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***“Regulatory Reform in the Russian Economy :
A Few Issues for Discussion”***

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Regulatory Reform in the Russian Economy: A Few Issues for Discussion

The recent favourable trends in the Russian economy provide an important opportunity for the realisation of key structural reforms, thereby creating a foundation for the medium and long-term sustainability of economic growth. A number of these reforms are related to the sphere of government regulation. It is therefore encouraging that the current Russian government has made regulation, together with its counterpart, deregulation, a major focus of recent economic discussions and reform programmes.

The Soviet economic system featured an extremely high degree of state regulation, although the primary goal of this regulation was the direct administrative allocation of resources in substitution for the market. By contrast, effective regulation in a market economy is aimed primarily at correcting specific market imperfections, thereby allowing markets and competitive forces to operate more efficiently. Primary targets of this regulation include imperfect competition (monopoly power), various externalities such as environmental pollution, and the financial sphere, where market imperfections can be particularly acute.

Regulatory reform in Russia has therefore been a process both of dismantling the former Soviet apparatus, and of building an entirely new regulatory capacity conducive to the healthy functioning of a market economy. Much has already been achieved in the past decade in fundamental legislation and the creation of regulatory bodies. Yet building effective regulatory institutions from scratch in Russia is a difficult task that is far from complete. That is understandable. Virtually every country in the world continues to struggle, to one degree or another, with problems of

regulation, while international experience and accepted wisdom on many questions continue to evolve. Here it is important not only to understand current international experience, but to interpret it for the particular case of Russia. As a member of the OECD delegation who has spent at least a bit of time working on Russia, I would like to devote my comments to some issues of regulatory reform that we have encountered in our recent work. Because of time, I will limit attention only to a few such issues.

The basic regulatory problem can be broken down into two basic, although interrelated, sets of questions: (a) the determination of optimal regulatory rules or policies, and (b) the design and creation of regulatory institutions to implement these rules and policies. This includes the provision of incentives to make regulators themselves interested in implementation. As might be expected in the transition period in Russia, the adoption of regulatory policies has often progressed quicker than the development of institutions that could ensure their proper implementation.

Regulations for consumer protection have received a lot of attention lately in Russia. At the outset of transition, given the lack of reputable firms and evidence of widespread fraud, it is understandable that the Russian government adopted many regulations to protect consumers involving standards in licensing, certification, sanitation, fire safety, and so on. As the government has come to acknowledge, however, these often well-intentioned measures did not always produce the desired effects. In particular, the abuse of regulatory authority by officials in charge of various numerous inspections, licensing, and certification has become virtually institutionalised, referred to now in the business community as the “government racket.” The burden of this racket is shouldered particularly by small and medium-size enterprises. Cross-country comparisons have emphasised this factor as one possible explanation for the relatively low numbers of small businesses in Russia.

In 2001, the Russian government prioritised a debureaucratisation reform initiative for the purpose of tackling this specific problem. This has resulted in new and improved laws on licensing, registration, and the defence of the rights of juridical persons during state inspections. This new legislation should certainly have a positive impact. Yet the final solution to this problem may require more subtle changes in institutional design, in addition to this refinement of federal regulations and the imposition of greater central control over state officials in regions and localities.

Some questions here relate to the sphere of government administration. One quite basic point is that, for central control and monitoring to induce responsible behaviour, regulators must feel that they have something to lose if they are caught behaving irresponsibly. Furthermore, in order to attract and maintain competent personnel for key regulatory posts, this must be something positive, such as a good sized explicit salary that they would lose in the event that they were fired. Yet existing state administrations and agencies in Russia are typically overstaffed, sometimes even with a majority of redundant personnel, while those officials making important decisions often receive quite small official compensation. This is therefore an issue that perhaps warrants close attention.

A second basic point concerns the relationship between federal, regional, and local governments in Russia, and the nature of the cat-and-mouse game played in the context of federal crackdowns. As we know, regional and local administrations have various different means of influencing or pressuring organisations operating on their territories. When the central government cracks down on one, they find another. Under these conditions, we would expect problems to continue until such a time as regions and localities themselves become sufficiently interested in improving the environment for business and fair competition on their territories. This suggests

possible changes in the division of autonomy and responsibility between different levels of government in Russia. In fact, much of our recent work on Russia in the OECD Economics Department has focused on fiscal federalist relations. We consider these issues to be inseparable from questions of building effective regulatory institutions and debureaucratisation.

The regulation of utilities in Russia (gas, electricity, heating, rail transportation) is intermeshed in a particularly complicated web of problems that touches on almost every aspect of economic transition in Russia. The solution to these problems also requires unavoidable simultaneous movements on many fronts. In my comments here, I will limit attention to energy, as that has been an area where we have done some recent work.

Russia has certainly made some progress in this area. We have witnessed the creation of a legally independent Federal Energy Commission, the creation of Regional Energy Commissions in most Subjects of the Federation, the empowerment of the Ministry for Anti-Monopoly Policy and the Support of Entrepreneurship to monitor the activities on the natural monopolies and uphold the law on Competition, and improvements in information dissemination and accounting standards. Ambitious programmes are being developed for organisational reform in the electricity and gas industries, including the introduction of markets and competition into those parts of the industries that are not natural monopolies.

But the remaining problems are quite serious and immediate. In the electricity sector, for example, many experts believe that Russia is moving toward a crisis due to a growing imbalance from rising demand and declining capacity. The gas industry is also in need of major fixed capital investment for the development of new fields. But the current regulatory conditions in these sectors appear to be consistent neither with

the efficient consumption of energy resources, nor with the realisation of needed fixed capital investment, either through retained earnings or the attraction of outside investors. What is wrong?

On the one hand, severely repressed energy prices and imperfect payment discipline can be associated with the over-consumption and wasteful use of energy resources. Second, for this and a number of other reasons, investors do not yet feel confident that they will receive a sufficient expected rate of return on their investments. This is directly related to regulatory practices themselves.

1) First, regulation is highly politicised and uncertain. The Federal Energy Commission works with a very low actual degree of independence from the federal government. Regional energy commissions typically operate with a very low actual degree of independence from regional administrations. On the one hand, energy commissions are officially instructed to set tariffs on the basis of costs, balancing consumer and producer interests. On the other hand, various political motivations have an obvious strong influence in practice. For example, we hear open discussions within the Russian government on the degree to which tariffs in the natural monopoly sectors should be used as a means of controlling inflation or stimulating manufacturing sectors of industry. Current tariffs appear to be much too low to cover costs of domestic sales, including fixed investment costs.

2) A second related problems is that the gas and electricity sectors have been used throughout the transition period for the massive subsidisation of households and firms through low average prices, poor payment discipline, and high cross subsidies. No explicit programme has yet been put on the table for the elimination of this

subsidisation over a fixed period of time, together with measures to deal with the implied social consequences.

3) Then there is the enduring problem of nonpayments, which adds another layer of complexity to the Russian regulatory environment. The return that energy firms receive depends not only on prices, but also on payments. Fortunately, recent years have witnessed significant progress in payment discipline, reflected in a substantial increase in payments and cash payments for energy. Nevertheless, payments problems remain serious, and could easily become even more serious in the context of higher energy prices. This point illustrates the dependence of effective regulatory institutions in Russia on areas such as insolvency, bankruptcy, and the court system.

4) A fourth problem is the lack of long-term commitment in regulatory conditions. A investor thinking of sinking capital today will look not only at today's prices and payment conditions, but will form expectations about the future. A lack of regulatory commitment also dulls incentives within firms for cost-reducing innovations or investments.

These considerations lead to the conclusion that repressed energy tariffs and high cross subsidies are not just the causes of problems, but the consequences of other deeper problems. This includes an insufficient degree of independence, clarity, and long-term commitment in regulation itself, and surrounding problems in nonpayments, social policy, insolvency, and other areas. A number of important potential topics for cooperation between OECD experts and the Russian government in the area of regulatory reform emerge from this discussion.

1) I have already mentioned *government administration and relations between different levels of government*.

2) One key issue is the *independence of regulatory bodies and practices*. On the one hand, the establishment of credible commitment to efficient and fair regulatory practices implies that regulatory bodies need to function with a high degree of independence from day-to-day political interference. On the other hand, if regulatory bodies are not answerable to the government at all, there is a high risk that they could be captured by the interests of the firms that they are regulating. The scope and influence of giant firms like Gazprom and RAO UES in the Russian Federation imply that this could indeed be an important problem. The dilemma of supporting both independence in regulatory decisions and the answerability of regulators to the government can be solved, at least partially, through the detailed codification of regulatory procedures in key laws or long-term contracts. This is also a means of supporting needed long-term regulatory commitment. There exists an international experience in this area that can be useful to Russia.

3) A major challenge is the design of a *comprehensive regulatory reform package* for the energy sector that could address a number of these problems simultaneously, mixing a strong commitment to a stepwise increase in tariffs and reduction in cross-subsidies with an effective and extensive programme of social support and measures to prevent a deterioration in payment conditions. The explicit development of such a programme would appear to be a necessity.

I have been so far assuming state regulation as a given condition, and raising questions as to how it might be made more effective. Due to inherent information and incentive problems, the best regulatory practices can only reduce, rather than eliminate, the inefficiencies inherent in state regulation. In addition, in many countries, state regulation extends beyond the boundaries of where it is essential for correcting market imperfections. For this reason, an essential part of the solution to inefficient regulation can be deregulation, namely, the replacement of regulation with markets and competition. This has become a major theme in reform efforts in many countries in the world, and Russia is no exception.

The question of deregulation in Russia raises a number of difficult questions, however, the understanding of which requires knowledge of both world experience and specific Russian reality. For example, we see a strong trend in Russia today toward greater integration and concentration of ownership, which raises obvious challenges for competition policy. On the other hand, we also know that one of the motivations for integration in Russia is the establishment of trust in relationships between interlinked firms. Due to continued weaknesses in legal contract enforcement, explicit contracts between independent firms may often be insufficient to support such trust. The problem in Russia of ensuring payment for goods or services delivered is a case in point.

And nowhere do questions of deregulation become more complicated than in the sphere of gas and electricity. Here the Russian government has an intent to follow international experience in organisational reforms that would break up monopoly power in these industries and introduce competition into those areas that are not natural monopolies. These types of reforms could indeed have strong potential benefits for Russia. But quite a number of difficult questions emerge here. One

fundamental question is how to proceed in this direction in the face of the severe regulatory and price distortions that I summarised earlier. Given the current regulatory environment in Russia, it is certainly possible to imagine scenarios under which attempts to introduce competition into gas and electricity could lead to disappointing results. Therefore, the explicit co-ordination of organisational and regulatory reforms, together with requisite social assistance and other programmes, would appear to be imperative at this point in time. My own personal feeling on this matter is that solving a number of the basic regulatory problems that I discussed earlier is a prerequisite to the overall success of organisational reform. But this is an issue that certainly warrants more discussion.