

CHAPTER 5 IMPROVING THE INVESTMENT CLIMATE

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The investment climate—the government policies and practices that influence the opportunities and incentives for firms to expand—also contributes to the productivity and growth of the Russian economy. Following the financial crisis of 1998–99, favorable macroeconomic conditions, combined with major regulatory reforms to the business environment in 2000–02, have propelled Russia’s economic expansion.

The Russian investment climate, although much improved in recent years, is still characterized by significant administrative costs, policy-induced risks, and formal and informal barriers to competition—all limiting the innovative and productive potential of its private sector. It is also characterized by unevenness in the treatment of different kinds of firms. Some firms benefit from relatively low investment climate obstacles, while for others the obstacles are far more severe. Preferential treatment of some influential firms—long recognized as a problem in the CIS and Eastern Europe—continues to affect the Russian economy and can deter investment, innovation, and growth (Yakovlev and Zhuravskaya 2005). Since 2003 the investment climate has also suffered from growing uncertainty about regulatory and policy changes and about the character of government-business relations.

In one sense, reforms to the investment climate require deeper changes—in the process of government, in the way the public sector does business, in the relationships between public officials and firms, and in the mechanisms of accountability, transparency, and restraint.

- Competitive legislatures permit disenfranchised groups to challenge the authority of incumbents, making it more difficult for executive-branch policymakers to make implicit transfers to firms without legislative approval.
- The tendency of governments to grant preferential treatment to some firms can be checked by increasing the transparency of decisions of public officials and providing broad constituencies with vehicles for expressing their collective demands.
- A free and independent media can make the public aware of the costs of corrupt practices.
- Embodying formal rules and processes in national constitutions that enable effective “veto” points in decisionmaking—such as checks and balances between different branches or levels of government—can constrain arbitrariness and business clientelism.

But countries do not have to do all this at once. They can reap benefits by addressing important investment climate constraints in a way that gives firms confidence to invest (World Bank 2005e, p. 57). Recent reviews of case studies around the world suggest that investment climate reforms can be initiated by seizing opportunities to place reform on the policy agenda—in much the way that administrative reforms were implemented in the early part of this decade by a new Russian government (Kikeri, Kenyon, and Palmade 2006). To this end, the proposals offered in this chapter are modest. They are intended to ensure that the proposals in previous chapters are

supported by complementary reforms to the investment climate—and that the incentives of key actors to support reforms will be strengthened. In particular, the chapter argues for clear commitments to stable conditions for private business, including a competition policy that allows tangible and intangible assets to be acquired and exchanged by small and medium firms, together with an expanded voice for those who will demand greater market openness, encourage greater investment in the non-resource sector, and promote further economic diversification (World Bank 2005a).

Around the world, the most innovative economies are characterized by high levels of competition. Russia is no exception. In large part, the competitive pressures develop not from centralized, top-down efforts to create them from scratch or solely from the efforts of public agencies to police the common market against monopolistic behavior. They develop from a policy environment that encourages businesses to start up and that enables fledgling companies to find customers for products without significant policy-induced costs, risks, or barriers to competition (formal or informal). As shown in chapter 3, firms facing the weakest pressures from domestic and foreign competitors innovate the least. This chapter explores in further detail the obstacles that Russian firms face in doing business, the consequences of these obstacles, and how they may be ameliorated.

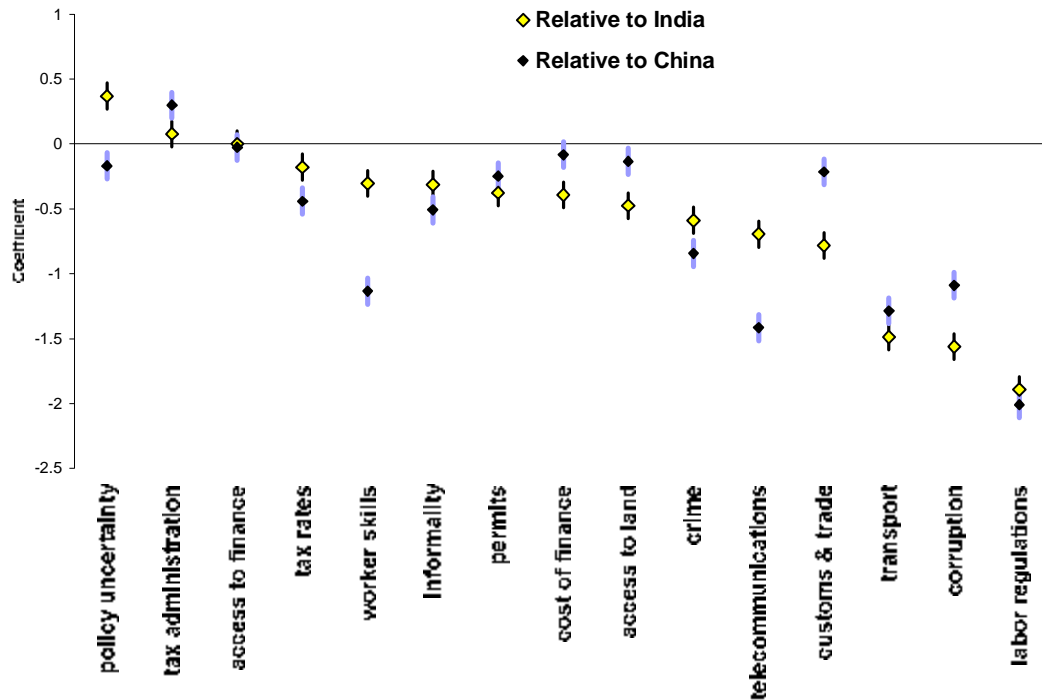
CROSS-NATIONAL COMPARISONS

In comparing the severity of investment climate constraints across countries, it is important to evaluate the choices facing an investor planning to finance enterprises in different countries.⁴⁶ Figure 5.1 estimates the comparative severity of these constraints in Russia, compared with China and India, controlling for sector, size, year, whether firms are exporters, and whether they are foreign-owned.⁴⁷ To control for the overall propensity to complain, responses of firms are included for a question on macroeconomic instability—a catch-all to capture systemic attitudes toward the investment climate.

⁴⁶ It is difficult, however, to do this by looking at mean responses of firms to questions of their perception of investment climate for three reasons. First, the totals do not control for different distributions of firm types across countries, and thus do not accurately show the “country” effect of the firms’ locations. Second, the scoring differs between Russian firms (four choices of severity) and firms from Brazil, China, India, and South Africa (five categories). Third, these totals do not account for the propensities of firms to “complain” about investment climate constraints in general.

⁴⁷ The benefit of the ordered-logit is that it enables an analysis of the effects of various explanators on changes in categories of severity, rather than on the actual likelihood that a firm selects a particular category—and thus avoids difficulties in comparison that may arise due to the fact that the number of allowable categories differs across countries.

Figure 5.1 The “Russia” effect on investment climate constraints



Note: Graph shows coefficients of the “Russia” country dummy variable generated from two separate ordered-logit estimations of each of the individual constraints, with \pm 95 percent confidence intervals. In addition to the Russia dummy variable, additional control variables include size, sectoral, exporter, and foreign-owned dummy variables, as well as a binary variable coded 1 if the firm considers macroeconomic problems to be an obstacle (moderate, major, or severe) or 0 otherwise.

Source: LME Survey.

Figure 5.1 identifies three priority problems for Russian firms relative to firms in China and India: policy uncertainty (relative to India), tax administration (relative to India and China), and access to finance (also relative to India and China). Russian firms are generally more likely to consider these constraints binding on their activities than firms in either of the other countries. The opposite is true for all other constraints, indicating that Russian enterprises are less likely to complain about these problems than are firms in these other countries.

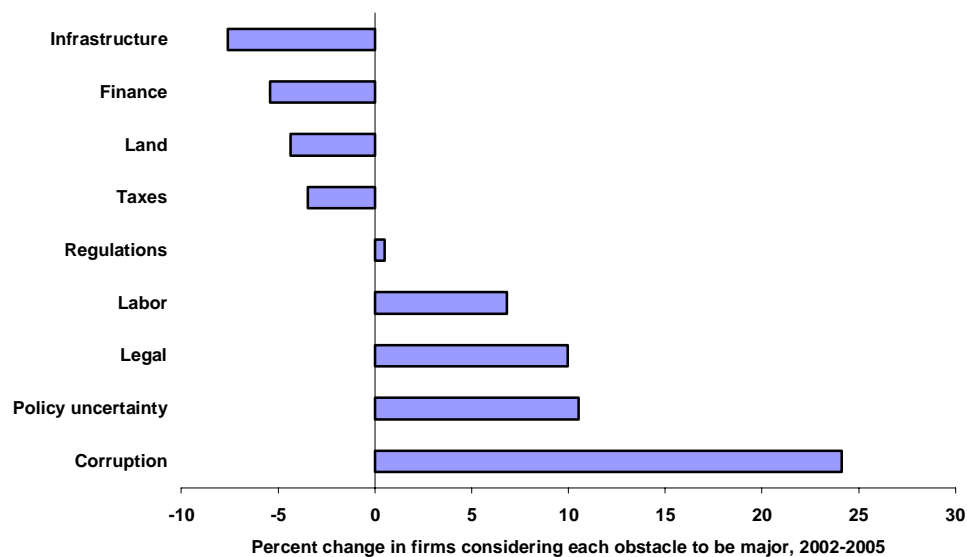
Table 5.1 Costs of starting a business in selected countries

Country	Year	Procedures to start a business (number)	Time to start a business (days)	Cost of starting a business (percent of income per capita)
Brazil	2005	17	152	10.1
China	2005	13	48	13.6
India	2005	11	71	61.7
Russian Federation	2003	12	29	8.4
	2004	9	36	6.7
	2005	8	33	5

Source: World Bank (2006a).

But in the past two years these reforms have slowed on some fronts, regressed on others. Surveys confirm the worsening of corruption, informal practices, and the quality of the legal system, among other areas. As figure 5.2 shows, while fewer firms consider obstacles such as infrastructure, finance (cost and access), land, and taxes to be major in 2005 than they did in 2002, several areas show deterioration. The percentage of firms that view labor (skills and regulations) as a major obstacle increased by 7 percentage points. Higher changes registered for crime and the quality of the legal system (10 percent), policy unpredictability (10 percent), and corruption (24 percent).

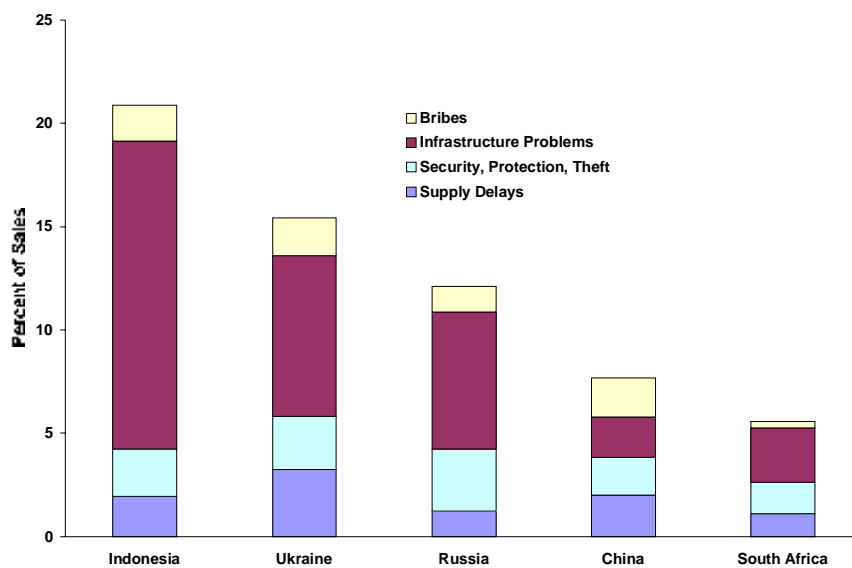
Figure 5.2 Change in firms' perceptions of investment climate constraints 2002–05



Source: BEEPS.

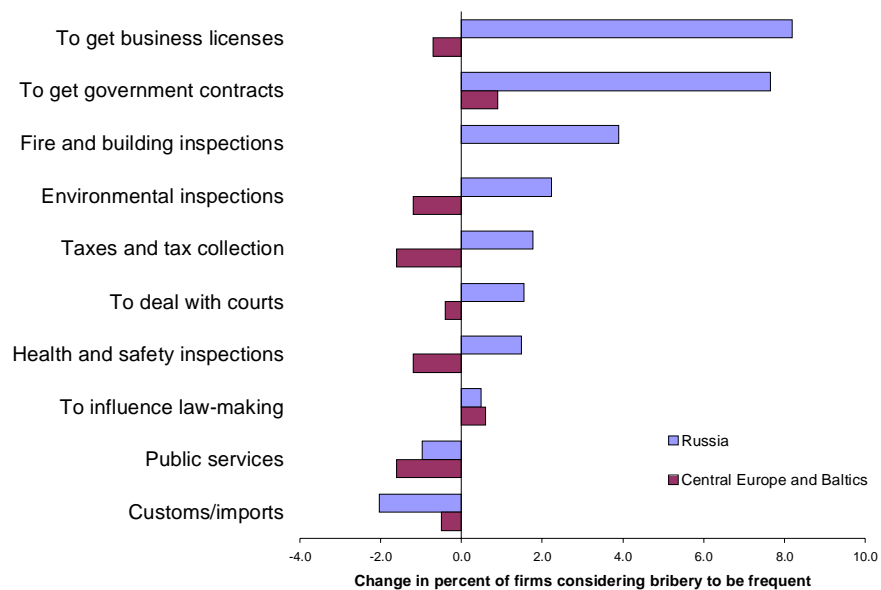
Many costs to firms are a normal function of commercial activity, but government policies and behaviors can impose additional costs on firms. For example, it takes less time and requires a smaller number of procedures and a smaller cost as a share of per capita income to start a business in Russian than in Brazil, China, or India (table 5.1). Even so, as figure 5.3 indicates, the losses that Russian firms suffer because of delivery delays, infrastructure problems (mainly utilities disruptions), crime, and bribe-paying are approximately 12 percent of total sales—about 50 percent larger than those suffered by Chinese firms and twice those for South African firms.

Figure 5.3 Share of administrative and transaction costs in sales in Russia and comparators



Source: BEEPS and LME surveys.

Figure 5.4 Change in percentage of firms considering bribery to be frequent in Russia and Central Europe region, 2002–05



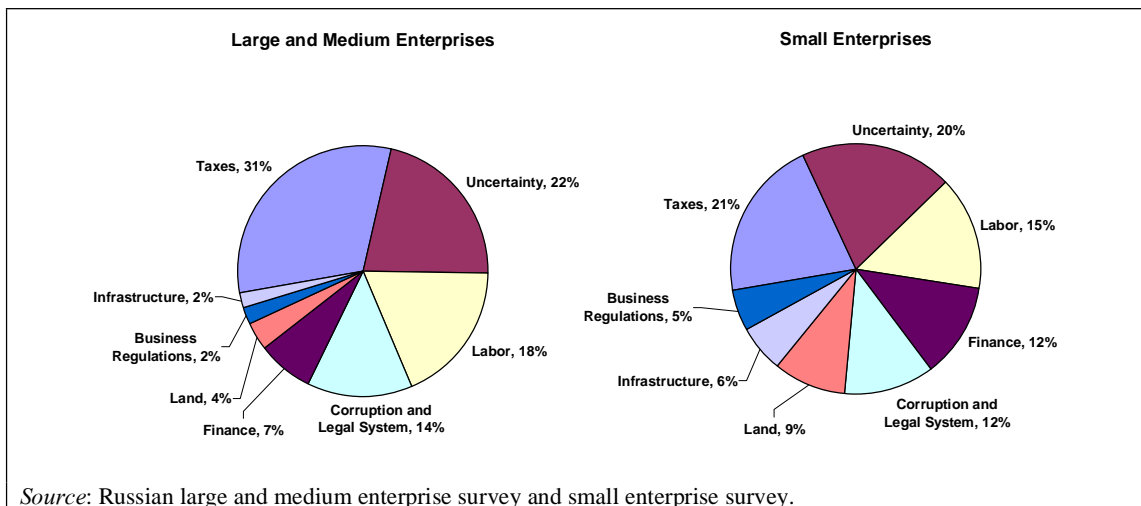
Source: BEEPS.

Corruption imposes its own costs. Figure 5.4 examines bribes paid by Russian firms. While there has been some improvement over the past few years, the average bribe paid by firms to acquire business licenses, to inspectors, to tax collectors, and in dealings with courts increased between 2002 and 2005, in sharp contrast to the declining trend for these types of bribes in the former Soviet states, Central Europe, and the Baltic region. According to the BEEPS, the percentage of firms stating that bribery is frequent in fire, building, environmental, and health and safety inspections was higher in 2005 than in 2002, while the CIS region overall exhibited a decrease.

DIFFERENCES AMONG SMALL, MEDIUM, AND LARGE ENTERPRISES

Many of these findings for investment climate priorities are confirmed in separate surveys of medium-to-large and small enterprises undertaken for this book. Firms of all sizes consider taxes, uncertainty (both macroeconomic and policy-induced), and labor problems to top their list of complaints. Figure 5.5 shows the percentages of large, medium, and small firms that ranked different categories of investment climate constraints as “the most important impediment” to their activities and development. Taxes, uncertainty, and labor top the list of major obstacles for Russian enterprises of all types. Smaller firms, however, tend to rank financial issues and land issues as their most severe obstacle.

Figure 5.5 Most severe constraints cited by firms, by size



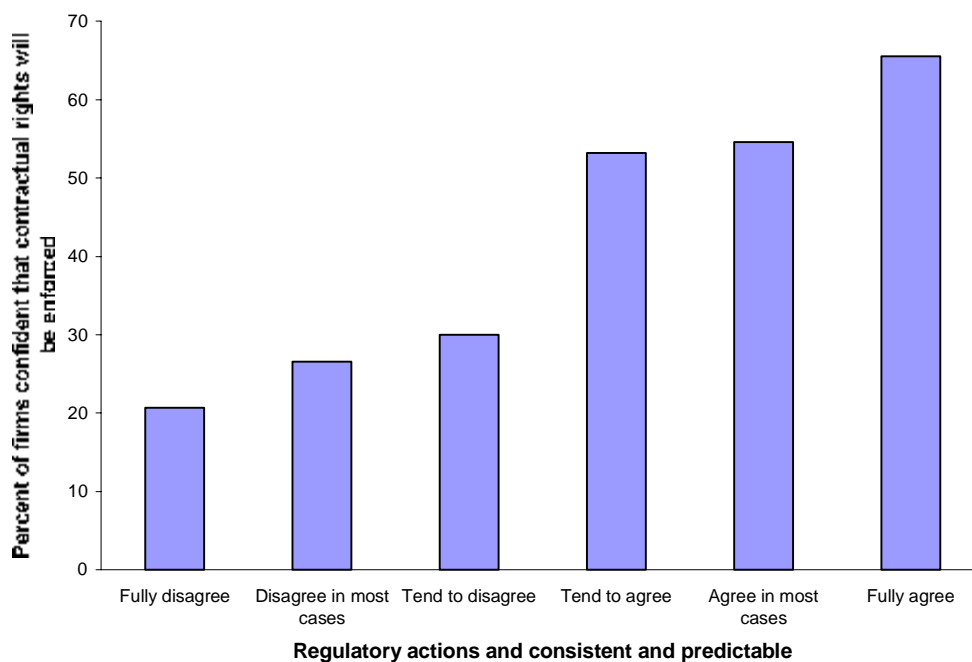
REGULATORY AND POLICY UNCERTAINTY

Investment is forward looking, deterred by uncertainty. Firms’ confidence in the future—especially based on expectations of the stability and predictability of government policies—is critical. A major concern of firms of all sizes is the unpredictability of economic and regulatory policy changes and the inconsistency of public officials’ interpretation and enforcement of regulations. Note that bribes and policy uncertainty are separate concerns of firms. They can be related, in that excessive bribe-taking can create costs, exemptions, and inconsistencies in the regulatory enforcement for firms from which bribes are extracted. But bribes are more properly thought of as a “cost” of doing business, while regulatory uncertainty is more appropriately considered a “policy-induced risk.” Unlike market-based risks, risks created by policy and regulatory instability are fully under government control and—short of expropriation—are generally more difficult to insure against. So these latter risks can unnecessarily thwart investment, knowledge absorption, and competitiveness because entrepreneurs cannot predict their potential loss in value due to government policy shifts.

In enterprise surveys the predictability of state regulations improved little between 2002 and 2005, with about 60 percent of firms indicating that regulatory unpredictability constitutes a moderate or major concern to business. Russian firms still face a very uncertain policy environment, characterized by unpredictable changes in regulations and by inconsistent applications of existing rules. While informal practices and crime are less of a concern than uncertainty, they also have worsened for Russian firms. According to the World Economic Forum, Russia ranks 75th of 117 countries in regulatory unpredictability (China ranks 48th, India 50th, and Brazil 65th).

The BEEPS confirm that policy uncertainty can generate uncertainty in other areas: Russian firms that perceive policy-induced uncertainty to be high also have less confidence that their contractual and property rights will be enforced (figure 5.6).

Figure 5.6 Firms confident that contractual rights will be enforced, based on their view of the consistency and predictability of regulation



Source: BEEPS.

The BEEPS also suggest that the views of surveyed firms on the predictability of state regulations improved little between 2002 and 2005, indicating the need for continued effort to reform the regulatory regime. In both of the surveys (BEEPS and LME) around 60 percent of firms in the manufacturing sector, and overall as well, suggested that regulatory regime unpredictability constitutes a moderate or major concern to business.

ADMINISTRATIVE, REGULATORY, AND TAX ISSUES

PROGRESS IN REGULATORY REFORM

After 2001 Russian federal authorities undertook reforms to streamline the regulatory regime and reduce administrative constraints. New laws were introduced for inspections (2001), licensing (2002), registration (2002), simplified taxation (2003), and regulations (2003). Reforms of tax and customs administration took place in the same period, with a new land code (2001) and customs code (2003). These recent reforms reduced administrative barriers facing the private sector and improved the business perception of the regulatory regime, though there is some

evidence of recent reversals, as indicated by joint monitoring by the Center for Economic and Financial Research (CEFIR) in 2001–05 in collaboration with the World Bank and the U.S. Agency for International Development (box 5.1).

Box 5.1 Monitoring progress in reducing administrative barriers to business

Licensing. Streamlining licensing procedures and requirements reduced the number of activities subject to licensing, lowered the license fee to 1,400 rubles, and extended the duration of licenses to five years. The number of activities subject to licensing is set to be reduced further, so that in a few years there will be 74 types of licensed activities, down from over 500 before the new legislation.

Although the process of obtaining licenses became less time-consuming in the first half of 2002, in the second half the cost of obtaining licensing rebounded to former levels—twice as high as the legally mandated fee—where it remained throughout later rounds of monitoring. In the fifth round in 2005, the share of licenses granted exceeded the number of formal requests for the first time. Yet, about half of such documents were either permits with dubious legitimacy or licenses for activities not subject to formal licensing. Meanwhile, license waiting times and costs continued to rise, while the median duration of licenses remained constant at 36 months, well below the term established in the 2002 law. This is partly due to the fact that the unification of licensing procedures at the federal level complicated the process for obtaining licenses from regional or local authorities, now requiring travel to Moscow instead.

The share of firms indicating business licensing and permits as a problem inched up from 32 percent to 34 percent between 2002 and 2005, above the CIS average. Similarly, the percentage of firms stating that bribery is frequent for business licensing increased from under 20 percent in 2002 to 28 percent in 2005, also above the CIS average.

Registration. The 2001 Law on Government Registration of Legal Entities aimed to streamline the registering of business entities by stipulating that the registration period should not exceed five days and capping the cost of registration at 2,000 rubles. It also introduced a “single window,” transferring the registration functions of 4,500 registration institutions at municipal and regional level to the Ministry of Taxation. Under the new law, registration improved considerably. According to CEFIR, 17 percent of firms completed registration (without intermediaries) in less than a week in 2001, 49 percent in 2004. In 2004 the share of firms that required more than a month to register declined from 18 percent in 2001 to 5 percent. The transfer of registration functions to the Ministry of Taxation from local administrations reduced the “stops” in the registration procedure from five on average to three.

Some areas of concern remain. Only 35 percent of the surveyed firms paid 2,000 rubles or less for registration (without intermediaries), up from 33 percent in 2001. In the fifth survey round, the share of firms that had to pay bribes increased significantly. Additionally, the “single window” principle has not been fully implemented.

Inspections. To reduce excessive interference of government bodies of different levels in economic activity and streamline the framework for inspections and controls, the 2001 Law on the Protection of Legal Entities and Individual Entrepreneurs during Government Control established the maximum duration and frequency of inspections, clarifying the rights and obligations of inspectors and economic agencies. Under the new law, state agencies cannot undertake more than one planned inspection every two years at any given enterprise, the duration of an inspection cannot exceed one month, and small businesses have to be operating for at least three years before being subject to inspections.

Although the number of visits by all the government agencies—and the amount of time spent on inspection—has declined significantly, second- and third-round monitoring shows that firms were often subject to multiple inspections by a single agency, in violation of the new law. In 2003 and 2004 the frequency of inspections by the agencies that conduct the most frequent inspections declined, but enterprises also reported unplanned inspections without warrants. Furthermore, the decrease in financial costs, noted in each of the last three rounds, was accompanied by an increase in the share of firms suffering financial losses, as well as the share of the firms fined in excess of legal limits.

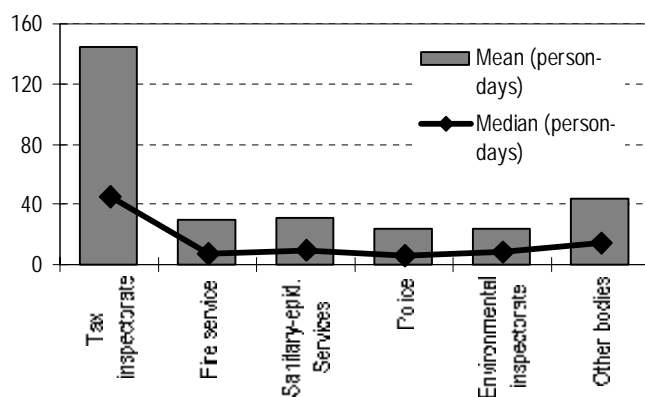
Inspections (above the allowed number) still remain because the new law does not address “unplanned” inspections. And half of police and certification inspections remain unplanned. And half of the unplanned inspections were conducted without a warrant: for the police, environmental protection, and certification agencies that share exceeded 60 percent.

Source: CEFIR (2005).

TAX ADMINISTRATION

The 2003 Law on the Simplified System of Taxation for Small Enterprises offered a reduced number of taxes and levies to small firms that adopt the simplified system. According to the monitoring study by CEFIR, firms that adopted the simplified tax system paid almost six different taxes and levies in 2005, compared with more than nine types of taxes in 2002. Those firms also gave much more optimistic subjective assessments of tax administration (CEFIR 2005).

Figure 5.7 Time spent by employees interacting with various control bodies



Source: LME Survey.

However, the recent reforms appear to have had a small effect on business perceptions of tax rates and tax administration. More than 50 percent of firms still considered them a problem, and tax administration was more problematic in Russia than in the CIS states as a whole or in the Europe and Central Asia region.⁴⁸

Medium and large enterprises in particular devoted considerable employee time to interactions with the officials of the Tax Inspectorate (45 person-days for a median firm), much more than other control bodies, such as the police or the sanitary-epidemiological inspection (figure 5.7). A median small enterprise also spent more than twice the number of person-days dealing with the Tax Inspectorate as other control bodies (5 person-days and 2 person-days, respectively), numbers much lower than those for medium and large enterprises.

Of the 11 different ministries and federal services, medium and large enterprises assessed the activity of the Federal Tax Service negatively impacting their business activities much more than any other ministry or federal service: 46 percent of respondents stated that the activity of the Federal Tax Service affected their business rather negatively, while no other ministry or service was given such an assessment by more than a quarter of surveyed firms.

⁴⁸ BEEPS (2002, 2005).

UNCERTAINTY IN ASSET OWNERSHIP

The landmark mass privatization of 1992–94 passed to private owners all physical assets (buildings, equipment, inventories, transport, and utilities) in 17,000 medium-large enterprises and in hundreds of thousands of small businesses. It did not, however, fully transfer control rights over two key assets: land and intellectual property rights. Both remain largely in the public domain.

Although less problematic for larger firms, smaller firms continue to face obstacles in buying or leasing land and premises. Surveys suggest that while some firms manage to go through the procedure relatively fast (two to three months), for others it can easily take well over a year. In 2003, as reported in the fourth round of CEFIR monitoring, about 90 percent of the firms trying to purchase land failed to finish the procedure in half a year. In the fifth round, the length of these procedures came down only slightly.

One of the chief sources of these problems is the lack of competition in real estate markets. Businesses continually complain that there has been very little land privatization and that the limited amount of privatization has suffered from severe inconsistencies, non-transparency, and favoritism. Business surveys reinforce these findings with complaints about the “need to rely on connections,” excessive discretion, and a higher degree of corruption associated with real-estate transactions than with most other administrative procedures (FIAS 2004a, chapters 1 and 4). Other surveys also found that potential foreign investors, in particular, were concerned about access to land (box 5.2).

Box 5.2 Speeding up land and real estate transactions

The work of the Foreign Investment Advisory Service (FIAS) in Russian regions and locales has shown that substantial improvements are possible in speeding up land and real estate transactions. Novgorod and Tomsk are two places where FIAS survey respondents report relatively simple, quick, and transparent land procedures. Novgorod implemented a “one window” approach to land and real estate transactions in the late 1990s, since recognized as “good practice” in the Russian Federation. FIAS recommended that Tomsk Oblast follow many of the positive examples in Novgorod, such as creating a “one window” system for land allocation procedures, increasing privatization of urban land for business use, and accelerating development of zoning and land-use regulations.

FIAS also worked with the Federal Antimonopoly Service to review several of their recent cases, specifically those for the anticompetitive practices of public sector bodies in land and real estate transactions (mostly under Article 7 of the Law on Competition). Cases in the sample materials fell into five groupings containing similar fact patterns or issues:

- Municipal acts resulting in the monopolization of services related to land or premises.
- Refusal or withdrawal of land or premises to benefit a specific competitor.
- Manipulation of the rules for allocating land plots by assignment or by auction to favor specific purchasers or to force payments from purchasers.
- Differentiation of payment rates for land rent.
- Demands by city authorities for “infrastructure” payments related to the allocation of land or construction permits.

FIAS provided detailed guidance to accompany the recommendations, including guidance on publicizing key information about real estate parcels available for privatization, tender procedures, and performance indicators. Tomsk Oblast implemented the bulk of the FIAS recommendations and increased privatization of land parcels to business from about 120 in 2002 to an estimated 200 in 2004. Survey results in Tomsk Oblast in 2002 and in 2004 also indicate better evaluation of authorities’ services in land and real estate related fields.

Source: FIAS (2004b).

MUNICIPAL LANDLORDS

The new Land Code of the Russian Federation explicitly calls for the land under privatized buildings to be privatized as well, thus allowing land and buildings to be consolidated in a single property registry. But most usable land remains in the hands of municipal governments. Although new federal legislation constrains municipalities’ legal discretion in setting rents and lease terms, they still abuse their dominant position through selective use of administrative barriers—more often to favor some firms over others or to exercise undue influence over local business development.

Many regions and municipalities have instituted mechanisms to privatize real estate, but few are transparent or fair, and the authorities have little incentive to improve their procedures and advance land reforms. There is some evidence that regions that had already adopted legislation on land privatization, ahead of the federal framework law (the Land Code), were also the ones that continued to be the leaders in land reform after the law’s adoption. In other words, while the

Land Code did clarify the overall principles for land transactions, it did not necessarily persuade unwilling regions to initiate land reform and land privatization.⁴⁹

As a result, few firms have managed to gain access to land. Among small and medium enterprises surveyed by CEFIR, only 6 percent own land. From FIAS surveys in 15 regions of firms that carried out land or real estate transactions in 2004 (mostly medium firms), the proportion of respondents reporting ownership rights to land was about 18 percent (table 5.2).

Table 5.2 Survey firms' reported land rights, 2004
(percent)

<i>Type of firm</i>	<i>Ownership</i>	<i>Lease</i>	<i>No land</i>
Small and medium enterprises	6	34	57
Firms involved in land/real estate transactions	18	45	43

Note: Percentages do not sum to 100 because some respondents have more than one parcel of land and may have ownership rights on some and lease rights on others.

Source: Data on small and medium enterprises are from CEFIR; data on firms in land and real estate transactions are from FIAS.

Administrative barriers in land acquisition procedures deter many firms from applying for land ownership. For example, even the relatively straightforward procedure of applying for ownership rights of land under a building already owned by a business takes an average of 11 procedures involving 8 agencies, 17 documents, about 220 days, and 70,000 rubles. Land transactions are also magnets for corruption. On average, according to “business intermediaries” who carry out such transactions on a regular basis, more than half the privatization transactions involved “unofficial payments.” Firms that carried out such procedures on their own behalf reported a somewhat lower level of bribes (about 36 percent), but about 25 percent of them were required to pay “sponsorships” to various foundations suggested by government officials, and more than 20 percent had to pay for other burdens, such as paving a nearby road.

DELINEATING AND PROTECTING PROPERTY RIGHTS

Key policymakers—including representatives of the Russian Duma, the Ministry of Economic Development and Trade, the Federal Antimonopoly Service, regional authorities, the Russian Urban Institute, and the private sector—have agreed on the need to create a competitive environment and a functioning land market—the lack of such a market has already begun to restrain economic growth. Three major issues hinder market relations in the land and real estate sectors:

- *Legal deficiencies.* There continue to be major deficiencies of the law in conceptual approaches, consistency among various statutes governing relations for land and construction facilities (land, forest, town planning), and specific procedural rules on registration of the respective rights.
- *Lack of interest by municipalities and officials in the development of competition in land and real estate.* The real estate market is monopolized, inflating prices, blunting equal access to the facilities for sale, and nurturing corruption.

⁴⁹ A notable exception to this is the Tomsk Oblast, which made use of this opportunity to promote reform.

- *Lack of appropriate informational and legal basis for land market development.* Most land plots have not been registered in the cadastre, and rights to real estate objects (in reality unified objects, such as adjacent land, building, and infrastructure) are fragmented and governed by separate and sometimes conflicting laws and regulations.

INTELLECTUAL PROPERTY RIGHTS

Firms also face uncertainties about the ownership of intangible assets, particularly intellectual property rights (IPRs). These uncertainties complicate the collaboration of research institutes with private firms, inhibit technology transfer, impair the development of spin-off companies into independent and growing businesses, create conflicts of interest for the institutes, and may even give rise to conflicting goals between individual researchers and their organizations. Russia's IPR regime has two main weaknesses:

- First, the assignment of IPRs remains unclear. In the 1990s Russia introduced patent and other IPR laws in which the stock of "author's certificates" (the prevalent form of registration for inventions in the Soviet economy) and new technology developed with state funding remained de jure state property. So there is ongoing debate over who owns these IPRs: the inventor, the inventor's employer (research institute or enterprise, either state-owned or private), or the state that may have paid R&D costs.
- Second, registered IPRs are weakly protected due to the inability or unwillingness of public authorities to police producers and importers of pirated goods and to prosecute violators—a particular concern for foreign investors and exporters facing copyright piracy or patent infringement by domestic producers or importers.

Different countries have different rules for allocating IPRs developed in private settings with public funds. In the United States the Bayh-Dole Act (1980) gave universities the right to patent all discoveries resulting from federally funded research—to make their technology-transfer activities more effective and to facilitate commercialization through patent assignments (sales), licenses, and spin-offs. This act reduced IPR disputes (previously United States law did not provide a clear answer to who held the right to patent federally funded research).

The rise in university patenting in the United States during the ensuing period and the stories of university discoveries generating significant licensing revenues are persuading European policymakers to consider similar legislation. Although European Commission funding of private research does not come with conditions in the ownership of resulting IPRs, national rules governing the ownership of results from publicly supported research differ. Some countries give exclusive ownership to academic inventors (Finland, Iceland, Italy, and Sweden). Others give universities the right to own patents on their research (Austria, Belgium, Denmark, France, Germany, Ireland, Netherlands, Norway, Poland, Spain, and the United Kingdom).

Allocating intellectual property rights is one of the most discussed problems in Russian science and technology policy, especially for intellectual property created with budget expenditures, because of contradictions between the laws on patents and on public procurement. A draft new law that would resolve these contradictions by transferring intellectual property ownership to research institutions has been approved by the Council of Ministers but not officially enacted.

The use and disposal of tangible assets theoretically owned by the state is poorly regulated in practice, since it is difficult to exercise control over the more than 10,000 currently existing state-owned enterprises (the “unitary enterprises”).

Box 5.3 Uncertainties of Intellectual Property Rights (IPR) regime in Russia

Pratt & Whitney (P&W), the aerospace subsidiary of United Technologies, was interested in partnering with the jet engine producer Permskiye Motory (PM) in the North Urals. The partnership stumbled over technology transfer agreements. The owners of PM felt that, when the company was privatized in 1994, it acquired all the assets developed by this national industry leader, including engine designs and related production technology know-how. It turned out to be not so. The intangible property remained with the state when PM assets were privatized, and current technology development and production continues to depend heavily on government procurement contracts. P&W’s prospective partners could not prove that they had any title to the technology developed and used in its production shops.

Scarcity of corporate R&D is the Achilles’ heel of the Russian innovation system: business enterprises contribute less than 20 percent of the national R&D expenditures, while the state finances more than 60 percent. Most of government funded research and development is carried out by research institutes, design bureaus, and business enterprises. As a result, 90 percent of all IPRs registered in Russia are created with state support. Russian inventors patent to mark their priority, an objective different from that of firms in the developed market economies where patenting is the first step to commercialization. Since it is costly to keep patents effective for the 17 years allowed by law, Russian patent holders tend to stop maintaining their patents after four to five years. As a result, only 35 percent of registered patents in Russia are active; the rest cannot be enforced if infringed by competitors. Patenting abroad is prohibitively expensive for most Russian technology intensive firms. Hence, the intellectual property of Russian innovators cannot be sufficiently applied to productive use and adequately strengthen their positions in markets of technology intensive goods and services, perpetuating Russia’s specialization on raw material industries.

Despite controversies and the incompleteness of the Russian IPR laws, most observers agree that their content and quality corresponds to international standards. But the institutions and procedures to enforce these laws remain weak. They need to be strengthened to comply with treaties in force (TRIPs), one of the stumbling blocks in Russia’s accession to the WTO. The market share of pirated goods is high: 97 percent of computer software, 85 percent of optical disks, 75 percent of audio records, and 45 percent of printed works.

Russian arbitrage (commercial) courts are hearing up to 200 cases related to violations of IPRs, half of which are initiated by foreign plaintiffs. Often cases are resolved before a verdict is reached. In only a few cases are defendants found guilty.

BARRIERS TO COMPETITION

Around the world, the most innovative economies are characterized by high levels of competition and competitive pressures. In Russia, too, firms facing the strongest pressures from domestic and foreign competitors innovate the most. Based on the regression analysis in the annex, the investment climate in Russia can be improved significantly by enhancing competition and strengthening public-private consultation.

COMPETITION POLICY

The Russian antitrust regime, with the Ministry of Antimonopoly Policy and Entrepreneurship Support (MAPES) at the center, was put in place early in Russia’s transition and has gradually increased the severity of punishment. A law on competition (“On Competition and the Restriction of Monopolistic Activity in Goods Markets”), passed in 1991, consisted mainly of cease-and-

desist orders for violators. Subsequent amendments and supplementary legislation expanded the responsibilities of the regulators and the sanctions for offenders. In 1999, as part of a response to anticompetitive actions of financial institutions, the antimonopoly regime underwent further reform, establishing the state commission on anticompetitive practices as a cabinet-level ministry (MAPES).

In 2004 the Russian Federation was the first non-OECD economy to participate in the OECD's Regulatory Reform Programme, which reviewed Russia's efforts to foster competition, innovation, and economic growth. The review identified several flaws in the Russian antimonopoly regulatory framework—structural and legal problems, excessive caseloads and limited capacity, and an enforcement mechanism characterized by weak sanctions for some transgressions and limited investigative powers (box 5.4).

Box 5.4 Competition policy and regulatory reform: the OECD assessment

Russian competition authorities—both MAPES and its predecessors—have faced a shifting policy environment that has not always directly supported competition or credible enforcement mechanisms beyond shorter term policy goals such as rapid privatization or crisis recovery. The OECD’s review identified numerous structural and legal defects in the current competition policy regime, weaknesses in the credibility of sanctions, and insufficient investigative authority granted MAPES under the current law.

Collusion. Criminal sanctions for price fixing, although available to MAPES in theory, were untested as of 2004. Although pricing agreements that establish barriers or are predatory are punishable by fines and prison terms, MAPES does not have direct investigative or prosecutorial powers, and any criminal sanction requires that the district prosecutors undertake criminal investigations and bring cases to courts.

Abuse of market dominance. Many abuse-of-market-position cases address alleged violations of natural monopolies and regulated utilities. The remaining cases typically concern “dominant” enterprises whose market share is well above the 65 percent. These cases tend to rely on this legal threshold and are rarely supplemented with additional analysis of market conditions. MAPES’s focus in the majority of these cases is on whether the behavior is abusive. The OECD review noted a lack of resources to conduct research, the paucity of official information sources, and the restrictiveness of the time frames, all of which make it difficult for staff members to perform any case-related economic analysis. The result: a strong incentive to take on cases with evidence of market dominance overwhelming and obvious.

Merger control. In addition to controls on mergers and transactions between related entities, the law on competition provides for the breakup of commercial firms if they engage “systematically” in monopolistic activities, defined as having been twice found to engage in monopolistic activities in a three-year period. Even so, refusals of permissions for mergers are rare. The OECD review notes that conditions for the “preservation of competition” are imposed on a mere 4.4 percent of merger filings. In the highly concentrated oil and gas sectors, the percentages are somewhat higher. Breakup orders—equally rare—can be issued only if the technological ties between the resulting entities are not tight, if the separated parts can be physically divided from one another, and if the part to be separated does not provide more than 30 percent of its production for the consumption of the remaining parts. In the period under review by the OECD report, only one such order was issued.

State actions. State bodies are required by a separate law to purchase goods and services for public needs through competitive bids. A special area of enforcement has been the restrictions of regional and local governments on the movement of goods and services into or out of their areas. MAPES’s enforcement efforts have reduced the number of prohibitions of this kind significantly since the 1990s. But its enforcement capacity is more limited when dealing with the provision of special assistance to specific firms by local or regional governments, assistance outside its reach until the repeal of the special laws that cover such assistance.

Unfair competition. MAPES does not have the power to estimate damages to complainants or to order compensation. Private parties may seek compensation through civil actions (citing a decision by MAPES as evidence of violations). But compensation for damages suffered that cannot be proven by specific evidence—say, damages estimated based on projected sales losses or similar evidence—is uncertain under the law. There are no provisions for punitive damages.

Consumer protection. The current formulation of the law on competition relates to “economic subjects,” generally defined to include commercial (and some noncommercial) entities but not individuals. For this reason, MAPES offices have combined enforcement of the competition law with enforcement of consumer protection laws. Procedural law, however, does not permit class-action suits, and there are no provisions for punitive damages.

Source: Reynolds (2004).

Despite these limitations, competition authorities in Russia have helped create competitive conditions, reducing barriers to the movement of goods and services, and establishing consumer-protection legislation.

Addressing competition law and competition policy in Russia requires amendments to multiple laws and decrees and to the organizational and operational practices of MAPES and local, regional, and federal governments. More important, expectations for centralized, top-down approaches to competition policy are often based on a presumption that the reforms will yield results and change the incentives of the main actors with some predictability. Experience suggests that this is far from so in a country as large and regionally diverse as Russia—and in a government as multilayered.

This is not to imply that reforms of the kind recommended by the OECD review are not important. There is, however, an imperative to strengthen the demand for competition from the bottom up—to empower and support the natural constituencies for competition and market openness.

COMPETITIVE PRESSURES

Monopolistic firms tend to obtain more favorable treatment from government authorities—they tend to suffer less from any given investment constraint than other firms, to pay less in bribes to secure government contracts, to suffer less from nonpayment, and to pay less in protection payments. It is likely that this differential treatment is due to loopholes, exemptions, or special exceptions in existing legislation, as well as the discretionary interpretation and application of regulations by public authorities (table 5.3).

Table 5.3 Firms facing the least competitive pressures have an easier time doing business

	<i>Firms facing the least competitive pressures</i>	<i>Firms facing the most competitive pressures</i>
Likelihood of paying bribes to get things done	29.5 %	49.2%
Percent of contract value paid in bribes for government procurement	0.9%	2.6%
Over-employment	5.1%	12.2%
Likelihood of nonpayment by customers	29.2%	71.7%
Protection payments (% of sales)	0.2%	0.7%

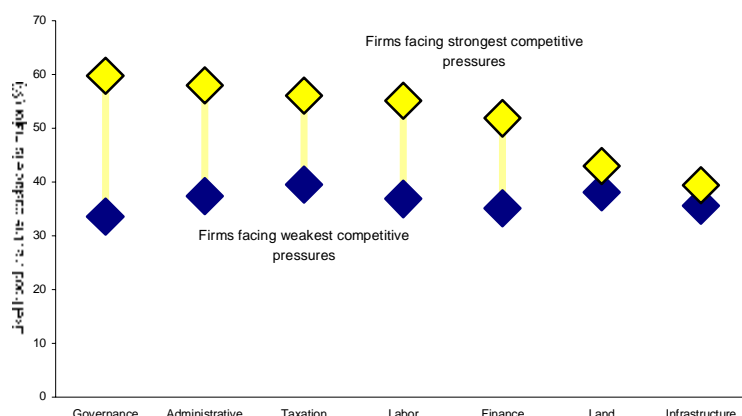
Source: LME Survey, estimates control for size, age, former SOE status, and location.

Previous analyses of enterprise performance in Russia revealed that some firms receive preferential treatment from federal and regional governmental authorities. These privileged firms tend to receive tax breaks, investment credits, direct subsidies, guaranteed loans, access to state property, and the creation of special economic zones on sites of specific enterprises (Slinko, Yakovlev, and Zhuravskaya 2003). The World Bank’s *Country Economic Memorandum* for the Russian Federation noted that firms controlled by regional private owners as well as foreign investors were most likely to receive preferential treatment. It also found that selective, preferential treatment toward the most politically influential firms had adverse effects on the performance of less influential regional firms (2005d).

In a similar vein, enterprise surveys for this report suggest that certain categories of firms face a more favorable investment climate in several respects. Firms facing weak competitive pressures from domestic and foreign manufacturers (the firms least innovative) tend to encounter smaller constraints in conducting their business, while firms facing greater competitive pressures also face a more severe investment climate. Given that the firms facing the most competitive pressures are also the most innovative companies in the Russian economy, this variation in investment climate constraints harms precisely the companies that could be the engines of diversification (figure 5.8). (Tables A5.2 and A5.3 in the annex show the relationship between the competitive pressures that firms face and the severity of various investment climate constraints.)

Figure 5.8 represents these findings. Controlling for systemic biases toward the investment climate in general, as well as size, age, sector, and regional location, firms facing competitive pressures are more likely to face harsher governance constraints (such as a poorly functioning legal system, policy uncertainty, crime, and unfair competition), less access to and higher costs of finance, higher taxes and a weak tax administration, more problems with labor (skill shortages and regulations), and steeper administrative barriers (customs and licensing barriers).⁵⁰

Figure 5.8 The investment climate “gap” between competitive and noncompetitive firms



Source: Russian LME Survey. Estimates are generated from stochastic simulations of regressions in annex 6, which control for firm size, membership in financial-industrial conglomerates, sector, region, and systemic bias toward the investment climate.

What accounts for this apparent punishment of the most innovative firms? State capture. Powerful private interests come to control legislative and regulatory processes to guarantee themselves a stream of uninterrupted benefits, protections, and rents. State capture does not, however, merely benefit private firms. Local and national public officials can also benefit in numerous ways—whether through direct payments or through political financing (campaign contributions) by captor firms. Meanwhile, firms that are not captors do not benefit, and may be

⁵⁰ The investment climate constraints are generated using principal-components weightings of the individual impediments, generating normally distributed, continuous variables with mean 0. These results also control for firm size, whether or not the firm is a member of a holding company or financial-industrial group, and a firm-specific, systemic “optimism” or favorable bias toward the investment climate. Sectoral dummies are also included.

targeted by public officials—inspectors, tax authorities, and politicians—to extract benefits from them (Frye 2002). Firms facing the greatest competitive pressures also pay more bribes to obtain contracts with the government, tend to have bloated payrolls, and tend to encounter more non-payment (table 5.3). How can the most vulnerable firms shelter themselves from these adverse effects of state capture?

BUSINESS ASSOCIATIONS

Russian firms belonging to business associations report that one of the most valuable services is information on regulations, standards, accrediting, and markets. Business associations can, moreover, serve as a “leveler” among firms. Although firms belonging to business associations report more severe investment climate constraints—both objectively and subjectively—they are also more likely to introduce new products and new technologies in their facilities (table A5.4 in annex). Moreover, those firms that not belong to business associations and that face the greatest competitive pressures were also more likely to have excess labor, more likely to pay more in bribes for government contracts, and less likely to believe that regulations were predictable. Among firms belonging to business associations, this gap disappears. The combination of competitive pressure and business association membership has the most favorable effect on investment climate costs and uncertainties (table A5.5 in annex). Problems of excess employment, regulatory burdens, regulatory unpredictability, and severity of bribe payment for government contracts are less constraining for competitive firms belonging to business associations than for either members of business associations or for firms facing competitive pressures alone.

There are two possible explanations for this “beneficial” effect. First, surveys indicate that a central service that business associations provide their members is information on regulations, pending legislation, and economic policymaking processes—information that may better equip business association members to anticipate regulatory and policy shifts, to prepare for changes in governing laws, and to identify “loopholes” or ways around often complex regulatory regimes. Second, it is possible that firms—especially smaller and medium-sized firms—that can band together are better protected from rent-seeking or predatory public officials. They are consequently less likely to pay bribes for commonplace tasks and procedures than firms outside business associations.

Russia’s SME associations have achieved considerable success in forging strong working relationships with their government counterparts (box 5.5). And Russian business associations as a whole have been characterized more by positive market-supporting behavior than by the negative rent-seeking behavior typically assumed of them.

Box 5.5 Can advocates of competition be empowered? Russian entrepreneurs and OPORA

Ineffective representation at the national level had already been a concern for small business leaders and had been discussed at a conference organized by the Institute on Entrepreneurship and Investment and the Chamber of Trade and Industry. When these leaders then approached the government to gauge its receptivity to working with one unified association of entrepreneurs, the response was very positive. In fact, the administration's support for such an association stimulated the smaller associations to unite their efforts, leading to the creation of the Association of Organizations of Small and Medium-Size Organizations (OPORA) in 2001. OPORA's mission is "to create positive conditions for the development of entrepreneurship in Russia, to represent and defend the interests of entrepreneurs in dialogue with all levels of government, and to participate in the creation of a national "middle class" on the basis of the best traditions of national entrepreneurship and Russian business culture."

OPORA was created as an association of associations; it began with 50 members and has over 100. One year after its founding, to give individual entrepreneurs and small businesses a direct voice and more direct access to its activities, it created OPORA Russia for this type of membership. OPORA Russia began with 46 regional divisions and has grown to 80. The Moscow division alone has more than 1,000 members.

OPORA was also able to demonstrate its value almost immediately, both to its membership and to the Russian government. According to one newspaper account of the press conference following a meeting with President Putin, "the group was surprised by the government's inability to formulate a policy on supporting SMEs." Since contributing to policy was one reason for creating OPORA, OPORA had an immediate way to contribute to the government's work. OPORA then showed how it could help its members. According to a senior OPORA representative, it was an open letter from OPORA that provided the impetus for President Putin's decision in 2002 to simplify business taxation.

One of OPORA's first major projects, participating in the government's program to reduce administrative barriers, focused on improving conditions for Russian entrepreneurs by reducing the role of the government rather than by lobbying the government for concessions. OPORA does not lobby for individual interests and considers it "bad tone" to do so. As Ms. Dina Krylova, one of OPORA's founding members and currently an executive director explained, OPORA's principle is "not to make it easier for you or me to breathe, but to improve the quality of the air."

To foster innovation, OPORA focuses on changing Russian small business. The small consumer goods trading operations that helped so many entrepreneurs get started have much less potential as large consumer goods companies enter the market and consumers become more discerning. The Russian government sees knowledge absorption and innovation as a potential motor of economic growth. OPORA's survey on challenges to the further development of innovative Russian SMEs contributed to the government's new policy. Although that policy includes creating a network of business incubators, it also limits how long companies can stay in them. OPORA's research on international best practice showed that incubators can fail when companies stay there for too long.

Sources: Yermakov and Kaganov (2000); Ostrovsky (2001); Ostrovsky (2002).

Business associations can, however, quickly become instruments of cronyism. So, consultative mechanisms should be inclusive, able to obtain input from their core membership. Broadening policy dialogues to include representatives of a wider range of interests—including consumers, taxpayers, and owners and employees of smaller businesses—can enfranchise previously excluded groups in policymaking.

RECOMMENDATIONS

Enterprise surveys for this report—and comparisons of findings with those from other developed and developing countries—suggest that employer warnings of policy constraints are real and should be heeded. They tell a broadly consistent story about the investment climate hurdles that potentially innovative, dynamic firms encounter. What should be done to improve the competitiveness of Russian firms and unlock their full innovative potential? Four things:

- Privatize municipally held land.
- Improve the allocation of intellectual property rights.
- Strengthen the consultative basis for regulatory decisions.
- Adopt one of several “review” mechanisms to deal with existing regulations.

Privatize municipally-held land. Land privatization will require greater use of auctions and tenders for vacant land and greater transparency in the procedures. It will also require lower prices, especially for land under buildings already privatized. Many bureaucrats involved in land and real estate privatization and registration appear to create or threaten delays to encourage “speed payments.” One way to deter such behavior would be for the Ministry of Economic Development and Trade to draft new legislation to impose time limits on the processing of applications, with “silent consent” coupled with a requirement for government officials to provide written explanations for any refusals, citing objective reasons. The Ministry of Economic Development and Trade should also require annual statistical reporting by regions and municipalities about land and real estate ownership, lease rights, privatization transactions, modes of privatization, and relevant prices. FAS might use official statistical data and survey data to identify possible abuses of market power by public sector bodies (such as municipal administrations) and to prosecute such cases in court as anticompetitive practices.

Improve the allocation of intellectual property rights. A current draft of the Civil Code allows research organizations to become owners of intellectual property rights (IPRs) for the technologies developed using government funds “provided that the procurement contracts do not specify otherwise.” Research and business communities are rightly concerned that this open-ended provision would allow public authorities to continue to exercise ownership for subsequent IPRs and prevent closer cooperation between innovators and firms.

At the end of 2005 an important step was taken toward improving the legal regulation of intellectual property created with public funding. According to Decree 685, “on the procedure for disposing of the rights to the results of activity in the sphere of science and technology,” the rights to the results of science and technology activity funded by the public may be transferred to the performer on the condition determined in the government contract (with some notable limitations). This decree has not yet granted the direct authors of inventions the right to dispose of the intellectual property fully and at their own discretion. And several aspects of the decree need to be further specified, including the conditions for transferring the rights to the performer of the work, obligations of the state in the early stages of technological development, and the procedures for determining the size of the compensation payments.

Strengthen the consultative basis for regulatory decisions. Difficulties in informing market participants about new and forthcoming legal and regulatory changes stem partly from Russia’s unfinished transition. A degree of regulatory instability is thus inevitable and generally well understood by market participants. But the government should intensify its efforts to develop adequate mechanisms to consult the business community and inform market participants in

advance of new measures. Regulatory transparency and predictability are particularly important for small domestic investors and for foreign investors, especially potential ones, because they are less familiar than incumbent firms with the national legal and regulatory environment. These small and medium-sized firms, moreover, are a natural constituency to demand openness and competition in markets.

Consultative processes can produce higher quality regulations that achieve legitimate goals at the least possible cost. They also permit basing regulatory decisions on objective analysis and transparency. But they should be inclusive, obtaining input from their core membership. Broadening policy dialogues to include representatives of a wider range of interests, including consumers, taxpayers, business owners, and employees, can also enfranchise groups previously excluded from policymaking. In principle, Russia has a fairly well structured network of business associations; in practice they do more to represent the interests of their members to the federal or regional authorities (OECD 2006).

Public disclosure of regulatory agreements as part of a broader framework for better information-sharing by the government can promote consumer rights, encourage rule-based enforcement of obligations, and reduce incentives for corruption. Several countries have standards of public disclosure—say, by posting the full content of infrastructure contracts, and regulatory and administrative procedures on websites.

Adopt one of several “review” mechanisms to deal with existing regulations. Although licensing and regulatory reforms in 2001–03 have streamlined administrative barriers, business regulation in Russia is often complicated by older rules still on the books. The Russian Federation should consider implementing one of the approaches used in Mexico, Hungary, and other countries to eliminate obsolete regulations. Requiring governing authorities to document and justify all business regulations to parliament by a given deadline, for example, has yielded positive results in several countries.