CHAPTER 1
INTRODUCTION

The Russian economy has been growing at 6 percent a year over the last five years. But there are concerns that this pace may have been supported largely by non-recurring events—years of labor shedding, devaluating after the 1998–99 crisis, and rising if volatile oil and gas revenues. The oil and gas sector accounts for less than 1 percent of Russian employment but about one-fifth of economic output and almost half of exports. Although productivity in the manufacturing sector has been rising, it has not kept pace with rising real wages in recent years, a trend associated with the appreciation of the ruble, which limits the international competitiveness of the Russian manufacturing.

This book builds on the conclusions of the 2005 CEM: "From Transition to Development—A Country Economic Memorandum for the Russian Federation." The CEM provides extensive analysis of the spatial and sectoral reallocation of employment to overcome the legacy of central planning. It also includes a quantitative analysis of firm heterogeneity at the sectoral level and shows how much productivity growth is attributable to within-sector growth and how much to reallocate across sectors. It underlines the need to reduce current overdependence on natural-resource exports—and to diversify.

Russian manufacturing firms have lower average productivities relative to labor costs than do other comparator countries. Even though Russia's manufacturing value added per worker is about the same as China's and India's, its comparative disadvantage lies in labor costs. These higher costs reflect shortages of skilled labor despite high enrollments in higher levels of education. Russia's inputs in terms of share of researchers in the population and aggregate outlays of R&D in GDP are comparable to those of Germany and South Korea and far ahead of other BRIC countries. But these high levels of inputs do not translate into high value added per capita, with Russia lagging behind OECD and other large middle income countries in R&D outputs as well as a relatively low number of patents and scientific publications per capita.

Given the low levels of value added in the manufacturing sector, this book focuses on the existing challenges facing enterprises in Russia, highlighting the sources of productivity growth and competitiveness within enterprises. It focuses on technological progress (knowledge absorption and innovation), worker skills, and the investment climate. More specifically:

- How does productivity in Russian manufacturing compare with that in other large economies, such as Brazil, China, India, and South Africa, as well as other developed economies? (chapter 2)
- What can be done to boost the knowledge absorptive and innovative capacity of Russian enterprises? (chapter 3)
- How can the skill base of workers be improved to meet the demands of global competition? (chapter 4)
- What are the policy-induced constraints to business activity that hold Russian firms back from becoming dynamic and internationally competitive? (chapter 5)

CONTEXT AND MOTIVATION

According to the CEM, structural change in Russia has produced a sectoral structure that is fast approaching that of market economies with similar incomes. The decomposition of productivity changes in the CEM, based on revised value-added figures for Russia, concludes that: "Restructuring within sectors, particularly industry, is a larger source of growth than restructuring between sectors, but much of the restructuring lies ahead."[1]

The CEM highlights three micro-level drivers of the structural change operating at the aggregate level. The drivers of productivity growth are efficiency improvements by firms already in the industry, reallocation of factors of production among these incumbent firms, and firm entry and exit dynamics. This book focuses primarily on the first, exploring the conditions for firm-level access to technology, best practices in manufacturing, skills, and human capital. One of the most important aspects shaping these conditions concerns the investments by firms themselves, which in turn are influenced by the overall investment climate conditions. The study aims at a deeper understanding of how investment incentives for different types of firms are related to binding investment climate constraints.

This analysis will not, however, address in detail the reallocation of resources among more or less productive firms and between new and incumbent firms, the two other important drivers of productivity. These important dimensions of productivity in Russia are discussed in the CEM. Nor will this analysis deal with heterogeneity at the regional level and spatial patterns of structural change and productivity. Both topics were treated in the CEM in some detail (yet more work will be undertaken in the new CEM under preparation).

Russia's recovery after the 1998 crisis exceeded expectations, as gross domestic product rebounded, investment accelerated, and foreign direct investment increased dramatically. This recovery was driven to a large extent by the devaluation of the real exchange rate, the availability of cheap domestic inputs, and excess capacity and labor hoarding. Thanks to these three factors, the last several years have witnessed balanced growth, with structural shifts toward the service sectors (consistent with Russia's goal of joining the club of post-industrial nations). Yet, a closer look at national accounts reveals that much of this shift has produced relative price increases in services (non-tradable) and full capacity utilization in industry—indicators more characteristic of a resource-dependent economy than of successful industrial diversification.

The pursuit of sound economic policies after the crisis and the rise in international prices for key natural resource exports have become the leading engines for economic growth. The results are better current account and fiscal balances, higher domestic demand, moderate inflation, and rising export revenues. But continuing dependence on commodity exports will leave Russia hostage to unpredictable shocks in international prices. Boosting non-oil exports, however, will not be easy: industrial production has been dominated by energy exporters and by ferrous metals since 2001. Moreover, exchange rate appreciations (Dutch disease) and boom and bust cycles could lower the chances of growth needed to bring Russia to OECD levels of development.

[1] The corrections made aim to eliminate the distortions caused by the use of transfer pricing to shift profits from production to trading in an effort to exploit tax differences across regions.

Russia's Government 2006–08 Midterm Program, approved in early 2006, addresses many of the country's most important development challenges. The government's program targets the absence of incentives and opportunities for the development of human capital, low efficiency of state governance, low levels of competition and a high share of the "non-market economy," weak diversification, a low integration into the world economy, infrastructure constraints, an uneven government reform record at the subnational level, and the immobility of factors between regions. The program emphasizes a number of policy directions to ignite the "innovation economy" in Russia, including a greater state commitment to research and development, better protection and enforcement of intellectual property rights, the formation of information technology parks, and state venture funds.

The medium-term development program includes some controversial areas of economic policy, which have had mixed results in world experience. These include active state interventions under a "new industrial policy" to stimulate diversification and the innovation economy. In these areas, the Bank can play a valuable advisory role in transferring global experience about potential advantages and risks in the pursuit of one or another specific policy. This book addresses the move to a diversified knowledge-based economy and discusses various measures of public support for upgrading the absorptive and innovative capacities in industry (World Bank 2006c).

METHODOLOGY AND STRUCTURE

The book uses different types of available data, including the Doing Business Database, the World Bank's Enterprise Surveys, and the Business Environment and Enterprise Performance Surveys, as well as a new survey of Russian enterprises commissioned specifically for this book (box 1.1).

On the basis of this data, the book presents international comparisons and benchmarks to illuminate the competitiveness challenges for the Russian economy. Where appropriate, this information is complemented by econometric regression results that illustrate the relationships among different investments, firm-level capabilities and characteristics, and the wider investment climate. The combination of international comparisons using aggregate and microeconomic data, econometric results using firm-level data, and relevant case studies— rather than relying on any one data source—increases confidence in the conclusions and policy recommendations.

The challenge of this book is to build on the empirical work and to connect the diagnosis and recommendations to the government's initiatives and the Bank's country dialogue.

The structure of the book is as follows: Chapter 2 examines the main trends in the Russian economy, benchmarking performance and identifying the sources of productivity growth. Chapter 3 addresses the low productivity of the Russian R&D sector and its weak economic impact, related to both domestic and foreign sources of knowledge absorption and innovation. Chapter 4 deals with the policies to upgrade skills, the bottlenecks faced by industry, and the need for in-house training to enhance absorptive capacity. Chapter 5 looks at policies to ease investment climate constraints (administrative, regulatory, and tax-induced) and the role of credit and collateral.

The policy matrix summarizes the recommendations in chapters 3–5.

Box 1.1 Sources of data used

1. **Enterprise Surveys**: Since 2002 the World Bank has undertaken ICS surveys (now called Enterprise Surveys) in more than 76 countries, covering more than 50,000 firms. The Enterprise Surveys capture firms' experience in a range of areas, including regulation, tax policy, labor relations, infrastructure services, technology, and training. The survey attempts to identify and, whenever possible, quantify firms' obstacles in the investment climate. Since the basic methodology is consistent across countries, many areas of the survey allow international comparison.

2. **LME Competitiveness and Investment Climate Survey–Russia**: An Enterprise Survey covering Russian firms was carried out specifically for this study. The survey consisted of the Russian Large and Medium Enterprise Survey (LME Survey) and the Russian Small Enterprise Survey (SE Survey). This survey was designed by the World Bank and undertaken in partnership with the Higher School of Economics in Russia and the government of Russia. The LME Survey covered a stratified random sample of 1,000 medium and large firms and the SE Survey covered 300 small firms.

3. **Business Environment and Enterprise Performance Surveys (BEEPS):** Developed jointly by the World Bank and the European Bank for Reconstruction and Development, these surveys were carried out in 1999, 2002, and 2005, covering countries in Central, Eastern Europe, and Central Asia. The BEEPS in 2005 was also conducted in Portugal, Spain, Greece, Germany, Ireland, and South Korea. The BEEPS examine a wide range of interactions between firms and the state that affect business environment. It is designed to generate comparable measurements in corruption, state capture, lobbying, and the quality of the business environment, which can then be related to specific firm characteristics and firm performance.

System-wide data: For the benchmarking of different segments of the overall economy in Russia, the study draws on country-level information collected and disseminated by the World Bank through its World Development Indicators, trade data from UN COMTRADE, labor productivity data from the ILO, and information collected by other international organizations such as the OECD.

Note: Please look at the annex for details on the LME Survey.