

Russian Federation: Competition, Innovation and Economic Diversification: A Policy Agenda

1. Consistency with DFSG objectives:

1. The proposed study will identify a set of measures to foster competition; unleash innovation and thereby promote economic diversification in Russia. Past experience shows that resource-rich economies may have difficulties in sustaining long-term growth, especially in the context of poor economic and political institutions. Under these institutional conditions, experience also shows that economic growth will disproportionately benefit countries' elites. By identifying an agenda of measures that can promote economic diversification the study will contribute to the ongoing policy dialogue aiming at fostering a sustained and shared growth path in Russia.

2. Diversification is often pursued through industrial policies that provide subsidies and insulate selected sectors from competition. Yet the review of these experiences provides mixed conclusions at best. A recent study performed by EBRD in 2008, for example, argues that such policies are rarely successful because they give excessive discretion to governments and little emphasis in market selection and incentives. On the other hand, countries that are often cited as success cases such as Chile, Malaysia and Mexico have often embraced open markets and adopted modern innovation policies. Cooper-rich Chile, for example, developed competitive agriculture and fishing industries based on active innovation and technology policies, while pursuing an aggressive unilateral open trade policy.

3. Russia has adopted a series of policies to foster economic diversification away from the oil and gas sector in recent years. These include the establishment of sector specific investment funds, the creation of state corporations for the commercialization of R&D (e.g., ROSNANO) and the development of industrial parks. Most assessments of Russia's National Innovation System concur that the country has developed a range of programs and most of the organizations that exist in most developed economies. Another conclusion often reached is that the system is dysfunctional in transforming the available knowledge-base into products and process that would boost economic growth. This report will address the innovation performance of the private sector in Russia, review its main programs propose measures to (i) enable higher business expenditures in R&D and (ii) promote the commercialization of public research.

4. Less emphasis has been given by the administration to the role of competition and competition policy in fostering economic diversification in Russia. Yet the entry conditions faced by new (innovative) firms and the exit of obsolete ones, which in turn would raise the productivity of surviving firms, are the main process through which the growth prospects of the in the non oil and gas sectors of the economy would be strengthened. Russia has one of the most restrictive product market regulations among developed and leading developing economies, according to a recent OECD report. Between 2001 and 2007 the share of highly concentrated markets in Russia increased from 43 to 47%, a high incidence of concentrated sectors compared to most developed economies. At the same time, SMEs

contribute a meager 13-17% of GDP and one-fifth of employment, significantly below the level in most OECD countries. Not surprisingly, Russian manufacturing firms have lower average productivity relative to labor costs than comparable firms in other countries. This report will address the relationship between competition, innovation and productivity in Russia, identify the main obstacles to competition in selected non-oil and gas sectors and propose reform measures.

2. Technical soundness and originality

5. The proposed study will build on a stream of analytical work focusing separately on economic diversification; productivity and innovation in Russia, including the last Country Economic Memorandum; and the last Investment Climate Assessment. Yet it will present two novelties: (i) the focus on competition and innovation as the two main drivers for economic diversification and growth and (ii) the adoption of a deeper assessment of competition and innovation policy issues enabling the identification of key measures and or reforms. In sum, the report aims to integrate its main recommendations into a comprehensive strategy for economic diversification.

6. The methodology for the study on the relationship between competition, innovation and productivity builds on the literature on competition and growth in light of a series of works developed by P. Aghion and others. The aim is to proxy competitive pressures at the industry and firm level by constructing proxies of pricing power, based on industry- or firm-level information. Several alternative measures of pricing power can be considered, based on different proxies of the Lerner index. The hypothesis to be tested is that competition policy aimed at increasing competitive pressures (i.e. a reduction of mark-ups) has positive effects on productivity growth. Several data sources are available for the analysis, as for example:

- Russian census data covering 16,000 manufacturing firms from 1995 to 2007 and representing approximately 80% of Russian Industrial Production. The data are available from the Center for Economic and Financial Research at the New Economic School (CEFIR) a key partner for the project.
- BEEPS 2008-2009 firm level data. Despite allowing a more limited number of options for the estimation of price-cost margins, these data allows to benchmark Russia in a cross-country comparison.
- Industry-level data available from ROSSTAT and UNIDO. These dataset will allow both country-specific analysis and cross-country benchmarking.

7. The review of Russia's innovation policy will follow the approach adopted in a series of similar studies implemented in other countries such as Turkey, Croatia; Poland; Brazil, India and South Africa (see for example the World Bank Report No. 48755 -TR).

8. The assessment of the main obstacles to competition in selected industries will follow the approaches offered by several Competition Assessment toolkits currently available (as for example the OECD's Competition Assessment Toolkit).

3. Relevance to country priorities

9. The government's "Long Term Strategy for Socio-Economic Development till 2020" aims to reduce the reliance of Russian economy on natural resources and set the stage for innovation-driven growth. Consistently, the current Russia CPS identifies diversification of the economy for sustainable development and growth as an overarching priority. The proposed study would add a new dimension to the work in support of economic diversification being carried out by PREM and PF (respectively, on regional development and innovation) by bringing competition at the center of the policy dialogue between the Bank and the Russian Government. It will also provide additional inputs for the ongoing innovation policy dialogue.

4. Knowledge sharing

10. A key local partner for the project is the Moscow-based Center for Economic and Financial Research at the New Economic School (CEFIR). CEFIR would provide both data and expertise in analyzing the issues of the proposed study in a Russian context. In consultation with the Country Unit, dissemination activities include the publication of the report and its presentation in high-level workshops. A broader communication strategy may be prepared with EXT upon the request of the Government and or the Country Unit.

5. Client and donor engagement

11. Economic diversification is a key priority for the Russian Government, as stated in the Long Term Strategy for Socio-Economic Development till 2020. The team is planning to engage the Ministry of Economic Development, the Federal Antimonopoly Service and, if possible, the Presidential Administration through a series of workshops and roundtables.