COMMENT II: FUNCTIONING MARKETS ARE NOT IN PLACE IN RUSSIA

A. Statement of the Issue Addressed in the Comment

Have functioning markets replaced the former centrally planned economy in Russia?

B. Summary of Comment

While Russia has dismantled its centrally planned economy, functioning markets still are not in place. The state still plays a large role in key sectors of the economy, including energy and transportation, and competition is nonexistent or severely lacking in the private sector because of the absence of enterprise reform and other structural reforms. In critical respects, Russia lacks the institutional structures necessary for functioning markets.

C. Comment

As explained above in Comment I, the question under the statute and Department precedent is whether Russia operates on market principles of cost and pricing structures (*i.e.*, whether functioning markets have replaced the state controls of its former centrally planned economy.

When the Department declined to revoke Russia's NME status in 1995, it recognized that Russia was "in the process of implementing extensive reforms to achieve its goal of becoming a market economy," including the "freeing of most prices in December 1991 and the privatization of most enterprises formerly within the state-planning system."[1] However, as noted above in Comment I, the Department found that:

> The Russian economy, having emerged from a centrally-planned system, is in a state of transition. Many of the state controls have been abandoned, but that does not mean that functioning markets have replaced controls.[2]

The same situation exists today: the centrally planned system has not yet been replaced by functioning markets in Russia.

First, despite the privatization that has occurred, "{e}normous parts of the Russian economy, especially the energy sector, are still under tight state control."[3] An International

---

[1] *Notice of Final Determinations of Sales at Less Than Fair Value: Pure Magnesium and Alloy Magnesium from the Russian Federation,* 60 Fed. Reg. 16,440, 16,443 (March 30, 1995).

[2] *Id.*

[3] Interview by Yekaterina Vlasova and Yelena Lashkina of Andrei Illarionov, *Gaider, Illarionov on 10 Years of Reform*, The Current Digest of the Post-Soviet Press, 1, 3 (December 5, 2001), attached as Exhibit 1.

Monetary Fund (“IMF”) article notes that

> In the key infrastructure services, including electricity, heating, natural gas supply and transmission, and rail transport -- state-dominated monopolies still play a major role. In purchasing infrastructure inputs . . . manufacturing firms (particularly new, smaller ones) have little choice: there is usually only one supplier {and} pricing is not cost-based . . . .[4]

Significant privatization has occurred in Russia. However, as noted in an IMF article,

> Although the ownership of many enterprises has changed hands thanks to privatization, *the industrial configuration established by administrative fiat and central planning during the Soviet era is still largely entrenched, and a new industrial sector in which competitive market forces determine corporate behavior has yet to emerge fully.*[5]

The article further explains that:

> Many manufacturing firms are shielded from competition because of structural and institutional impediments, including significant seller and buyer concentration — “horizontal dominance” — in regional markets, a high degree of vertical integration and exclusive buyer-seller relationships in certain industrial sectors, geographic segmentation, interregional barriers to trade and investment, and policies that make entry difficult for new firms. Furthermore, these impediments are more pronounced in Russia than in other transition economies.[6]

The article notes that Russia has not “eliminated administrative barriers that hinder new domestic and foreign firms from entering the Russian market. Indeed the scarcity of de novo private firms in Russia is particularly striking in comparison with other transition economies.”[7] One result is that, in comparison with other transition countries, “the growth of small and medium-sized enterprises in Russia has been exceptionally slow.”[8]

The IMF article further states that

---

[4] Harry G. Broadman, *Competition and Business Entry in Russia*, Finance & Development, vol. 38, number 2 (June 2001) (emphasis added), attached as Exhibit 2. The article draws on a much larger World Bank publication: Harry Broadman (*ed.*), Russian Enterprise Reform: Policies to Further the Transition (World Bank 1999).

[5] *Id*.

[6] *Id.*

[7] *Id*.

[8] *Id.*

> Evidence suggests that in many sectors, the principal constraints on entry by new private firms in Russia are *the anticompetitive market structure and the anticompetitive conduct of existing dominant firms, which is often sanctioned or supported by local governments*. In effect, incumbents do not leave enough structural space for new entrants to make a go of it.[9]

Other commentators have recognized that the centrally planned system has not been replaced by functioning markets in Russia.:

> When communism collapsed, the government lifted its economic controls {and} . . . rapidly privatized enterprises. However, these enterprises — a coordinated network of suppliers and producers under communism — quickly formed a network of their own outside government control. The new network did not behave as enterprises do in market economies.[10]

The result is that extensive reform is still necessary to create effective, functioning markets in Russia. As the World Bank has found,

> {v}irtually all indicators point to deficiencies in Russia's environment for enterprise restructuring and private sector development. Investment is low relative to saving; {foreign direct investment} is very low relative to Russia's resource endowment, location and own market potential; rates of new business formation are low; the take-up rate of the pool of unemployed workers is very low; capital flight — although difficult to estimate with any precision — is by all estimates very high . . . ; non-payments (arrears and non-cash settlements through such mechanisms as barter) are becoming progressively more prevalent.

The World Bank identified numerous causes for what it called the "deep underlying problems at the systemic level" in Russia, including "lack of clarity over the role of the state in relation to enterprises," "non-competitive access to business premises and urban land," and "limited competition in many output markets."[11]

The World Bank and many other observers have noted that many of the problems are institutional, including the lack of adequate corporate governance mechanisms and barriers to the development of a sound financial system that lie in the areas of taxation, accounting and property

---

9 *Id*. (emphasis added).

10 Alvin Rabushka, *Is Russia on the Road to Recovery*? 32 REASON 67 (March 1, 2001), attached as Exhibit 3.

11 *Memorandum of the President of the International Bank for Reconstruction and Development and the International Finance Corporation to the Executive Directors on a Country Assistance Strategy of the World Bank Group for the Russian Federation*, The World Bank, para. 33 (1999), attached as Exhibit 4.

rights.[12] An August 2000 paper published by European Bank for Reconstruction and Development ("EBRD") found that Russia and other countries of the Commonwealth of Independent States ("CIS") "still have problems with the transition toward credible market based institutions and financial systems."[13] Another paper noted that "{p}revious rules and behaviors that evolved in the context of central planning persist, while other institutional structures necessary to support the continued evolution of capitalism are notably weak or absent."[14]

Indeed, it has now been recognized, even by some of the experts that advocated rapid privatization for Russia, that privatization has not led to the creation of an effective, functioning market economy, in large part because of the weakness or absence of the necessary institutions. In 1999, former World Bank chief economist Joseph Stiglitz suggested that rapid privatization failed to achieve the desired results in Russia because it "gave little attention to the laws and institutions required for an effective market economy, to concepts such as corporate governance . . . ."[15] In addition, observers have noted that the problem has not been so much a lack of laws, but rather the lack of infrastructure and the political will to enforce them.[16]

In summary, further privatization and very substantial structural reform is necessary in Russia before functioning markets can be said to exist there.

---

[12] *Id*.

[13] Daniel Gros & Marc Suhrcke, *Ten Years After: What Is Special About Transition Economies*, Working Paper No. 56, European Bank for Reconstruction and Development (August 2000) (emphasis added), attached as Exhibit 5.

[14] *See also* Clifford S. Poirot, *Financial Integration under Conditions of Chaotic Hysteresis: The Russian Financial Crisis of 1998*, 23 J. OF POST KEYNESIAN ECON. 485 (2001), attached as Exhibit 6. *See also* Bernard Black, Reinier Kraakman and Anna Tarassova, *Russian Privatization and Corporate Governance: What Went Wrong?*, 52 Stanford Law Review 1599, 1731 (July 2000) ("*Russian Privatization and Corporate Governance: What Went Wrong?*"), attached as Exhibit 7.

[15] Paul J. Saunders, *Why Globalization Didn't Rescue Russia*, Heritage Foundation Policy Review (February 1, 2001), attached as Exhibit 8; *See also Russian Privatization and Corporate Governance: What Went Wrong?,* attached as Exhibit 7.

[16] *See Russian Privatization and Corporate Governance: What Went Wrong?,* attached as Exhibit 7 ("The privatizers, ourselves included, underestimated the extent to which functioning law requires honest courts and prosecutors that can redress gross violations") *Id.* at 1756.