate information be produced and made readily accessible to all railways, to their customers and to the public at large. The last few years have seen remarkable progress in the publication of accounting data, but some rail traffic and operating information that would be regarded as public in most OECD countries remains restricted in Russia. The restriction of information severely reduces the quality of analysis and debate on crucial issues. Standard and Poor's assessment of RZhD underlined the need to increase the transparency of regulation, and to improve the quality and availability of data. Such steps will reduce risks for potential investors and they are a precondition for achieving improved credit ratings. Making good and detailed data available to the public will also improve the quality of public understanding of the reform process and make the inevitable trade-offs between different goals that will have to be made throughout the process of reform more readily accepted.

Transparent accounts of costs and revenues are a necessity. They should be presented according to International Accounting Standard methodology by line of business. They should identify in particular losses and subsidies. This is essential if the economic impact of reforms is to be understood. It will also be needed to monitor the progress of reforms, and present them to the Duma, the press and the public. This is a universal lesson from reform in other countries.

Transparent accounts are also essential to prepare the way for *replacing cross-subsidies* to loss-making passenger services with direct financing. The team recognises the work done for MPS by Deloitte and Touche[12] on the losses associated with social services and the need for more transparent and IAS-compliant accounting. RZhD needs to continue and to accelerate its effort to develop line-of-business-based, fully IAS-compliant reporting. The accounts published by RZhD on its first year of business are a major step in this direction. More detailed IAS based reporting of information is needed both for better management and for improved access to capital markets, as the Standard and Poor assessment makes clear. More generally, the government will need to develop standard sets of data for all carriers to submit in order to enable it to regulate the industry effectively.

Next steps in reform

The trade-offs to be made in achieving the objectives of reform need to be more clearly identified for all of the government bodies involved in reform. There is an important trade-off between:

a) improving the economic performance of the railway system itself, the stated goal of the reform process, and

b) using the railway to promote *social policies and regional development* policies, a stated goal in the methodology of development of the freight tariff schedule.

International experience suggests that social and regional development goals should be addressed by direct government support, not by manipulating the tariff schedule to create favoured commodities and regions at the expense of other commodities and regions. The economic costs of social and regional development goals need to be identified accurately and transparently. There is a major risk of damaging the railway when these goals are hidden, rather than addressed by direct financial support and other government measures.

For the next steps in reform it is essential to clarify the goals of introducing *competition*. To date, the railway itself has led many aspects of the reforms and developed the concepts for the introduction of competition.[13] With the incorporation of RZhD, stronger leadership from government will be required, because no for-profit company has the incentive to create competition for its own services. Government responsibilities for the development of competition policy and law for the railway sector[14] now need to be clarified. The laws already adopted stress the importance of competition, but competition can take different forms and serve different purposes. What kind of competition is to be encouraged in Russia?

- Rail *versus* truck and barges?
- Rail *versus* rail? And if so, where? Should it be among:
  1. vertically-integrated freight/infrastructure companies on parallel lines?
  2. vertically-integrated freight/infrastructure companies competing to serve customers at commonly served points (often called “source” competition)?
  3. vertically-separated competing carriers running trains on the same line?

It will also be important to clarify the priority of competition relative to other objectives. If competition is critical, the structure of the industry and the formulation of access charges have to be set first and foremost in ways that enable competition.

In markets where a significant degree of competition is achieved, either intermodally or between rail companies, then the need for, and the approach to, regulation can and should change accordingly. For example, it is not appropriate to regulate end-user rail tariffs in parts of the market where there is strong competition from road haulage. And the need to regulate access charges will be reduced if there is competition between vertically-integrated operators.

As the goals for competition become more clearly defined, it will be essential to review the compatibility of the tariff system with those goals. The plans for structural reforms will also have to be reviewed to ensure that all three components – competition, regulation and structural changes – are mutually supportive, not conflicting. The next steps in reform should focus on the coherence and complementary among these three parts of the reform programme.

Potential inconsistencies arise in the formulation of charges for a shipper or operator who wishes to provide both wagons and locomotives and pay RZhD only for the use of its infrastructure. No tariff schedule has been published for the sale of infrastructure services alone. In principle, of course, it should be possible to derive charges for infrastructure usage alone from existing end-user tariffs. Ancillary services, such as loading, insurance or marketing, could be subtracted when these are also provided by the shipper or independent carrier. But the net result would be higher than the amount typically charged in the European Union, where *track access charges are established on the basis of infrastructure costs* from the bottom up. Instead of being based on infrastructure costs, Russian infrastructure access charges are based on commodity class and other demand factors. This may well increase the ability of RZhD, as the infrastructure company, to cover its total costs. But there is a strong risk that current infrastructure charges are higher than the economic costs directly attributable to infrastructure use. This will act to limit the ability of new carriers to enter and compete with the freight carrier operation of RZhD. And it could severely limit the ability of all rail-freight carriers to engage in competition with trucking companies.

Russian law identifies monopoly sectors of industry where tariffs are regulated. The railways are in this category. Nevertheless, strong competition already exists in some markets. Competition from road haulage for higher-value freight is developing rapidly in European Russia, particularly over distances below 400 km. Niche rail operators owning their own wagons carry more freight than RZhD in some markets. For example, own-account transport companies carry 60% of the oil carried on the national rail network. In markets demonstrating competition, end-user tariffs ought to be free of regulation. If tariffs remain regulated in markets where rail faces competition from other transport modes, the railways risk long-term insolvency, just as US railways came close to bankruptcy in the 1970s. If tariffs are not freed in markets where rail-on-rail competition develops, some of the benefits of competition will be foregone, and prices to shippers will be higher than they need be. Niche carriers, who are free to negotiate shipping rates, currently charge shippers substantially more than RZhD's regulated tariffs (in return for better assurance or rolling stock availability). *Freeing tariffs* in these markets would of course make the current approach to setting access charges redundant, as it is based on

deducting the costs of wagons and locomotives from the regulated tariff (which would cease to exist). It would require a new approach to setting access charges based more directly on costs.

The current approach to introducing *competition* in the railways is to create the legal framework for the emergence of new carriers to compete with the RZhD freight carrier on infrastructure owned by RZhD. Fostering the emergence of general freight carriers that compete with vertically-integrated Russian Railways will be a demanding task for the regulators. The danger is that the effort could result in little more than the development of specialised niche operators. Establishing a regulatory system that promotes competition between carriers within the existing rail industry structure will require a major effort from the government. The team considers that further thought should be given to *reducing the regulatory burden* in the railway sector. This could be achieved by creating a vertically-separated structure with full organisational separation and no dominant train operator, or else by separating the railways horizontally and establishing vertically-integrated companies that would compete with one another.

Key actions to be taken now

It is urgent to *complete the licensing and regulatory framework for competition* through access to RZhD infrastructure for independent common carriers. It is also urgent to *free RZhD from end-user tariff regulation in markets where there is competition* from these carriers or from trucks. Inflexible tariffs hinder competition and expose RZhD to the possibility of losing potentially profitable business to own-account carriers and to trucks. Making tariffs more flexible was one of the central recommendations of the Standard and Poor report in order to enhance the credit rating of RZhD.

RZhD has made proposals for the structure and level of *future charges for the use of infrastructure*. These proposals need to be reviewed by government and a decision taken in conjunction with the liberalization of tariffs in potentially competitive markets.

As envisaged in the reform plan, *passenger rail transport* should be separated rapidly from the rest of the system. This separation might start with a separation of the financial accounts for various passenger functions (including payment for infrastructure-access and use). This step could be followed by an institutional separation, with separate companies for the various intercity and suburban services. The assets that should go to the passenger companies should be established and the cross-subsidies from freight to passenger services ended. For loss-making suburban services, *contracted public service obligations* should be developed, as done in the European Union. Direct government funding might be introduced for the long haul, intercity passenger companies, as in the case of Amtrak in the USA and Via in Canada. (It is possible, however, that – with pricing flexibility and direct government support for reduced-price fares – the intercity passenger services may require little additional support.)

Involve local governments in planning and funding of local rail services. Everywhere it has been tried, when local governments were included in the planning and made responsible for a small part of the financing, it tempered their demands for public rail services and brought greater efficiency to the way the services were organised.

The procedure for *spinning-off subsidiaries* from RZhD was initially designed to handle businesses that were destined to remain in the public sector, such as intercity and suburban passenger train operations. Under the procedure, RZhD forms a subsidiary

company which is then passed to the government to conclude the sale or transfer of the subsidiary. This process, however, is unnecessarily long for commercial activities that could be sold to the private sector. Authorising RZhD to handle the sale of these businesses through the direct creation and sale of subsidiaries could greatly speed up this essential part of the reform process.

If a decision is to be made on whether and how to introduce the kind of *competition* envisaged in the third stage of the reform program, the necessary data-collection and analysis needs to begin now. The government will have to collect detailed information on freight flows, from origin to destination. Models must be made to assess where competition would be possible. Making this information available researchers outside of the government would enhance the quality of analysis and at the same time address the demands for more information on the regulatory environment made in the Standard and Poor's report.

Conclusion

The urgent need is to *continue the reforms*. The profound transformation of the railways over the last three years has been achieved in a remarkably short time. Positive results are already apparent in terms of investment, productivity and traffic. The risks of delay are probably greater than the risks of pushing through the reforms. Given the rapid pace of economic development in Russia, allowing the railway reforms to lag could be very damaging both to the rail system and to the national economy. Planning and analysis for the next stages of reform should commence as soon as possible. Questions that need immediate attention include:

1. In which areas of Russia, and for what commodities, is rail *versus* rail (as opposed to truck *versus* rail) competition needed?
2. Does the current tariff schedule encourage or discourage the entry of new common carriers into businesses that will compete with RZhD across the full spectrum of general freight? And does the tariff schedule permit adequate pricing flexibility for rail-freight carriers, including RZhD, to compete with trucking companies for high value freight?
3. Will there be line *versus* line competition in Western Russia? If so, how should the railway be divided and restructured? What data are required to design a system of competing railways that minimises the need for detailed regulatory intervention? Will the competition be on parallel tracks, at commonly served points, or both?

Though RZhD will need to prepare for the next stages of reform with analysis of the potential options, it cannot be expected to lead the process of introducing competition. This can only be done by the Russian government and its regulatory agencies. It would help to identify a lead ministry or agency in this regard. The priority for RZhD will be to adapt it methods of analysing costs[15] to a market environment. The respective roles of the Ministry of Transport and the Ministry of Economic Development and Trade need clarification. So do those of the Federal Antimonopoly Service and the Federal Tariff Service, particularly in relation to leading reforms aimed at promoting competition in rail markets.

Notes

1. *Regulatory Reform of Railways in Russia*, ECMT, Paris, 2004, ISBN 92-821-2309-X.

2. See the Web site of RZhD, *www.RZD.ru*, for details of the Management Board, Board of Directors and Audit Committee.
3. For example, the 158 km line built by SUAL to serve its bauxite mine in the Komi Republic.
4. Figures from State Scientific and Research Institute for Road Transport (NIIAT), see for example *Prospects for the use of low sulphur motor fuels in the Russian Federation,* ECMT, 2002.
5. Currently income from profitable parts of freight traffic is diverted to support loss making passenger traffic. Taxes on the railway's profits would be a less distorting, more transparent and more sustainable way of raising the revenues needed to support these services.
6. This figure is based on Table 4.2, *Regulatory Reform of Railways in Russia*, ECMT, Paris, 2004, which provides details of region-to-region freight movements.
7. By way of comparison, the economic regulator for railways in the United Kingdom has a staff of about 140. The safety regulator has about 300 staff members directly involved in railway issues.
8. Losses on long-haul operations are also high. At 30 billion roubles, they outpace losses on suburban services. But revenues represent a higher proportion of operating costs on long-haul trains, so they come closer to "breaking even".
9. RZD Russian Railways is a joint stock company owned 100% by the Government and formed to own and operate rail infrastructure, freight and, at least temporarily, passenger services. Prior to October 2003, the Russian railway system was managed and operated by the Ministry of the Means of Communication (MPS).
10. The 2003 Federal Law on Railway Transport provides for the licensing of "carriers" to compete for business with RZD across the board as well as undertaking transport for their own account. The law also provides for the approval of "operators" that provide their own wagons for RZD to carry their goods in and thereby secure certainty in the availability of rolling stock and train paths for their shipments.
11. In October 2004 about 2 300 companies owned rolling stock, 50 with over 1 000 wagons each, and of these 29 had been licensed as carriers.
12. Deloitte and Touche, and Scott Wilson Consultants, "Report of the Consortium of the Advisers on Analysis of government spending in the railways transport of Russia", Moscow, 2002.
13. The former Antimonopoly Ministry directed the introduction of competition and the provision for non-discriminatory access to infrastructure.
14. As opposed to exercising powers under existing laws.
15. Data on approximate marginal costs will be most relevant.

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Building Rules for the Market

Chapter 6

Electricity Reform*

* For more information see: *Russian Electricity Reform: Emerging Challenges and Opportunities*, OECD/IEA (2005).

Introduction

The Russian government has embarked on a highly ambitious programme of electricity reform. Russian policymakers recognise that the need for timely and appropriate investment can best be met by creating efficient electricity markets within a robust legal and regulatory framework. Fully competitive markets, in which transparent prices accurately reflect costs, are needed to ensure that the government achieves its long-term economic targets. Such markets can attract the new investment that the industry will need to maintain security of electricity supply beyond 2010.

If it is to succeed, the reform programme will have to create market structures, market rules and a regulatory framework that will foster the emergence of competitive markets in electricity. Many challenges are likely to arise during the reform process, both at the policy stage and during implementation. This chapter focuses on some aspects of the proposed reform that could have a bearing on its ultimate success.[1]

The Russian electricity sector: the context

Electricity generation

Russia is the world's fourth largest generator of electricity, after the United States, China and Japan. In 2003, it produced 916 TWh, an 11% increase over 1998. Thermal

Table 6.1. **Electricity generation by region, TWh, 1991-2002**

	1991	1995	1997	1999	2000	2001	2002
Central	249	190	187	190	195	197	197
Siberia	216	191	182	187	194	197	191
Volga	216	173	166	170	173	174	174
Urals	160	122	121	119	129	129	132
Northwest	99	79	80	83	85	86	86
South	77	67	61	59	59	65	67
Far East	48	38	36	37	41	42	42
Russia	1 065	860	833	845	876	890	889

Source: Economics and Energy of the Regions, A.M. Mastepanov and V.V. Saenko, Moscow, 2001, and *Fuel and Energy Complex of the Regions of Russia*, Volumes 1 and 2, Moscow 2003.

Table 6.2. **Electricity generation by fuel, TWh, 1990-2003**

	1990	1993	1995	1997	1999	2000	2001	2002	2003
Total	1 082	956	860	833	845	876	890	889	916
Natural Gas	512	430	354	357	359	370	377	385	402
Coal	157	149	161	157	161	176	169	170	174
Hydro	166	173	175	157	160	164	174	162	157
Nuclear	118	119	100	108	122	131	137	142	149
Petroleum Products	129	83	68	52	41	33	30	27	31
Renewables	0	2	2	2	2	3	3	3	3

Source: IEA Statistics to 2002 and IEA estimates for 2003 based on RAO UES and RosEnergoAtom data.

generation accounts for 66% of total production, and two-thirds of that amount comes. from natural gas. The balance is hydro-electricity (17%) and nuclear power (16%). Nuclear-based generation increased by 42% from 1998 to 2003 and the load factor at nuclear power plants rose from about 55% in 1998 to 76% in 2003.[2]

Russia is divided into seven regional grids, or energy systems. Almost 80% of Russian electricity is produced in four of these systems: Central, Siberia, Volga and Urals. Nuclear power production is largest in the Northwest system. It makes up about 25% of production in the Central and Volga systems. Hydroelectricity accounts for almost half of production in Siberia and almost a quarter in the Volga and Far East systems. Thermal power generation accounts for 70% to 90% of production in the Urals, North Caucasus and Far East, and over half in the Siberia, Volga and Central systems.

Hydro generating capacity has remained fairly constant since 1990, as has its share in the fuel mix for electricity generation. Thermal capacity has increased only slightly, but the shares of the different fuels – oil, coal and natural gas – have varied significantly. Since 1990, fuel-oil consumption for electricity generation has dropped 76%, while the share of natural gas dropped 21% and coal's share increased by 11%

Generating capacity

In 2003, there were more than 700 electricity plants in Russia, with a total generating capacity of 214 GW. Thermal and co-generation plants represent 69% or 148 GW of installed capacity; hydroelectric plants, 21% (44 GW); and nuclear plants, 10% (22 GW). In Russia combined-heat-and-power generation extensively accounts for about a third of installed capacity. About 80% of generating capacity in the European part of Russia (including the Urals) is natural-gas based. In the Eastern part, over 80% is coal-based. The overall share of natural gas in the thermal fuel mix is 66%.

Before 1990, the age of Russian generating capacity was in line with that in other European countries. Since then, however, construction of new capacity has fallen dramatically. The condition of the Russian electricity sector has gone from bad to worse. This has not yet posed serious supply problems – because electricity demand dropped by a quarter over the 1990s. But the replacement and expansion of generating capacity will become an increasingly pressing issue as demand for electricity grows. A hopeful first sign that this trend is reversing is reflected in the financial results for RAO UES for the first nine months of 2004,[3] which showed capital additions slightly in excess of depreciation.

Table 6.3. **Construction of new capacity, 1990-2003, GW**

	"90	"91	"92	"93	"94	"95	"96	"97	98/99	2000	2001	2002	2003
GW	4.0	2.0	0.7	2.5	2.1	1.0	1.3	0.6	0.8	1.1	1.3	0.8	2.1

Source: RAO UES.

According to Russia's 2003 Energy Strategy, electricity sector infrastructure has been depreciated by between 60-65% on average. The IEA[4] estimates that USD 157 billion worth of new generating capacity is needed over the next 25 years. But the near-term investment needs will be relatively low, amounting to USD 1.5 billion a year to 2010. About USD 21 billion will be needed to refurbish existing power plants to 2030. Over 80% of new

generating capacity in the next 25 years is expected to be gas-fired, because gas-fired combined-cycle gas turbine (CCGT) plants will be the lowest-cost option.

Electricity consumption

Domestic electricity consumption totalled 618 TWh in 2002. Industrial consumption was about 320 TWh (52%), while households consumed about 143 TWh (23%) and transport and services 133 TWh (22%). Russia's per capita consumption is low by OECD standards, but its energy intensity is high. During the economic decline that began in 1990, electricity consumption decreased by almost a quarter, to 579 TWh in 1998. Consumption fell in all sectors except households, where it actually *rose*. Electricity consumption increased to 618 TWh in 2002, but the rate of growth has declined since, possibly in response to increasing electricity prices.

Higher economic growth will continue to raise electricity demand if it is not offset by efficiency gains and customer resistance. The IEA projects electricity-consumption growth of 1.3% a year from 2002 to 2030, with the strongest growth in demand coming in the first decade. By comparison, the moderate-economic-growth scenario of the Russian Energy Strategy[5] projects annual growth of 1.75 to 2020

Network

The Russian electricity network is linked by over 2.5 million kilometres of national and regional transmission lines and local distribution lines, including over 145 000 km of high-voltage lines with between 220 and 1 150 kV.

The regional energy systems of the Soviet Union were based on the principle that key electric-power plants would supply electricity to the sub-regions that lacked sufficient electricity generation capacity. Very little inter-regional trade was envisaged or necessary under the centrally-planned system. In its Energy Strategy of 2003, the Russian government expressed concern that, because of its weak connections, the existing network may not be able to provide necessary access to generators in the future competitive market. The same document raised the question of whether the network could provide enough inter-regional connections to ensure against the formation of regional monopolies. Weaknesses currently exist in practically all the energy systems, at various levels. This concern is reflected in the 2004 investment programme of the Federal Grid Company (FGC) with its focus on strengthening sub-regional links within the Northwest region the serving the Kolskaya nuclear plant as well as the inter-regional links between the Siberia and Urals energy systems and the European part of Russia.[6] The IEA estimates that investment needs for transmission and distribution between now and 2030 will be on the order of USD 200 billion.

Wholesale and retail prices

Except for 15% of the wholesale market, electricity and heat prices continue to be subject to government regulation. At the federal level, the regulator is the Federal Tariff Service (FTS). It sets wholesale electricity prices, as well as transmission tariffs and UES subscription fees. The FTS also sets maximum and minimum prices for retail electricity and heat. The actual prices, as well as prices for the transit of heat and electricity over the network are set by regional energy committees within the limits laid down by the FTS.

Over the last decade, the government has used its control of electricity tariffs to manage inflation and maintain the short-term competitiveness of the Russian economy. Prices have been based largely on social and political considerations. Over the 1990s, electricity prices rose only half as fast as industrial producer prices. As a result, power companies have performed poorly, and investment in the sector has dropped dramatically. Regional Energy Commissions have continued the practice of cross- subsidising to assist residential consumers, state organisations and farmers at the expense of industrial consumers.

Since 2000, electricity prices have risen faster than inflation. Residential tariffs have begun to catch up with industrial tariffs as some cross-subsidies have been phased out. In 1999, residential tariffs were 44% lower than industrial tariffs; by 2003, they were just 10% lower. The gap is expected to narrow, and tariffs to residents are expected to exceed those to industries in the next few years. Residential electricity tariffs would have to be from 25% to 40% higher to reflect fully the difference in costs.

In its efforts to keep inflation below 10%, the government has capped prices in the "natural monopoly" spheres – gas, electricity and railways. To stimulate efficiency and cost reductions in these industries, the Ministry of Economic Development and Trade is seeking to refine its price-regulation mechanisms by replacing cost-plus regulation with price-caps.

Security of supply

Russia's economy has grown phenomenally since the financial crisis of August 1998. GDP growth peaked at 10% in 2000, and has averaged almost 6% since then. Growth was 7.3% in 2003. The government foresees growth of 6.2% per year over the period 2000-2007. In 2001, RAO UES projected that the combination of high economic growth and under-investment in generating plant would reduce reserve margins below minimum tolerance levels by the period 2004-2006. Although peak demand has increased over time, it was, in fact, almost 5% less in 2005 than in 1993. With installed generating capacity of over 200 GW, there is still considerable excess capacity that could be harnessed.

The dramatic drop in Russian GDP during the 1990s depressed electricity consumption. At the same time, investment in new capacity and maintenance plummeted. The construction of several nuclear power plants was halted in the late 1980s and early 1990s. Supply amply meets demand now.[7] Conservative estimates, including those of the International Energy Agency, foresee little tightening of electricity supply until well into the 2010s.

A key issue which, is poorly understood due to the paucity of reliable data, is how much of the generating capacity that was mothballed in the 1990's can be effectively reconnected and used. Nuclear plants have increased their load factors dramatically since 1990 by shortening maintenance periods and by improving the fuel cycle and the reliability of certain components. Hydro load factors have remained relatively stable over the last decade. These factors are largely dependent on regulatory practices and rainfall. In the case of hydro dams along the Volga River, the impact of increased loads on the fisheries in the Volga delta and the Caspian Sea – and the risk of floods along the highly-populated banks of the Volga – are vital factors in how their capacity is regulated and used. Hydro generating capacity in Siberia is much less affected by such factors.

The load factor of thermal generating plants has dropped almost 15% since 1990, from over 60% to 47% in 2003. Accounting for almost 70% of Russia's generating capacity, thermal plants and their load factors play a critical role. There is little information on the state of this

large segment of Russia's generating capacity apart from its age structure – two thirds of the plants were commissioned almost 25 years ago. During the 1990s, regulators sought to balance load equally across all thermal power plants, so that all capacity would continue to operate, irrespective of its relative efficiency. It is not known how effective this policy was. Nor is it known how many electricity units were cannibalised for spare parts. The answers to this question will mean the difference between major new investment needs in the sector – or limited needs that could be met through refurbishment of existing capacity.

In the 1990s, rampant non-payment of bills was the key problem plaguing the electricity sector. By 2003, RAO UES had recovered most of the arrears, but non-payment, particularly by households, continues to be a problem in certain regions. At present, the main risk to security of supply across Russia is the chance that the plants may not be able to accumulate enough fuel to meet peak-load requirements. Inadequate repair and maintenance before the winter months could also pose a supply problem. In 2003-2004, however RAO UES ensured reliable and uninterrupted power supply to consumers despite extremely cold weather in some areas.

Despite the current over-capacity in the Russian market overall, some tightening is already perceptible on a regional level. Network extensions by the Federal Grid Company will be critically important to ensure inter-connection between the deficit and surplus regions and within certain regions. Electricity-sector restructuring and liberalisation will be essential in attracting investment when new generating capacity is needed. But it will take potential investors some time to evaluate Russia's success in implementing the various aspects of electricity sector reform. The time to move ahead with reform is now.

The Russian electricity sector: restructuring

The legislative and corporate framework for reform

In the Soviet era, the Russian electricity sector was vertically integrated, with no competition at the wholesale level and no choice of supply for consumers.

In July 2001, the Russian government announced an ambitious plan to create a competitive electricity sector over the course of this decade.[8] The main objectives of the reform included improving the sector's efficiency and transparency, promoting investment and ensuring reliable supplies for all users.

In 1992, Presidential Decrees 922 and 923 transformed the Russian electricity sector, with the exception of nuclear generators, into a single joint-stock corporation, United Energy Systems (RAO UES). All non-nuclear generation, transmission and distribution assets were divided between RAO UES and 75 regional power utilities known as AO-*energos*. RAO UES owns all of Russia's large thermal plants and hydro facilities, as well as the high-voltage grid and the Central Dispatch Unit. It retains varying degrees of control over the regional *energos*, which in turn hold regional monopolies in supply and distribution, as well as the majority of co-generation assets in their regions. Minority shares in RAO UES and in its large power plants and *energos* were privatised. Nuclear power generation is 100% owned by the Government. Nuclear plants are operated by the state company RosEnergoAtom.[9]

In April 2003, a set of laws and regulations was adopted to put the reform in motion. They mandated the break-up of vertically integrated structures into competitive generation and supply companies, on the one hand, and regulated transmission and distribution companies, on the other. The laws outlined the structure and rules for

competitive wholesale and retail markets and for network and system operation. New regulations dealt with access, pricing, investment, institutional arrangements and crisis management.

On 29 May 2003, RAO UES adopted a "conceptual strategy" for the period 2003-2008, which has come to be known as the "5 + 5 strategy".[10] It laid out the procedures for the corporate restructuring of RAO UES, defining the basic principles and processes of corporate restructuring of the electricity sector. On 27 June 2003, the government set out its own "action plan" for restructuring the electric power industry over the period 2003-2005. Thus, parallel corporate and government processes were set in motion, to complement one another as they were independently carried out. Implementation is currently progressing in parallel on several key elements of the reform programme. The process can be divided into three phases.

Phase 1 (2003-2004)

RAO UES began its programme of restructuring and incorporation. According to the original legislation, the physical unbundling of competitive and "natural monopoly" activities was to have been completed by 1 January 2005. This has since been rescheduled to 1 April 2006. Key steps during this phase included:

- The creation of wholesale generating companies.
- The creation of a national system operator.
- The transfer of transmission assets from RAO UES to the Federal Grid Company.
- The creation of inter-regional transmission companies.
- The creation of a Trade System Administrator (ATS) to operate the wholesale market.
- Four pilot projects to provide a model for unbundling regional *energos*.
- A start to the restructuring of regional *energos* on a functional basis.

Trading arrangements for the wholesale market during the transition period were developed and implemented. Key elements included:

- Establishing rules for the transitional market.
- Implementing Phase One of the transitional wholesale market (with voluntary user participation) as of 1 November 2003.

Work proceeded on developing the legislative and regulatory framework. Key elements included:

- Developing and ratifying transition period rules for wholesale and retail markets.
- Developing and implementing rules for non-discriminatory access to "natural monopolies".
- Developing new principles and methodologies for regulated tariffs during the post-transition period.
- Developing a regulatory framework for supervising competition.
- Determining the scope and authority of the new regulatory bodies.
- Setting standards for information disclosure and establishing certain dispute-resolution procedures.
- Developing licensing arrangements for retail suppliers and Guaranteeing Suppliers.

Many of these arrangements were completed and others were well advanced in 2003. Delays occurred in 2004, however, due in part to the government reorganisation in May. The deadline for the distribution of federal assets and the incorporation of wholesale *gencos* has been pushed back.

Phase 2 (2005-2006)

The restructuring and incorporation programmes continue. Wholesale generation companies are to be created and incorporated. The regional *energos* are to be fully restructured. Territorial generating companies and inter-regional distribution companies are to be established. The transitional wholesale market will be extended to Siberia.

Decisions are to be taken on the reorganisation and incorporation of remaining UES assets. The national system operator and the Federal Grid Company are to be separated from UES. The remaining thermal generating companies are to be incorporated and sold off. The super-hydro wholesale generating company is to be incorporated. The territorial generation companies are to be incorporated and sold. A holding company for regional distribution is to be created. Remaining UES assets are expected to be consolidated. A holding company is likely to be created for Guaranteeing Suppliers, isolated regional *energos*, non-consolidated regional generation companies and other non-core assets.

At the end of this process, the government will control at least 52% of the voting stock in the Federal Grid Company and the national system operator, a controlling interest in the super-hydro generator and unsold wholesale generating companies. It will own all nuclear facilities.[11]

The final version of the wholesale-market guidelines and rules will be decided upon. Guidelines will be developed for retail markets. The decision will be taken to end the transitional period and launch the competitive wholesale and retail market. (But this decision is unlikely to enter into force before 1 January 2006).

Phase 3 (2006-2009)

The RAO UES restructuring programme is to be completed during 2008-09. Competitive wholesale and retail markets will open progressively as cross-subsidies are unwound. Price controls will be removed for sales in the competitive sector. A regime of vesting supply contracts will be implemented for regulated electricity sales. The decision will be taken to extend customer choice to all users (some time after 2010, in all likelihood). And government equity in the FGC and the national system operator will increase to 75% of voting capital plus one share.[12]

Implementation challenges ahead

Establishing a sound strategic policy direction for advancing electricity reform programme represents a considerable achievement. But greater challenges lie ahead. International experience indicates that electricity reform can raise many technical issues in relation to market design, market structure and regulatory arrangements. Emerging issues tend to be complex, often interrelated and sometimes specific to particular circumstances. Such details matter enormously in the context of implementing electricity reform, and can be expected to determine the extent to which the government's strategic policy is ultimately translated into practice. Experience has shown that inappropriate responses to technical details affecting market design, market structure or regulatory

arrangements can frustrate strategic policy objectives, distort reform. Such responses can even derail reform entirely, as was the case in California and Ontario.[13] Establishing effective price signals and allowing market participants to respond to them may prove to be one of the greatest challenges facing Russian policymakers and regulators.

International experience also suggests that substantial reform can create "winners" and "losers". Stakeholders may seek to influence implementation in a manner that would seriously distort the substance or timing of the reforms. Managing the transition in a way that secures support from key stakeholders, balances competing interests and maintains the essential integrity of reform has proven to be a considerable challenge in other countries. It may prove to be so for Russian reformers. However, given the technical challenges inherent to electricity reform and the potential for undue compromise to fundamentally undermine successful implementation, it is important that every effort be made to ensure that the strategic policy directions are translated into practice to the greatest extent possible.

Market structure and ownership

The competitiveness of the wholesale and retail market structures that emerge from the reform process will largely determine whether the new market can achieve real efficiency gains while limiting the abuse of market power.[14] Experience in other countries points to the importance of separating those elements of the market that are subject to competition from those considered part of a natural monopoly. In light of the same experience, it is important that there be enough horizontal and vertical unbundling to promote competition at each step in the value chain.

Wholesale market structure

Russian policy makers recognise the importance of maximising competition among generators, both within and among regions, in order both to promote efficient wholesale markets and to avoid abuses of market power. The government currently proposes to create as many as 26 wholesale generators and territorial generation companies which could compete among themselves across the entire wholesale market. A key aim of this proposal is to spread ownership as evenly as possible, by technology, by location and by size.

The proposal may deliver considerable diversity of ownership and a highly competitive wholesale-market structure. Overall, the largest firm – the aggregated hydroelectric generator – would control about 15% of total generating capacity, while the three largest would control about 34%. The situation would, in this respect, compare favourably with that in other reformed electricity markets.

Network congestion is likely, however, to provoke the appearance from time to time of *de facto* regional markets within the national wholesale market. During such periods, prices and dispatching patterns will reflect local supply-and-demand. Fewer generators will be involved, and they will have increased opportunities to abuse their strong market positions. It is important, therefore, to consider the *regional* implications of the proposed wholesale-market structure. The diversity of the proposed system appears a good deal less impressive when viewed from a regional perspective.

Another revealing indicator of market concentration and the risk of excessive market power is the potential share of residual demand controlled by each generator. "Residual demand" means the amount of demand that remains to be met after all plants but one are

running at full capacity. A generator's ability to price-gouge depends on the overall supply-demand balance for a given hourly interval, the relative elasticity of demand and the availability of imports from other regions. Also crucial is the generator's ability to control residual capacity within each region.[15]

Because demand, nationwide, remains lower than total capacity, it is unlikely in the short-term that any of the proposed generators could abuse its market position on a national scale. But opportunities to exercise market power in relation to residual demand are likely to occur on a regional basis. Indeed, there are some regions where tight supply conditions have already begun to emerge. The proposed restructuring could lead to cases where a single generator would control the remaining capacity to meet residual demand. The largest generator in at least two of the six regions would have both the ability and the incentive to control the remaining capacity to meet residual demand. The two largest generators in three of the regions would dominate the supply to meet residual demand. This situation could lead to collusion and other forms of market manipulation. Technological or seasonal problems affecting one of the two large companies could sharply increase the other's ability to control the available capacity to meet residual demand.

The ability of companies to abuse a dominant market position could emerge on a regional level in a variety of circumstances – when the constraints on the inter-regional network limit trade or when peak demand or extraordinary events lead to a tightening of the supply-demand balance. Similar risks could develop at various points on the supply curve and at different times of the year or even *times of day*. (Trading in electricity is unique, in that discrete markets are formed within it for each trading interval throughout the day.)[16]

Further unbundling of generation capacity to produce more regional generation companies would reduce the risk of market power abuse without cutting into economies of scale. By selling off individual generating assets, the government could reduce the costs of entry for potential market participants. This might increase the pool of new investors, including large Russian companies, thereby augmenting diversity of ownership and making the structure more competitive.[17] But this solution may not be feasible. Current minority shareholders could sabotage it. And it may prove difficult to create commercially-viable enterprises capable of raising the capital for new investment.

The reform plan seeks to strike a delicate balance between maximising the diversity of ownership and creating viable businesses. To this end, it envisages the creation of a number of wholesale thermal generating companies of about equal size, each with assets in several regions. But some of the proposed companies are still quite large in absolute terms; so there is room yet for further diversification of ownership. The distribution of assets outside these integrated energy systems to the new generation companies could discourage international investors who felt they lacked the local expertise to compete. It could also encourage a later trend toward regional rationalisation, which would increase the concentration of ownership.

Alternatively, competition could be developed by encouraging inter-regional trade through a strong transmission network linking main centres of power production and consumption. This would be one response to worries about regional market power.

Diversity of ownership

Diversity of ownership is a precondition for efficient wholesale electricity markets. But the effectiveness of such diversity will depend heavily on the asset owners' sensitivity and responsiveness to price signals.

Large domestic companies which are already shareholders in RAO UES could dominate private ownership after the coming divestitures. Investors with substantial interests in other lines of business may not necessarily respond to price signals from the electricity market in the same way as those for whom power generation is the core business. (If an aluminium company were to control generating capacity and use its production for its own needs, in effect setting the price for itself, that kind of *de facto* vertical integration would reduce the reach of competition.) If responses vary too much from an efficient market one, the overall competitiveness and efficiency of the market may decline. One way to parry this risk is by organising an efficient divestiture process in which barriers to new entrants are kept at a minimum and the greatest possible diversity of ownership – both domestic and foreign – is encouraged.

A prominent feature of the post-reform ownership structure is that the government will continue to own all the country's nuclear facilities, a controlling stake in the super-hydro generation company and possibly the residual generation assets that do not find a buyer. The state's nuclear and hydro assets alone account for over 49 GW, or a little over a quarter of Russia's total generating capacity.

Government ownership in itself may not be a problem, particularly in the nuclear field. Because of their special technology, there are strong incentives for any owner of nuclear facilities in a competitive market to operate as base-load generators. Keeping nuclear facilities in public hands may be the more efficient way to deal with politically sensitive issues such as nuclear safety and the secure disposal of nuclear waste. But public ownership of a large part of the country's generating capacity is bound to raise doubts among other market participants about the government's neutrality. They will see a clear conflict of interest between the government's role as rule maker and regulator and its role as a competitor in the market.

Continuing government control of hydro generators could lead to pressures on the government to intervene in the markets. The perception may arise that the government continues to operate these assets in order to influence market behaviour. Such pressures may be hard to resist, especially after excess capacity is absorbed and wholesale prices start to rise. But it is vital that the government do resist such pressure. Even the *idea* that the government might be willing to intervene in this way could damage the market's credibility and the confidence of market participants. Uncertainty would grow, increasing regulatory risk. Efficient and timely investment would be discouraged. Such a perception must not be allowed to arise.

A strong expression by the government of its commitment to good corporate governance, and the publication of a business plan for its hydro and nuclear assets, could allay some of the market's concerns. Officials at RAO UES are currently working on new corporate governance guidelines based on international best practice. This is a very positive step.

In the Nordic market, privately owned and managed hydroelectric generators now operate successfully in a competitive environment. Sensitive public issues, such as public safety, environmental impacts and fisheries management, could be dealt with through

licensing. Bearing in mind the inherent importance of hydro generators in wholesale price formation, and given the concerns about continuing government ownership, the government should give serious consideration to the combination of licensing with unbundling and the eventual privatisation of hydro assets once the target market is operating effectively.

Post-reform rationalisation: a threat to diversity and efficiency

In several countries, the initial restructuring and opening of electricity markets has been followed by a strong trend toward rationalisation and concentration of ownership. Between 1998 and 2002, the European Union's internal electricity market saw 96 major mergers and acquisitions. Mergers were most frequent in countries with a diverse market structure, such as the United Kingdom. Mergers also took place in countries with large customer bases in the competitive sector and a strong potential for commercial development, such as Germany, the Netherlands and the Nordic states.

By 2002, seven large utilities had grown to dominate the EU internal electricity market, controlling nearly two-thirds of all electricity sales. These companies continue to grow rapidly. Some analysts predict that the EU electricity market will be dominated by just five large companies in 2010.[18] This trend could significantly reduce the effect of market competitiveness and open the way to collusion. Regulators in the Nordic market estimate that cross-ownership has reduced competitiveness in their jurisdiction by an amount equivalent to a 28% increase in ownership concentration. Regulatory supervision of the rationalisation process has proven to be quite difficult. Some of the mergers that have occurred could be justified on the grounds of improved efficiency, economies of scale, better risk management, lower transaction costs and cheaper access to financing.[19] But the concentration that has resulted from unchecked rationalisation could hamper the development of robustly competitive and efficient markets.

The Russian electricity sector is likely to see similar trends emerge after the market is in place. As a result, competition regulation will become more important than ever. If the regulator fails to act effectively, the results could include a less efficient market, a reduction of competitiveness and increased opportunities for the abuse of market power. Russian policy makers recognise the risks. One of the options they are considering is a moratorium on mergers and acquisitions for a certain period after privatisation.[20] This move would certainly address the issue of undue concentration. It is appealing as a short-term measure, since it would give the Federal Anti-Monopoly Service time to refine its expertise in supervising the reformed electricity market. On the other hand, a moratorium could, especially if long-lasting, hinder efficient market development and operations, ultimately imposing additional costs on consumers. The longer a moratorium remained in force, the greater the efficiency loss and costs might be. There are no simple regulatory solutions that can replace effective competition supervision. Some degree of judgment and discretion will be required of regulators in dealing with structural and behavioural issues in the new market.

The supervision of competition is almost sure to be contentious. The regulator can expect to come under intense pressure, particularly in connection with merger and acquisition cases. The proposed legislative framework provides the regulator with general policy guidelines and broad legal powers, but the actual interpretation and application of competition rules will ultimately be done on a case-by-case basis. The regulator will need to be credible. He must be seen to be acting transparently, objectively and impartially. He

will need adequate resources, as well as independence and resolve. The government may need to review the issues of regulatory independence and regulatory funding. In particular, the regulator must be given the means to perform sophisticated technical investigations or to outsource such work.

Investment

Russian policy makers recognise the major challenge involved in attracting timely investment. Conservative sentiment in international financial circles and the worldwide competition for limited investor capital are just two of the factors that will magnify the problem in the short term. The collapse of Enron and the financial difficulties of many merchant power plants in the US have shaken investors' confidence in the electricity sector generally, and financial institutions have become more discriminating in their lending to electricity projects.

Attracting investment in power generation

Although the reform is rooted in the proposition that price signals stimulate efficient investment, the Electricity Law reflects a concern that such signals may not prove strong enough to attract the investments that the power sector will need, particularly during the transition period. The law enables the government to make "safety-net" investments in generating capacity if the market fails to deliver an adequate response. A capacity payment mechanism and an investment-guarantee fund are being considered to address this concern.[21] The capacity payment mechanism is expected to commence in 2006. Key features of the proposal may include:

- Long-term capacity supply contracts for existing and new generating capacity to provide revenue certainty during the transition period and during the capital pay-back period.
- Associated long-term fuel supply contracts covering the term of the capacity contracts.
- A requirement for electricity retailers to enter into long-term capacity contracts with generators (for delivery of capacity up to three years in advance).
- An annual capacity auction to allow contracting parties to manage potential imbalances. And
- Costs to be passed through to users.

Investment Guarantee Fund has been proposed as a regulated "safety net" to address critical short-term investment requirements until 2008, when the capacity mechanism will become fully operational. At present, it is likely that the fund will target specific projects totalling around 4 000 MW of new capacity. The fund may be enlarged starting in 2009-2010 to enable it to respond to critical investment needs should the capacity market fail to deliver an appropriate response. It is anticipated that market participants would pay a levy to finance the fund's operations.

Several arguments are used in favour of capacity mechanisms. They are said to smooth investment cycles and reduce investment lags, to reduce the high cost of capital and to deal with the risk associated with under-investment in peak capacity.[22]

Designing capacity-payment mechanisms is a delicate task. Poorly designed mechanisms run the risk of crowding out efficient private investment. In the worst case, they tend to entrench a form of central planning which is incompatible with competitive markets. Capacity payments can also distort markets and reduce efficiency in other ways. They can

foster collusion and other forms of market manipulation. They can give existing companies a competitive edge. They can lead to inefficient and inappropriate investment, and even encourage over-investment. They can discourage flexible responses to peak prices.

A case can indeed be made for using a capacity mechanism during a transition. Investment in new generation slumped during the period when the California reform package was being developed, reflecting investors' uncertainty and their worries about the shape of future regulation. But investment picked up again once the legislation was enacted and investors had had time to observe the market's performance. This may be pertinent in Russia, where key details of the wholesale market remain to be worked out.

There is a school of thought that goes still further and advocates an *ongoing* capacity mechanism, even after the transition period. The argument is that the confluence of underdeveloped capital markets, inexperienced electricity-market participants and an untried legal and regulatory framework render a long-term capacity mechanism necessary in the Russian context.[23]

The argument is not entirely convincing. Aside from its probable negative effects on efficient price formation and market development, long-term capacity payments representing a very high proportion of generators' asset values could very well inflate those values unduly. This would discourage international participation in the coming divestiture process, and it could limit the ability of new owners to raise funds for subsequent investments.

Price signals can be strengthened by effective financial markets. Such markets, when they are both liquid and deep, can reduce the *volume* risk to investors by ensuring that there will be robust demand for their production. *Price* risks can be managed through sophisticated trading and risk-management products.

Better access to full and accurate information on supply-demand balances and trends would bolster efficient decision making by investors. It would complement the information they get from the price signals sent them by financial markets. Regulators and market institutions in several countries already supply just this kind of useful information. Examples include the Joint Energy Security of Supply Report in the UK and the annual Statement of Opportunity by NEMMCO in Australia. Publishing such valuable data, including regular projections of medium- and long-term trends in the growth of regional supply and demand, would help to facilitate efficient and timely investments. It could serve as an alternative to extending capacity mechanisms beyond the transition period.

Investment in transmission

The success of the reform programme will depend, in large measure, on the performance of the transmission system. An efficient transmission network linking the six regions of the proposed electricity market would deliver real economic benefits. It would improve market competitiveness and capacity utilisation, thereby postponing the need for some expensive investments in generating capacity. It would improve reliability through more efficient arrangements for sharing reserve capacity.

Some of these benefits are already being reaped, through transfers from surplus to deficit regions. Some experts warn that parts of the network are over-loaded and that it may, indeed, be approaching the end of its economic life. Nevertheless it appears that the system still has considerable excess capacity in some places. Moreover, the Federal Grid

Company, which controls most of Russia's transmission infrastructure, has undertaken a programme of network augmentation.

Electricity reform, with the unbundling and independent decision-making it implies, is likely to change radically the way the transmission network is used. Key decisions relating to network use and investments were once made in a centrally co-ordinated way within vertically-integrated utilities. In the future they will be made by a number of independent market participants. Decentralised decision making can fundamentally change utilisation of transmission networks. Previously stable and relatively predictable patterns of network use will, in many cases, be replaced with less predictable usage, greater volatility of flows and greater use of long-distance transportation.

Changes in network flows, new trade patterns and increasing demand could lead to significant new congestion. Correctly timed, located and sized investments can resolve these issues. But such investment will not necessarily be forthcoming. It is not always easy to identify economic opportunities to alleviate congestion and to maintain reliable transmission capacity. In other reformed electricity markets, the issue of ensuring regulated returns sufficient to attract new investment has also proved to be a contentious one.

Investment returns

In the past, transmission tariffs were set as a function of the volume of transmission services provided to RAO UES. They were not subject to separate economic regulation. Regulation of the Federal Grid Company (FGC) began only in June 2003. Tariffs are now based on cost-plus methodology, which allows FGC to pass on all allowable costs and to recover an "economically justifiable" return. FGC has the right to retain for two years any savings over the various allowable costs after which they are redistributed to users via lower tariffs. The electricity legislation calls for annual price reviews.

Cost-plus regimes provide little incentive to cut costs or improve efficiency. Once the market is in place, it is likely some form of CPI-X methodology – which reflects inflation minus an efficiency factor – will be introduced. At a still later stage, CPI-X could be replaced by an even more sophisticated form of incentive regulation based on the capital-asset-pricing model. It will be of crucial importance, at that point, properly to determine and evaluate the asset base. The results of this important exercise will have a strong influence on future operational and investment incentives to network owners.

In other countries, this process has proved difficult and contentious. It is hard, in any event, to set a market value on network assets that were built in an era of central planning. Moreover, changes in network usage after the reform is in place may well result in the stranding of certain existing assets, thereby undermining the initial determination of the asset base.

Determining a regulated rate of return on network assets can also be a contentious affair. A delicate balance must be struck between lowering network charges and providing returns that will stimulate new investment when and where it is needed. Under-investment in transmission networks and inter-connectors has been a thorny issue in the US, and it now appears to be emerging in Europe, particularly in the wake of the power failures of 2003.

Regulators are beginning to explore some innovative models designed to create financial incentives for more efficient performance, and especially for cost reductions. An incentive-based approach of this kind could reduce Russia's high network losses, which

mainly result from inefficient operation and maintenance, rather than the technical losses incidental to all electricity transmission. The Federal Tariff Service is likely to focus on cost-reduction incentives, at least initially.

Returns on network investments need to be competitive with those from other investments that have similar risk characteristics. Russia's electricity legislation recognises this point and calls for commercial rates of return on regulated network investments. But a government order in February 2004 indicated that returns should lie somewhere between the lowest yield on Russian government bonds and the refinancing rate of the Central Bank of Russia. A more recent report calculates the resulting pre-tax return on FGC assets at about 3.1% for 2004, well below a commercial return on capital.

The *World Energy Investment Outlook 2003* points out that the risk premium on energy investments in transition economies can be sharply increased because of their underdeveloped organisational and institutional structures and by the lack of clarity and transparency in their legal and regulatory arrangements

The regulatory risk perceived by investors may be heightened by the prospect of annual price reviews. Other countries have adopted a longer period between reviews, often five years. Using a longer interval allows a greater degree of certainty in predicting cash flows. This reduces the perception of regulatory risk and so eases the transmission owner's task in raising capital for network extensions.

Planning and approval processes

The planning and approvals processes are key factors in assuring efficient investment. These processes must be transparent and objective. They must deliver results that are beneficial to the market overall. During the transition to a free market, they should help in the quick removal of constraints on transmission so as to allow trade between deficit and surplus regions.

In the regulated regime in force in many IEA countries, the planning role is played by the transmission system operator, who develops investment proposals based on the planning he has himself carried out. But this model carries certain risks. Both at the planning stage and in the working out of investment proposals, a transmission system operator may be inclined to favour extension of the existing network over competing alternative approaches. Such approaches could include new generation, other network investment or even demand responses.

Most regulatory regimes rely on an electricity regulator to keep the system operator in line. But the regulator can do this effectively only if he has the information and the technical expertise fully to evaluate the planning process and related investment proposals. The regulator can be at a particular disadvantage if he has to rely on technical advice and information provided by the transmission system operator. Uncertainties, disputes and delays are endemic in this kind of situation. Access by the regulator to accurate and reliable information about the operational condition of the network is crucial to the effectiveness and credibility of the planning and investment-approval processes.

Nodal pricing could enhance transparency about the performance of transmission networks, allowing both regulators and participants better to identify cost-effective options for network expansion and investment. It could also help regulators develop better performance initiatives.

Separating the roles of national system operator and transmission owner may help here. An independent system operator would be in a position to gather accurate and timely information on network capability and performance. He would also have the technical expertise to interpret and apply such information to transmission planning for the market as a whole. Removing planning and related functions from the for-profit sector could also improve the incentives to transmission owners to operate their networks more efficiently.

But separating the roles of system operator and transmission operator does raise some new issues. The technical roles and responsibilities of both parties will need to be clarified. And care must be taken to ensure that the system operator does not act in a way that devalues transmission or otherwise causes undue financial damage to the transmission owner. The two roles should be separated only after these issues are resolved and where co-ordination costs do not exceed the potential benefits. For the moment, the Russian government has recognised both problems and is addressing them through bilateral service contracts. Russian authorities might do well to consider as possible models the independent system operators in the north-east of the United States and the Australian NEM, which also separates the functions of system operation and transmission ownership.

The approval processes for construction and sitting and the application of environmental standards will also affect the potential for new transmission investment. They need to be made efficient, objective and consistent if they are to be found credible by all parties.

Efficient price signals

Cost-reflective and transparent price signals are an essential ingredient of timely decisions on investment in, and the operation of, competitive electricity markets. They create incentives for efficient behaviour in an environment marked by independent and decentralised decision making at each step in the supply chain. Cost-reflective prices are also critical for the financial viability of market participants.

But cost-reflective electricity prices tend to be volatile, particularly short-term wholesale prices. It is essential for price formation in a competitive market that fluctuations in price not be unduly masked or capped where they reflect movements in the underlying supply-demand balance. If they are distorted, they will send the wrong signals and communicate the wrong incentives.

Wholesale price volatility

Electricity cannot be stored efficiently and demand for it is relatively inelastic in the short term. As a result, generators meeting residual demand can – in the absence of price-caps or similar devices – set prices above the value of electricity consumed at the margin. In markets where price-caps are imposed, it is essential to determine a price level which, while it protects consumers from gouging, does not unduly distort price and investment signals.

The Russian Electricity Law calls for the imposition of a regulated price regime whenever capacity shortages lead to unacceptably high wholesale prices. If that were to happen, competitive price formation would be suspended and replaced by a regulated pricing regime. Details of how this would work are expected to be published in the Wholesale Market Rules during the third quarter of 2005.

Regulated price regimes can suffer from several weaknesses. Often, the trigger mechanism is based on a price ceiling that does not take into account the underlying

supply-and-demand situation. As a result, regulated price-caps can mask *legitimate* price volatility and undermine incentives for efficient market responses through the electricity supply chain. The exercise of regulatory discretion can reduce this problem. But the introduction of powers of discretion in this area could also create uncertainty and expose governments to backroom pressures to intervene. RAO UES considers that regulatory discretion in price-capping would create regulatory risk and could lead to inappropriate government action to manage prices in the future.

Poorly thought-out price-caps can have the unintended consequence of driving market participants to the edge of bankruptcy. In California three years ago, a retail price-cap prevented the utilities from recovering their spiralling wholesale costs. Price-caps that are set too low distort efficient responses to price volatility. They discourage both efforts at demand flexibility and inter-regional investment.

Inappropriate price-caps can also prevent the development and use of financial products that could shield consumers from wholesale-market volatility. Such instruments could achieve the price stability that price-caps are designed to ensure, but without the drawbacks of capping.

An alternative approach would be to use a wholesale price cap that reflects the economic value of consumption at the margin. The UK and Australia, among others, use wholesale price caps based on the system value of lost load (VoLL). VoLL-based price limits are superior to arbitrary price caps in that they maximise the opportunity for economic price formation and efficient responses to price signals, while also protecting the consumer from excessive price gouging.

Tariff rebalancing

The Russian government has worked hard to achieve cost-reflective pricing, but so far it has been only partially successful. On average, regulated tariffs have increased by about 240% in nominal terms over the last four years, with residential tariffs rising by 340% and industrial tariffs by 200%. With the unwinding of cross-subsidies, residential prices have risen from about 60% of those charged to industries in 2000 to near-parity in 2004. These are positive developments, and they have made prices more nearly reflective of costs. Better debt collection and the resulting rundown of arrears have also improved the sector's commercial viability.

But Russian electricity prices are still very low by international standards, and they will not yield the returns that will probably be needed to attract new investment. Average prices for residential consumers and government agencies were about 2.3 US cents per kWh in 2003. Industrial users paid about 2.5 cents. By comparison, average prices in IEA countries in 2002 were about 11.4 cents for residential consumers and about 5.9 cents for large industrial users.

Further major adjustments will be needed to achieve more cost-reflective prices. Estimates of the magnitude of the required rebalancing vary considerably, often because of regional differences. However, the total value of cross-subsidies remaining to be unwound is estimated at between USD 2 and USD 3 billion per annum.[24] One recent estimate suggests that if residential tariffs are to be made fully cost-reflective, they would have to be 25% to 40% higher than industrial tariffs.

Average wholesale electricity prices have increased sharply since 2000, reaching about USD 18 per MWh in the third quarter of 2004. The World Bank estimates that Russian

wholesale tariffs need to rise 40% more – to the range of USD 25 to USD 30 per MWh – in order to cover long-run marginal costs. That will be hard to do, because of the large additional cost it would impose on users.

Rebalancing tariffs and removing cross-subsidies are necessary pre-conditions for market reform. Competitive price formation is expected to deliver cost-reflective pricing in those sectors open to competition. Revised regulatory arrangements can ensure commercial returns for network services and more cost-reflective prices for regulated customers. Electricity market reform can help in the tariff-rebalancing task by encouraging greater efficiency and so reducing the absolute level of cost-reflective prices.

The challenge is large and the need to move ahead with the rebalancing task is a matter of high priority. Some large users are said to have been denied full access to the transitional "free" market because their withdrawal from the regulated sector would have harmed existing energy suppliers financially. Such reports point to the need for arrangements to allow customer choice while cross-subsidies are still being unwound.

The current proposal for addressing this challenge focuses on creating a regime of regulated bilateral contracts, known as vesting contracts.[25] It is envisaged that these contracts will largely replace existing regulated-supply arrangements starting in January 2006.[26] These vesting contracts would provide a means of guaranteeing the supply of electricity at a fixed regulated price through the value chain, from generator to retailer to end customers. The regulated price will be determined by the Federal Tariff Service, and may be increased annually to help unwind cross-subsidies. A complex web of contracts is likely to emerge which would tie particular users and retailers to a number of generators and *vice versa*.

It is envisaged that the period of the vesting contracts would vary by customer group. Large energy-intensive users would be offered vesting contracts for up to 10 years. Households and other vulnerable users would be offered vesting contracts for up to 3 years; while other commercial users would be offered contracts for 1 year. Consideration may be given to rolling over the vesting contracts at least once for the household and commercial groups depending on their ability to secure affordable electricity from the free market.

During the vesting-contract period, it is expected that cross-subsidies would be funded more transparently. Among the options being considered for the transition period are transfers from free-market participants the regulated portion of the market – or direct budget funded subsidies from the federal government. A combination of these options is likely, with initial transfers being replaced by budget-funded subsidies once the competitive market becomes the dominant source for electricity purchases.

A key feature of the proposed vesting contracts is that the amount of electricity provided at a regulated price would be progressively reduced each year. By the end of the contract period, it is hoped, all purchases would be sourced from the free market at cost-reflective prices. It is expected that up to 85% of total electricity purchases will initially be covered by vesting contracts and that the total regulated portion will be reduce by about 15% each year. End users may have the choice of replacing some or all of their vesting contracts with purchases from the free market, but they would not be able to go back once they elect to leave.

The proposed regime of vesting contracts is likely to create a very complex Web of regulated contracts that may discourage users from switching to the free market during the

transitional period. It is also likely to extend the transition period out to around 2012 if it is implemented in January 2006.

However, it possesses several positive features. Such a mechanism provides a clear and more certain path for gradually unwinding cross-subsidies while at the same time allowing competitive wholesale and retail markets to be progressively introduced. It will give the government the flexibility it will need to rebalance tariffs in a way that is consistent with sound macro-economic management and which avoids causing undue financial stress, particularly for households. The recent public backlash against the monetisation of certain public services demonstrates the importance of getting this balance right. Effective management of tariff rebalancing will be critical to maintaining the public credibility of the reform. The vesting contracts would also support the commercial viability of existing generators by providing greater certainty of cash flows during the restructuring period. This may also help to strengthen asset values during the forthcoming divestment process.

But there is still a danger that the unwinding of cross-subsidies might stall, perpetuating a major distortion of efficient price formation. The government, therefore, must continue act decisively in this area. Cross-subsidies should be unwound, at least for industrial and commercial users, within the five-to-seven-year life of the proposed vesting-contract regime.

Such action would send a positive signal to potential market participants and prospective investors, reaffirming the government's commitment to establish economically sustainable electricity markets and to ensure commercial returns for network service providers.

Government ownership and price formation

As noted earlier, the government will retain control over the nuclear and hydroelectric generators, representing around 25% of Russia's total generating capacity. There is a risk that ongoing government ownership could be used to manage wholesale market prices. Government-owned generators could, for example, engage in a form of counter-trading in which they would dump large volumes of cheap electricity onto the market. They could, in this way, displace mid- and peak-price offers that might otherwise set the system marginal price during peak periods. Even price-taking plants[27] would be in a position to influence wholesale price formation through a strategy of this kind.

Ongoing government control of strategic generating assets could create pressures for government intervention, which may become very strong as excess capacity is absorbed and wholesale prices begin to rise. It is important for the government to resist such pressure. Intervention may succeed in controlling wholesale spot prices in the short term, especially where government-owned generators control the majority of excess capacity. But it is likely to distort the efficient development and operation of the market.

Further assurances may be required of the government to convince market participants of its commitment to genuine electricity-market reform. The OECD said in a recent report that a commitment from the government to refrain from using its generating assets to manage wholesale prices and a commitment to withdraw from the generation sector soon after the transition would provide a reassuring signal to investors.

Governance, regulations and institutions

Good regulation starts with an effective governance framework. Governance arrangements should clearly establish the responsibility and accountability of all involved parties, including the government, market institutions, regulators and market participants. Accountability and responsibility should be assigned in accordance with the role and function of each stakeholder, so that the parties best able to manage particular responsibilities at least cost are held accountable for them.

In an electricity market, the governance arrangements should clearly delineate the legal rights and responsibilities of stakeholders. They should enhance transparency and create appropriate mechanisms to ensure accountability and the right of appeal. They should spin a web of incentives for appropriate behaviour and performance.

Legislative framework

The legislative framework should translate the government's policies into practical rules and regulatory requirements. It should codify the responsibility and accountability of all stakeholders, and particularly those of the market institutions and regulators.

Where powers of discretion are granted to executive bodies, the legislative framework should clearly prescribe the nature, scope and limits of those powers. This may be hard to do where responsibilities overlap or are somewhat ambiguous. Regulators do need some flexibility if they are to do their jobs properly. At the same time, policymakers need to make the intent of the regulatory arrangements they provide clearly understood.

Equally important are mechanisms to uphold legal rights and enforce accountability, and procedures for changing the market rules. The electricity legislation of March 2003 provides a good foundation for establishing effective governance and regulatory arrangements, but many of the key details are yet to be worked out.

Regulatory principles and institutional arrangements

Regulatory and institutional bodies responsible for administering regulations day-to-day – including third-party access to networks, network tariffs, market operation and system operation – need to apply the rules and provisions established by the legislator with integrity. Several principles are beginning to emerge, including:

- Effective and timely communication with all involved parties.
- Transparency of process, including effective consultation with stakeholders.
- Consistency of the regulatory processes and predictability of decision making.
- The flexible use of regulatory instruments in response to changing market conditions.
- Autonomy from political or economic influence.
- Efficiency and cost-effectiveness of information collection and other administrative processes.
- Effective accountability, including clearly defined decision-making processes, public reporting, the publication of the reasons underlying determinations, and a well-established right of appeal.

Some countries with reformed electricity sectors have sought to enhance confidence in the regulatory framework and institutions by establishing these institutions as independent bodies with independent funding. This has often been the case where

governments retain some ownership of market assets. Several advantages have been ascribed to independent regulatory arrangements including:

- Improving economic efficiency in a market-based framework by shielding day-to-day regulatory functions and enforcement from political intervention.
- Improving regulatory quality by ensuring a high level of sector-specific technical expertise.
- Ensuring a stable and predictable regulatory environment.
- Increasing transparency.

But institutional independence may not be a practical option where the governance framework is incomplete or weak. One alternative mechanism is regulation by contract. Regardless of the mechanism, however, maximising the quality, consistency and objectivity of regulatory decision making ought to remain the key objective.

Concerns have been raised in other countries about the possibility that regulatory discretion may create uncertainty and confusion. The practice of executive discretion is a necessary component of an effective regulatory regime. It provides the flexibility regulators need to maintain effective incentives for efficient performance. Some regulators have sought to address the problem of uncertainty by issuing non-binding statements of regulatory intent.

Russia's current reform proposal does not include an independent regulator. That is a serious omission. Under the 2004 restructuring of government activities, the federal agency responsible for electricity-sector regulation (now the Federal Tariff Service) was initially placed under the authority of the Ministry of Economic Development and Trade. More recently, this agency has been put under the prime minister. There may be good reasons for keeping this body under the direct supervision of the prime minister during the transitional period. But there is a serious risk that perceptions of conflict of interest may arise resulting from the government's double role as regulator and market participant. Such perceptions could undermine the credibility of the regulatory regime and could damage confidence in the objectivity and integrity of regulatory decision-making processes.

The creation of strong, well-financed and independent regulatory agencies would send a clear signal of the government's commitment to effective regulatory arrangements.

The Russian electricity legislation envisages *ex ante* regulation (the setting out of detailed regulatory requirements in advance that will hold good in a wide variety of situations). This system is becoming more common than *ex post* regulation (the application of rules on case-by case basis after a violation occurs). But e*x ante* regulation tends to be a resource-intensive and demanding task. Regulatory agencies need to be well-financed to succeed at it. The Russian government may wish to re-examine the issues of regulatory independence and resource adequacy with a view to establishing an independent regulator for the electricity sector in the post-transition period.

Effective co-ordination of policy, regulatory and institutional bodies

The electricity reform package calls for a separate market and system operator, and it separates system operation from the transmission system owner. It also reallocates responsibilities for network regulation between the Federal Tariff Service (FTS), which will regulate the transmission system, and the Regional Energy Commissions (RECs), which will regulate local distribution networks subject to tariffs set by the FTS.

Efficiency in this context will require co-ordination:

- Between the market and system operator, to ensure efficient dispatch in all circumstances, and to ensure efficient and timely responses to shortages or other emergencies.
- Between the FTS and the regional commissions to reduce the risk of inconsistent interpretation and application of the tariff-setting regulations.
- Among the policy bodies and market institutions, the regulatory agencies and the competition authority, to ensure that seamless and complementary regulatory arrangements are established.
- Among the different government agencies with responsibilities for other matters affecting the electricity sector, such as investment approvals.

Following the transition, it is envisaged that co-ordination among the key agencies and other parties will take place largely through a web of bilateral contracts and on the basis of reporting requirements established bylaw. In practice, however, some responsibilities may be hard to define precisely. There will be a need for ongoing *informal* co-ordination. Some regulatory activities may require multilateral and closely sequenced co-ordination to avoid incompatible or contradictory decisions and undue delays in decision making.

After the transition, there will be a real risk of unco-ordinated and possibly contradictory interpretation and administration of the rules and regulations. The risk will be greatest where regulatory responsibilities are spread among several government agencies and between national and regional governments. Poor co-ordination can increase the impression of regulatory risk, create uncertainty and undermine confidence in the market. Comprehensive processes need to be established after the transition to achieve transparent, effective and ongoing co-ordination among these bodies.

Implementation

Implementing electricity reform is a complex, sensitive and time-consuming exercise. The specific details are often complicated and they interact at many levels. The sensitivities of all involved parties must be carefully handled.

Experience in other countries suggests that key features of an effective implementation process include:

- A thorough strategy with clear goals, which identifies the potential risks and provides a well-thought-out sequencing of the elements of reform; it is usually best to establish the legal and regulatory framework and the market structure before the market opening and major asset sales.
- An open and transparent process that provides for consultation with stakeholders and their participation in developing and implementing specific elements of the package.
- Transitional programmes to facilitate the testing of the new arrangements and to develop the expertise of all involved parties.
- The allowance of ample time.
- Continuing government leadership to ensure that implementation stays on schedule.

Russia's proposed implementation strategy has three stages. The initial timetable proposed that the key components of market design and the regulatory framework be dealt

with in a first stage, to be completed by 2005. It was envisaged that key elements of industry restructuring would also be undertaken during this first phase. These elements included the creation and incorporation of several large thermal generating companies and the creation and physical separation of regulated transmission businesses. Selling off the government's thermal generating assets was also scheduled to begin during Phase One.

The incorporation and divestment of regional assets is scheduled for subsequent phases,[28] with restructuring still expected to be completed during 2008. The target competitive wholesale and retail markets are expected to start operating during the second phase, in 2006, at which point, about 60% of customers will gain the right to choose their own electricity supplier. Eventually *all* customers are to be given free choice, but a date for that step has not yet been set. It is unlikely, however, that full customer choice can begin much before 2009 or 2010.

The implementation strategy is broad and very ambitious and its successful implementation within the currently proposed timeframes would represent an enormous achievement, rivalling, and in some respects exceeding, the performance of most other countries.

A parallel implementation process was designed to meet this ambitious schedule. It seeks to strike a balance between timeliness and thoroughness, to minimise uncertainty and risks during the transition period and to avoid design flaws to the greatest extent possible.

But the plan is not without its risks and challenges. Parallel development exposes the process to the possibility of cascading delays. Progress on market design and regulatory reform slowed in 2004 due to the restructuring of the government. That slowdown has affected the timetable for industry restructuring.

Differences in the pace at which major elements of the reform programme are developed increases the risk of unco-ordinated and inconsistent progress. Under-informed decisions may be made on how to implement the market, and these could distort the final outcome. Uncertainty over the precise nature of market rules and regulatory arrangements could also hinder the concurrent divestment process, reducing investor interest and depressing asset values. It may still be possible to reduce these risks by rationalising the sequence in which key components of the reform are implemented.

Dealing with minority shareholders in the existing generating entities presents an immediate challenge. The issue needs to be handled in a way that avoids alienating or disenfranchising existing private shareholders while at the same time maintaining the integrity of the reforms. Parallel implementation magnifies the problem, since existing shareholders have strong incentives to lobby for market design and regulatory arrangements that serve their particular interests.

Delays have already occurred. At least fifteen of 49 milestones have been passed, but several key steps are likely to be delayed by a year or more. Moreover, government statements have occasionally created uncertainty about its commitment to the reforms. But such concerns should not be overstated. RAO UES and a number of Federal Government agencies continue to work hard on developing and implementing the reforms. Many of those involved believe that the process has gone too far now to be completely abandoned. Nonetheless, the risk that reform will be delayed or distorted remains.

The most promising sequencing of implementation would start with a clarification of the key elements of the restructure, market design and regulatory framework. It would then

move on to asset sales and the phased introduction of customer choice. The government now has an opportunity to strengthen the process by advancing its work on market rules and regulatory arrangements, a dossier that is beginning to fall behind that on industry restructuring. By accelerating work on market rules and regulations, the government could reduce the risk of cascading delays and unco-ordinated or contradictory implementation, while also enhancing regulatory certainty in the divestiture process. The vesting-contracts proposal could support this process by providing greater stability, certainty and public acceptance during the transition period, allowing the government to strengthen the implementation process so that the reform can be fully and successfully completed.

The proposal to delay the privatisation of wholesale generation companies until the completion of a short initial operating period may provide an opportunity to deal with emerging imbalances in the implementation process. It may also provide potential investors with time to observe how the wholesale companies are likely to perform in practice. But too much delay in the divestment process could be very counterproductive. In this regard, the recent statement by the chairman of the Inter-Ministerial Commission on Electricity Reform reaffirming the government's commitment to divestment is reassuring. Similar positive signals from senior members of the government, together with continued tangible progress toward establishing the wholesale generation companies, may be necessary to reinforce the message and to strengthen confidence among private stakeholders.

The government would do well to review the priority given to certain components of reform, with a view to focusing its efforts on those of most immediate importance. Implementing the final *tranches* of customer choice could, for example, be put off until other critical elements have been implemented. The introduction of full customer choice will raise many complex and sensitive issues. It may be very resource-intensive and expensive to implement. A failure to get this aspect of the reform right would undermine public support for the reform overall. It could also encourage inappropriate and expensive intervention in electricity markets, as occurred in California and Ontario.

Before proceeding to full customer choice for households, Russia will have to establish cost-reflective prices, to install appropriate metering and information technology, to educate the public about how to exercise choice and to set up a consumer-protection regime. Because of these challenges, it may make sense to extend the phase-in period for introducing full customer choice, and possibly increase the number of phases. As proposed, vesting contracts could be used to manage the transition, and to support tariff rebalancing, which is still another critical precondition for customer choice.

Strong and consistent leadership from government will be required to resolve the many policy issues and detailed technical questions that will emerge over the course of the transition, and to maintain momentum toward a successful completion. A system of co-ordinating committees was initially established to supervise implementation, but the committees virtually ceased to operate after the government restructuring. The re-establishment of an Inter-Ministerial Commission on Electricity Reform in August 2004 and the commission's first meeting on 24 November 2004 were very positive developments.[29] More recent statements, in particular the December 2004 decision to accelerate development of proposals on several key aspects of the reform including the corporate restructure, the wholesale market model, unwinding of cross-subsidies, and the investment guarantee mechanism, with proposals to be submitted for Government

consideration before the end of the 1st quarter 2005,[30] provide further positive indications of impetus to move the reform ahead.

Confidence in the government's commitment to the reform programme could be further enhanced by its adopting explicit deadlines for the main transitional steps toward full implementation of the reform. Public commitments to this effect would add impetus to the implementation process.

Notes

1. This chapter is based on the IEA publication, *Russian Electricity Reform: Emerging Challenges and Opportunities*, released in Spring 2005. See also *www.iea.org* or contact Doug Cooke at *doug.cooke@iea.org* or Isabel Murray at *isabel.murray@iea.org*.
2. According to the *Strategy of Nuclear Power Development in Russian in the first half of the 21st Century*, endorsed by the Russian Government on 25 May 2000 and reiterated more recently in the journal RosEnergoAtom No. 1/2004, the load factor at Russian nuclear plants is expected to reach 80% by 2010, and to exceed 85% by 2020.
3. See *www.rao-ees.ru/en/news/pr_depart/show.cgi?020205fin.htm*.
4. IEA, *World Energy Investment Outlook 2003 Insights*, (2003), pp. 400-401 and 446.
5. See *Russian Energy Strategy* at *www.mte.gov.ru/docs/32/1779.html*.
6. See the Federal Grid Company Web site and discussion on investment at *www.fsk-ees.ru*.
7. Based on Ministry of Energy data, in 2002, overall Russian electricity generation reached almost 85% of what it was in 1991. Nonetheless, constraints are already being felt in some regions. Certain electricity systems are nearing 90% of their 1991 production – Siberia (88.7%), the South (87.7%) and the Northwest (86.6%) regions.
8. Decree 526, *On Restructuring the Electric Power Industry of the Russian Federation* (11 July 2001).
9. With the exception of the Leningrad nuclear power plant, which is independent.
10. The reform plan was developed by RAO UES over the five year period 1998 and 2003 and is expected to be implemented between 2003 and 2008. Hence, the strategy is commonly referred to as the "5 + 5". For more detailed information on the 5 + 5 Strategy, see *www.rao-ees.ru/en/show.cgi?info/con2003.htm#1*.
11. Federal Law #35-FZ, *On the Electric Power Industry* (26 March 2003), Articles 8 and 12, and Federal Law #36-FZ, *On Specific Features of Functioning of Electric Power Industry During the Transitional Period and on Introduction of Amendments into Certain Legislative Acts of the Russian Federation and on Recognizing Certain Legislative Acts of the Russian Federation to Have Lost Their Force in Connection with Adoption* (26 March 2003), Articles 8 and 9.
12. Federal Law #35-FZ, *On the Electric Power Industry* (26 March 2003), Articles 8 and 12.
13. See IEA (2002) and IEA (2003) for further commentary on the experience in California and Ontario.
14. Experience in the United States and the United Kingdom illustrates well the influence that market structure can have on efficiency and competitiveness. See Joskow (2003) and Green (2004).
15. See OECD (2003) for further discussion of this issue.
16. Trading intervals of one hour have been proposed, meaning that there would, in effect, be 24 separate wholesale markets every day. This unique feature of electricity markets reflects the special characteristics of the product: the fact that it cannot be stored and the need instantaneously to balance supply and demand.
17. For further discussion, see *Structural and Design Issues in the Russian Electricity Reforms – A Policy Note,* World Bank, June 2004, pp. 20-22.
18. See Centre d'Économie Industrielle, École Nationale Supérieure des Mines de Paris (CERNA), (July 2003), Mergers and Acquisitions in the European Electricity Sector: Cases and Patterns, pp. 114-131.
19. See National Economic Research Associates, *Consolidation in the EU Electricity Sector: Report to the Dutch Ministry of Economic Affairs* (April 2003).

20. Raised during discussions with Russian officials of the Russian Ministry of Economic Development and Trade during the IEA mission to Moscow in November 2004.

21. Details are drawn from Russian Federation, Resolution #50 (24 December 2004) and bilateral discussions between IEA and RAO UES officials and from Troika Dialogue, *Liberalization Clarified*, issued 21 January 2005.

22. IEA (2001), *Competition in Electricity Markets*, pp. 94-95.

23. Inflated asset prices could dampen interest in the auctions. This could ultimately affect the diversity of ownership and the underlying competitiveness of the wholesale market.

24. Anatoly Chubais, CEO of RAO UES, stated in an interview in late 2004 that he estimated the total cost of cross-subsidies between customer classes at Rb 60 billion per annum. This was corroborated by another RAO UES official in discussions with the IEA (February 2005) that it estimates the total cost of cross-subsidies resulting from subsidies between customer classes as well as those special purpose subsidies to pensioners and other vulnerable groups, and between regions to be in the order of Rb 65-80 billion per annum, or USD 2.3-2.8 billion per annum. The majority of this subsidy is related to general transfers from industrial consumers to households.

25. Vesting contracts have been proposed to enable Guaranteeing Suppliers to contract for electricity supplies at a regulated price consistent with the regulated tariff set for small volume consumers which they are obliged to supply, thus shielding them from price risk exposure to the competitive wholesale market.

26. The following description is drawn from Russian Federation, Government Decision #2124 (27 December 2004) and bilateral discussions between the IEA and the Russian ministries of Economic Development and Trade, and Industry and Energy; the ATS (the free market operator); and from Troika Dialogue, *Liberalization Clarified*, 21 January 2005, pp. 4-5.

27. Price-taking plants include: nuclear facilities, hydro facilities during the spring thaw and combined heat-and-power facilities during winter.

28. Originally, the deadline for compulsory separation of natural monopoly assets was 1 January 2005. That date implied that industry restructuring would be completed by 2007. At the end of 2004, the deadline for separation of assets was extended to 1 April 2006. The new date implies the completion of industry restructuring in the spring of 2008.

29. The new Inter-Ministerial Commission was created by a resolution of the Minister of Industry and Energy of August 2004 #84. Its membership includes the Ministry of Industry and Energy, the Ministry of Economic Development and Trade, the Federal Antimonopoly Service, the Federal Tariff Service, the Ministry of Justice and the Federal Agency of Atomic Energy.

30. Russian Federation, Government Decision #2124, 27 December 2004.

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The background material used to prepare this report is available at: ***www.oecd.org/regreform/backgroundreports***.

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