Christian Foster

Institutional Reform in Russia: What Are the Prospects?

Russia is a key customer for U.S. agricultural exports. But due to the inadequacies of institutions inherited from the Soviet Union, it is a relatively high-cost and risky country in which to do business. Nearly a decade of attempts to produce genuine institutional change has rendered small results. The financial crisis of 1998 amply demonstrated Russia's inability to meaningfully reform budget planning, tax collection, and myriad other areas. Perhaps most significant for Western exporters, Russia's barriers to trade have impeded the growth of trade.

Trade barriers can be deliberate policy measures, such as tariffs and quotas, or they can be unusually high transaction costs that stem from institutional shortcomings. Most Western economies have been able to eliminate institutional inadequacies over time, so transaction costs are relatively unimportant.

In contrast, Russia and the other countries of the former Soviet Union inherited institutions from the Soviet era that function poorly in a market environment and have withstood most attempts at change. Unreformed institutions have engendered considerable trade transaction costs, which in turn have cut off large portions of the country from the benefits of domestic and international trade.

Major Costs of Doing Business in Russia

Impediments to trade in Russia are of particular concern for U.S. meat exporters. Since the breakup of the Soviet Union, Russia has become an increasingly important market for U.S. meat and poultry exports. As trade grew, from 1995 to 1998, exports to Russia averaged 43 percent of the value of all U.S. poultry exports and 12 percent of the value of U.S. frozen pork exports. The U.S. supplied Russia with more than half of the poultry consumed there. In 1998, the financial crisis in Russia severely disrupted this robust trade relationship. Meat exports to Russia collapsed after a combination of low oil prices and meager tax revenues led the country to default on its own debt issues.

In the ensuing years, the U.S. has continued to be a major supplier of Russia's livestock needs, and U.S. poultry exports have recovered to more than half of their pre-crisis levels. But the high costs and risks of conducting business in Russia continue to present challenges to U.S. exporters. U.S. pork exports to Russia have remained stagnant, but this is due more to subsidized competition from the European Union than to Russia's institutional barriers to trade.

A recent Economic Research Service (ERS) study shows that most of the Russian livestock market is isolated from world markets—in great part as a result of the large costs of doing business within the country (see ***box***). In particular, transporting meat and other goods between ports and provincial regions, obtaining information about agricultural market opportunities, and enforcing existing contracts involve substantial costs for Western exporters operating in Russia.

Under communism, Russia's transportation infrastructure favored delivery of imported goods to urban centers; it provided only rudimentary links between most rural areas and cities. As Russia has had little money to update the system, it is still less expensive to import agricultural goods from the West than from the country's provincial regions. As a result, Western importers enjoy an advantage in Russia's urban markets, particularly in Moscow and St. Petersburg. They cannot, however, expand their export base into other parts of Russia, where trade opportunities are largely untapped.

While the lack of modern transportation infrastructure provides some advantages to Western livestock producers who export to major Russian cities, the lack of freely available market information puts them at a disadvantage. Again, the problem has its roots in Russia's communist past. Because Soviet central planners determined output targets and prices administratively, there was no need for farmers to gather market information—nor for a national-level institution that would gather and disseminate information to them. To this day, Russia has no counterparts to the public and private institutions in the U.S. that provide farmers with price information and analysis on a daily basis throughout the country, such as USDA's Market News or the Chicago Mercantile Exchange.

U.S. farmers can choose from a vast array of available information to make production decisions for the future and to find profitable sales opportunities in different

Linkages of Russian Pork & Beef Markets to the World

How well has Russian agriculture integrated into world markets? ERS researchers examined the extent to which changes in world prices for pork and beef were eventually transmitted to, and reflected in, Russian consumer prices for those goods. Poultry prices in Russia were unavailable for analysis because the Russian statistical agency Goskomstat has never collected them.

For purposes of the study, "price transmission" refers to the percentage by which the Russian domestic price of beef or pork changed in response to a percent change in beef or pork import prices from Russian customs statistics. A "price transmission" of 100 percent means that domestic prices rose by the same percentage as import prices. A "price transmission" of 0 percent means that domestic prices did not respond at all to changes in import prices. A number between zero and 100 indicates domestic and international prices are partially linked.

ERS staff measured average price transmissions for pork and beef in Russia's 30 largest cities. The cities fell into four categories based on their geographic accessibility: cities with seaports (6), cities on the Volga (7), cities on the Trans-Siberian railroad (6), and landlocked cities with no significant trade access (11).

According to ERS' findings, no cities except Moscow and St. Petersburg had price transmissions statistically greater than zero. This result confirmed that even in large cities such as Ekaterinburg and Nizhnij Novgorod, agricultural markets are not significantly integrated into world markets. The behavior of the markets in Moscow and St. Petersburg is markedly different and is consistent with previous research showing that Moscow and St. Petersburg rely on imported food much more than the rest of the country.

In Russia, Average Price Transmission for Meat Is Low

	Beef	Pork
	Percent	
Moscow	34	--*
St. Petersburg	51	48
Other cities	--*	--*

Price transmission is the percent change in a domestic price in response to a 100-percent change in import prices. 1994-99 data.
*Calculated value was not statistically different from zero. Study included 28 other cities.
Economic Research Service, USDA

Many Western observers sent to Russia do not often travel outside of Moscow and St. Petersburg. This can lead to confusion when the observers extrapolate the experience of the two capitals to the entire country. For example, there is a misconception that, before the economic crisis that hit in August 1998, Russia imported more than half of the food it consumed. While that is true for the two capitals, it is not true for Russia as a whole.

For more details on U.S. meat and poultry exports to Russia, see the February issue of Livestock, Dairy, and Poultry Situation and Outlook at ***http://usda.mannlib.cornell.edu/reports/erssor/livestock/ldp-mbb/2001/ldp-m80.pdf.***

regions of the U.S. Lack of publicly available information in Russia means that domestic and foreign sellers of agricultural products must each invest considerable time and effort researching marketing opportunities. This wasteful duplication of effort would not be necessary if a national information gathering system existed. The lack of information puts foreign sellers at a disadvantage, because domestic sellers have access to at least local information. Not surprisingly, research done by ERS and other organizations indicates that prices in domestic Russian markets currently move independently of one another, so that farmers in different regions are not sharing information or taking full advantage of marketing opportunities.

In addition to coping with the dilemma of scant market information, Western exporters in Russia face two major difficulties in enforcing contracts. First, local government officials often interfere with transactions by intervening at crucial and unanticipated junctures. In countries governed by the rule of law (the idea that laws will be enforced consistently), exporters can predict when governments will intervene in a transaction simply by keeping abreast of legislative developments. In Russia, however, legislation is often contradictory, and local officials' on-the-spot decisionmaking authority can in practice supersede it.

Second, injured parties find it difficult to obtain legal relief when a contract is breached, because Russia's commercial legal system does not resolve contract disputes in a timely and predictable manner. The Soviet judicial system was geared toward forcing state-owned firms to comply with rules, not toward hearing complaints about private contract disputes. In the early 1990's, Russia created an entirely new judicial system to adjudicate contract disputes between privately-owned companies, called the "arbitration court" system. The new system does not rely on precedent—that is, rulings made in previous cases—to reach decisions. The legislative environment in Russia is too fluid and the case history too short for precedent to provide useful guidance to judges in lower courts. Instead, higher arbitration courts in Russia review all decisions of the lower courts to ensure that proper procedures were followed. Decisions are sometimes overturned even when no appeals have been filed—which means that all arbitration cases are in effect automatically appealed, drawing out the legal process.

Further, it is not clear whether the political interests of local authorities influence judges' decisions. To the extent that judges' decisions are subject to political manipulation, the outcome of the legal process is unpredictable. The inability of injured parties to find timely and predictable resolutions to contract disputes introduces an unwelcome element of uncertainty into all large-scale commercial transactions.

Prospects for Institutional Reform

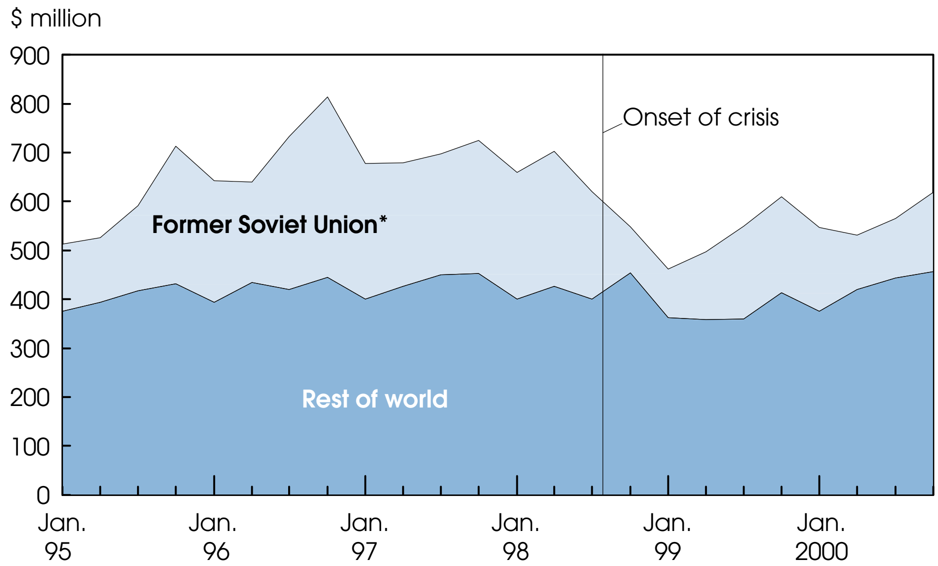
Clearly, successful institutional reform could reduce the cost of doing business in Russia and so expand domestic and foreign trade in meat and other goods. But if, for example, Russia's livestock markets were fully integrated with world markets, would Russia increase or decrease its imports of meat? As indicated earlier, imported Western livestock products currently dominate the urban markets of Moscow and St. Petersburg because of the relatively high cost of transporting goods from the provinces to urban areas. If institutional reforms were to lower the overall cost of trading in Russia, U.S. exports in their traditional Russian markets would face increased competition from the country's provinces—even as lower trading costs would allow U.S. exports to penetrate more deeply into provincial markets.

The primary issue is whether Russia enjoys a comparative advantage in livestock production—that is, whether the "opportunity cost" of producing livestock in Russia is lower than in other countries. (The opportunity cost of producing a good is the sacrifice of producing alternative goods.) If opportunity costs of livestock production were lower for Russia than for its trading partners, it would benefit from exporting meat.

ERS research has shown that Russia does not have a comparative advantage in the production of meat or even grain (in contrast to fuel, metals, and many industrial goods, such as fertilizer). For example, Russia's domestic livestock production is costly relative to domestic petroleum production, while the opposite is true of the U.S. Therefore, Russia could pursue its comparative advantage and gain from trade by importing livestock products from the West and exporting oil products.

While institutional reform in Russia would bring numerous benefits to domestic and foreign traders alike, prospects for meaningful change are not encouraging. The reforms suggested to Russia by Western experts in 1992, particularly reform of the judicial system, are largely incomplete.

U.S. Poultry Exports Dropped Following Onset of Russian Economic Crisis



*Includes Baltics. Quarterly data.
Source: *Foreign Agricutural Trade of the United States.*
Economic Research Service, USDA

Performance of the arbitration courts will improve if the legislative environment becomes more stable. A stable legislative environment means the upper courts will have time to clarify gray areas of the law, which will make arbitration court decisions more timely and predictable. Tax law is one of the main sources of legislative uncertainty, because the President and the Duma (the Russian legislative body) are often at odds and issue conflicting legislation. Approval of the tax code that the Duma is currently considering would help stabilize tax legislation.

Prospects for developing a national market-information system are poor. While the creation of an institution that distributes market information would have a stabilizing effect on commodity markets—a key policy goal—the Russian Ministry of Agriculture is not seriously considering it. According to the Ministry's recently published 10-year strategy for agricultural policy, commodity market stabilization is best achieved through government intervention in the market.

However, there is potential for formation of major private commodity exchanges, including the eventual expansion of some existing regional commodity markets in Russia to cover the entire nation. A number of web sites already bring together Russian grain buyers and sellers and have the potential to grow into on-line commodity markets. Rebuilding the transportation infrastructure will be the most expensive of all the reforms, and the Russian government currently has more pressing priorities for its scarce funds. Not surprisingly, the press contains little on any plans for renewing Russia's transportation infrastructure.

For the above reasons, little progress is expected in these potential areas of reform in the near future. U.S. exporters of meat and other products will likely face significant difficulties expanding their share of the Russian market, at least in the near term. **AO**

Stefan Osborne (202) 694-5154
sosborne@ers.usda.gov