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Overview of Structural Reforms in Russia after 1998 Financial Crisis

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Structural reforms developed by the international financial institutions within the framework of adjustment programs usually mean the transformation of the economy involving changes in the institutional basis and regulation principles. On the whole, the term “structural reforms” means everything that is not included in the macroeconomic, fiscal and monetary policies.

In the narrow sense, structural reforms include activities governing the dynamics of the institutional framework of business development, namely:

privatization and corporate governance; bankruptcy procedures; land and real estate market; labor market; tax system design; financial institution development; international trade and foreign direct investment policy; and regulation of specific sectors (natural monopolies, agriculture). In the broad sense, structural reforms additionally include a set of issues relating to the expenditure side of the budget: budgeting, as well as education, health, housing and utility reforms.

Clearly, it is structural reforms in the narrow sense that have the strongest impact on real sector growth while structural reforms in the broad sense have but an indirect effect on such growth (via budget deficit and social incentives). Therefore, hereinafter we will focus on the former.

Such focus is especially justified in view of the fact that real sector growth became one of the top priorities after the August 1998 crisis. In spite of a significant peak output drop during the crisis, the post-crisis conditions have been quite favorable for economic recovery and growth resumption. Apart from the devaluation, favorable factors include a gradual remonetization of the economy due to a sizeable reduction of the sovereign debt service level and generation of a sustainable positive primary balance of the state budget, as well as a rather flexible response of the productive sector to changes in the environment (which became clear somewhat later).

In view of an extreme scarcity of funds for real sector growth, it was natural for politicians to focus on mobilizing institutional resources. Besides, the institutional development sphere provided more freedom for political maneuvering while the macroeconomic policy was strictly predetermined by the objective reality.

There are two documents outlining the post-crisis structural policy priorities (i) *Measures Planned by the Government of the Russian Federation and the Central Bank of the Russian Federation to Stabilize Socioeconomic Conditions in Russia*,

dated November 16, 1998, and the related Action Plan (Government Resolution No. 1529 of December 20, 1998); and (ii) *Letter of Development Policy for the Third Structural Adjustment Loan* and the related Action Plan (both approved by Government Resolution No. 829 of July 19, 1999).

In fact, the former became the first program statement of Russia's first left/centrist government and naturally contained elements of conductorship and intensified direct interference in the economy. The latter resulted from a resumed dialog with the international financial institutions and was signed after Primakov's government resignation and therefore largely reflected the economic policies discussed in summer 1998 during the preparation of the emergency assistance package proposed by the international financial institutions.

Being a compromise, these documents were naturally less ideologized than statements made by politicians and views of individual experts. The initial concepts underwent further changes in the relevant Action Plans, and especially in practice. Nevertheless, two structural policy paradigms can be clearly seen in the actions taken by Primakov's cabinet, on the one hand, and successor governments headed by Stepashin and Putin, on the other.

Given a certain recovery of production in the second half of 1998-1999, a major objective goal of the structural reforms was to create an enabling institutional and regulatory environment for companies and reduce administrative risks and transaction costs.

It is possible to identify the following major directions of the structural reforms implemented:

1. Privatization, corporate governance, shareholder and investor right protection. Development of the bankruptcy procedures. Task to address: developing efficient business incentives.
2. Further implementation of the tax reform. Task to address: reducing tax burden on companies; establishing a more "fair" and "business-friendly" tax system; encouraging official business development.
3. Bank restructuring. Task to address: establishing a sustainable bank system capable to meet the real sector needs in terms of payments and credits.
4. International trade policy. Task to address: encouraging exports and protecting domestic market.
5. Natural monopoly policy. Task to address: creating a competitive environment in the natural monopoly sectors with a view to a more efficient cost and price (tariff) control.

Privatization

Though Primakov's program had a separate privatization section there was only one insipid paragraph on privatization as such. At the same time, there was a page-long list of measures to improve state property management, which was rather consistent

with the logic of intensifying the regulatory role of the state. State property management was expected to focus on monitoring and encouraging managers of state unitary enterprises and developing the trust management mechanism.

Another priority declared under the same logic was the corporatization policy, i.e. establishment of large corporations with state-owned shares in order to improve management, streamline the flow of funds, and re-orient idle assets to the production of hi-technology items.

The policy to support competition, small and medium size businesses was also declared, but no specific actions were envisaged to that end.

In practice, the only result of Primakov's program implementation was the suspension of the privatization process. Thus, the list of strategic companies not subject to privatization was significantly extended in February 1999.

The Government had to revisit the privatization issue when preparing the Letter of Development Policy. It identified 7 large companies for CBC privatization in 1999 and another 8 companies for privatization in 2000. A proposal was made to accelerate the sale of the remaining state shares in small and medium size companies, including those already within RFPF's jurisdiction and those removed from the "strategic" list in 1998.

A more detailed account of the strategic approach to the privatization issues is given in the Russia State Property Management and Privatization Concept approved by Government Resolution No. 1024 of September 9, 1999. The Concept contains a rather critical assessment of the current status of the state property management system and, in fact, recognizes that the state is incapable of an efficient management of its property under present circumstances. Therefore, the Concept proceeds from the need to further develop the privatization process.

The Concept proposes the largest possible reduction of the number of unitary enterprises, which shall be reorganized into joint stock companies; at the same time, it does not establish any criteria for retaining state blocks of shares: the issue is shifted to the sphere of politics. The Concept uses a differentiated approach to liquid and illiquid blocks of shares. Sale of liquid blocks of shares shall be oriented to the financial result while sale of illiquid blocks to investment and social commitments of the buyer. Privatization tools would be more diverse and include, *inter alia*, direct negotiations with the investor if the auction or tender is considered invalid; and issue of securities against a deferred right to purchase state shares.

Reallocation of assets using bankruptcy procedures is a powerful instrument to improve production efficiency in a situation when many companies are already privatized. Therefore, the LDP pays much attention to such measures. In particular, in July 1999 the Government lifted the January moratorium on insolvency claims against companies and entities, which are in arrears to the budgets and extrabudgetary funds, imposed by Yu. Maslyukov.

The LDP envisaged a number of legislative amendments and changes to the bankruptcy law with a view to:

- a) Eliminating court discretion in overruling the creditors' decision to liquidate the debtor enterprise;
- b) Accelerating the introduction of external management of enterprises under bankruptcy;
- c) Conducting an intensive restructuring of commercially nonviable companies without resorting to judicial resolution of bankruptcy cases ("out of court" bankruptcy);
- d) Enhancing personal liability of debtor enterprise managers.

With respect to competition development and private sector support, the LDP proposed the following measures:

- a) Reducing anti-competitive horizontal and vertical concentration and integration
- b) Establishing new merger guidelines;
- c) Reducing the list of activities for which licenses are required;
- d) Establishing a cross-national network of Business Start-up Information Centers.

Major policy priorities relating to corporate governance and investor right protection were as follows:

- a) Ensuring legal protection of minority shareholders' rights;
- b) Enhancing control of transactions with affiliated persons.

The above set of measures seems quite reasonable, however, most of them shall be introduced by laws none of which was passed by the Duma in 1999, so the measures could not have any impact in 1999.

Thus, structural reforms in private sector development have generally yielded a very insignificant result. The private sector development policy largely consisted of intentions – partially pro-market, partially anti-market – rather than actions.

The privatization process was practically discontinued in 1999; however, the plan to establish state corporations was not implemented, and the legal framework for private sector operation did not change significantly. Bankruptcy became an efficient tool for asset reallocation. At the same time, regions retain significant and efficient tools to restrict competition.

Tax Reform

In spite of a general "conductor-like" nature of Primakov's program, it featured a rather liberal approach to the tax reform. The program's major objective was to reduce the tax burden and create an enabling environment for the resumption of growth.

In particular, the program envisaged a phased reduction of the VAT rate (to 10% as of January 1, 2000), profit tax reduction from 35% to 30%, and elimination of a number of unjustified tax privileges.

Early in 1999, Primakov's Government managed to have the Federal Assembly approve a package of basic laws implementing the tax section of the program; however, the President subsequently vetoed the VAT reduction law.

Nevertheless, in spite of a relatively liberal orientation of the program's tax section, it failed to address the key issue of the tax system: an extremely high ceiling of the payroll tax rate (taking into account contributions to extrabudgetary funds), which encourages tax avoidance, creates extremely unequal operating conditions for conscientious tax payers, and prevents a general reduction of tax rates. Moreover, in the beginning of 1999 the State Duma increased the marginal income tax rate to 45%, which was adjusted downward only at the end of 1999 (to 30%).

It should be noted that a similar weakness is also typical of the program prepared by Stepashin's Government in summer 1999, which also ignored the principal defects of the current tax system design. Moreover, Government-initiated amendments to Part I of the Tax Code definitely disturb the balance of rights of the taxpayers and tax authorities through placing the burden of proof on the taxpayer during the process of tax audit; eliminating the statute on mandatory use of the court system by the tax authorities in dispute settlement; and giving the tax authorities the ability to issue liens, at their discretion, on any resources of taxpayers. In a situation when the tax authorities widely use public agencies and local authorities to put pressure on commercial companies and entities or when they act as a instrument of criminal competition, such tightening of tax administration is very unfavorable for private sector development, especially for small and medium size businesses which, unlike large companies, do not have required financial and/or political resources to prevent arbitrary actions of the tax authorities. Anyway, excessive powers of the tax authorities significantly increase business transaction costs.

On the whole, it can be stated that in 1999 there was a moderate progress towards improving the tax system design (profit tax reduction and elimination of a few privileges) and a certain step-back in tax administration.

International Trade Policy

International trade policy is an area of structural reforms where significant changes were taking place in 1999 since objective and subjective prerequisites for vigorous actions coincided in that case. The objective incentive for modifying the international trade regulation system included a drastic change in the international trade environment caused, first, by a real devaluation of the ruble and, second, by rapid variations of the international energy and raw material prices. On the subjective side, it was attention paid by the left/centrist politicians to the issues of domestic market protection, import replacement and encouragement of manufactured goods export.

However, priorities changed as a result of the crisis. The devaluation of the ruble brought about a drastic cutback of imports, and, therefore, it was the reduction rather

than the increase of import duties that was on the agenda at the end of 1998. Nevertheless, the reduction was quite selective: import duties were lowered, first of all, for subsistence goods and components required for the operation of specific industries. At the same time, implementation of the program ensuring a phased reduction of import duties announced in 1998 was effectively frozen by Government Directive No. 1894-r of December 30, 1998 and has not been unfrozen yet, in spite of Russia's commitments to the World Bank assumed under the Statement on Economic Policies.

The second phase of foreign trade regulation development involved the restoration of export duties. The terms of energy resources and raw material trade, extremely favorable for Russia, drastically enhanced their export, raised domestic market prices and created problems for the secondary industry. All these events were taking place against the background of an improving international price situation.

In the beginning of 1999, export duties were introduced for oil (they were repeatedly adjusted upward thereafter) and other energy resources and raw materials. Though such measure seemed reasonable from the viewpoint of export efficiency and revenue collection improvement it established new channels for a re-oriented behavior of domestic producers. At present, not only import, but also export duties are subject to bureaucratic bargaining.

In addition to the tariff restrictions imposed on international trade, non-tariff restrictions have been gaining strength, as well. Thus, in October 1998, export licenses were introduced for oil plant seeds and raw hide (Government Resolutions Nos. 1267 and 1268 of October 31, 1998). The Government resumed attempts to regulate exports through a mandatory evaluation of export goods quantity and quality (Government Resolution No. 155 of February 11, 1999).

Finally, we should mention the most scandalous event in the international trade regulation, i.e. the effective reintroduction of export quotas for oil and oil products. Government Resolution No. 262 of March 10, 1999 established that oil producers might have access to export pipelines provided there was an adequate oil supply to the domestic market while Resolution No. 866 of July 10, 1999 unambiguously stated that all producers should be given targets for oil product supply to users in the Russian Federation (in fact, plan tasks). If a producer fails to meet the oil product supply plan task, the customs authorities will not clear its export documents.

Such regulation brings us back not even to 1995 when there was a struggle for the elimination of oil export quotas and price regulation, but directly to the Gosplan era.

It is noteworthy that Resolution No. 866 was issued 10 days after the signature of the 1999 Letter of Development Policy whereby the Government committed not to impose new quantitative restrictions on international trade transactions.

Tightening of international trade regulation in 1999, though implemented by bureaucratic means and lobbying, reflects the fundamental issue of the international trade policy in Russia, i.e. an extreme dependence of Russian producers on the international market conditions. At first (in 1998), short-term variations of the international energy and raw material prices drastically reduced the efficiency of

Russian exports and became a factor of ruble devaluation, and then rapidly improved the export efficiency, facilitated stabilization of the ruble and generated the so-called “windfall profits” in the primary industry.

Continued variations of the international prices and national currency exchange rate create a very unstable price background for domestic commodity producers. It is clear that under these circumstances the state is trying, on the one hand, to mitigate the implications of varying international trade conditions for the domestic market, and, on the other, to take part of the export superprofit to the budget by introducing export duties. Nevertheless, the state has failed to achieve its goal: establishing more sophisticated regulatory systems can only increase uncertainty for economic entities and prevent long-term strategic investment.

However, a relative stabilization or at least predictability of the international trade conditions remains a fundamental issue for the forthcoming period of economy restructuring and growth resumption. The issue requires an integrated approach using both exchange rate policy instruments and tariff regulation, with due regard for the strategy and tactics of negotiations on WTO accession.

Infrastructure Monopolies

In the second half of 1998/early 1999, the issue of infrastructure monopoly reform was practically taken off the Government’s agenda. The principal question was to ensure control of infrastructure monopoly prices and tariffs, which was implemented through their indexing based on wholesale industrial price change (Government Resolution No. 253 of March 3, 1999). A somewhat better developed scheme was used in the electric power sector where dual household tariffs were set up in every region as of January 1, 1999: the upper limit corresponded to the actual full electricity cost in the given region while the lower limit constituted 50% of the full cost.

The question of infrastructure monopoly reforms was reopened and discussed at large in the Statement on Economic Policies under the pressure of the international financial institutions. The document provides for several reform priorities:

- To improve the information transparency and tighten the cost control of infrastructure monopolies;
- To improve payment discipline in the infrastructure monopoly sectors;
- To ensure the institutional separation of naturally monopolistic and non-monopolistic segments of the sectors; create a competitive environment in the non-monopolistic segments; and allow equal access to networks.

Pursuant to the structural adjustment program, the infrastructure monopolies were to prepare their financial accounts in compliance with the International Accounting Standards (IAS), starting from 2000; these financial accounts shall be audited annually by international auditors. The program envisaged transition to an open tender-based procurement system to ensure cost reduction.

As to the settlement issue, the task was to reduce and, subsequently, eliminate non-cash payments and arrears and ensure that the share of cash collections in total sales

increase between Q2 1999 and Q4 2000 from 25% to 70% in the electric power sector, from 25% to 75% in the natural gas sector, and from 52% to 90% in the railways sector.

Actions to implement the program include a further reduction of the “strategic” list, elimination of the system of “re-sellers” in the procurement of inputs and product sales, introduction of new payment systems such as advance payments, LOC, joint and escrow accounts.

With respect to the institutional development, the most significant changes were envisaged in the electric power sector: establishment of generating companies (Gencos) with a view to further privatization; sale of RAO UES shares in AO Energos to private investors; improvement of dispatch guidelines in order to reduce fuel costs and ensure a non-discriminatory access to networks.

Restructuring objectives in the natural gas sector were less ambitious. Establishment of gas transmission companies was the only significant action that also envisaged developing a system of gas transmission tariffs and price regulation for gas production monopolies.

The railways were to undergo the least radical reforms. In fact, all sector-specific restructuring plans developed in 1997 had been abandoned, the divestiture of non-core activities being the only exception.

The infrastructure monopoly reform is a typical example of restructuring policy degradation.

Since 1998 the Government and infrastructure monopolies have been very unwilling to undertake structural reforms and divest non-monopolistic segments. At the same time, the infrastructure monopolies mask their actual costs by complicated accounting and settlement systems, arrears and intermediaries. As a result, the structural adjustment program is skidding while the international financial institutions are combating arrears by Gosplan methods, i.e. setting up quarterly and sector-specific targets. We believe that the only way to address the issue of cost and tariff control and the related issues of intermediaries and arrears is the internal restructuring of infrastructure monopolies, i.e. producer separation from the network and subsequent privatization. Only then real market incentives for an efficient use of resources will be put in place.