TITLE: THE ROLE OF COMPETITION IN RUSSIAN ENTERPRISE ADJUSTMENT and
THE ORGANIZATION OF MARKETS AND ITS ROLE IN
MACROECONOMIC STABILIZATION DURING TRANSITION

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ON YOUR MARX, GET SET, GO:
THE ROLE OF COMPETITION IN RUSSIAN ENTERPRISE ADJUSTMENT

Barry Ickes, Randi Ryterman and Stoyan Tenev

The purpose of the paper is to explore the role of market structure in the choice of adjustment strategies adopted by Russian enterprises. Our central proposition is that market structure affects the decision to adjust by altering the costs and benefits to enterprise managers of adjusting. The critical problem that inhibits adjustment, in our view, is that enterprises cannot evaluate the effects of adjustment strategies independently of the decisions of other enterprises. The problem is that the former state-owned sector was a network of enterprises organized to operate together. The costs and benefits of adjustment change radically if other enterprises are adjusting. As constituents of a complex chain of producers, the incentive to deviate will depend on what others do. We argue that mutual dependence operates as a force that naturally makes enterprises conservative. The extent of this dependence, however, depends on the nature of the market in which the enterprise operates. When alternative trading partners are present and when adequate market infrastructure is available to support creating relationships with these trading partners, the extent of interdependency is lessened, and the forces inducing conservative behavior are reduced.

We contrast this role to the conventional view of market structure, which focuses on the importance of competition to adjustment. Most economists interpret the theory to suggest that competition will foster the adjustment of enterprises from socialist institutions to capitalist ones. First, competition creates an incentive for firms to adjust because firms that do not adapt to markets are unlikely to survive in the market place. Second, competition provides information that facilitates adjustment. By comparing their production strategies and techniques to firms that have successfully adapted to markets, firms can imitate and, ultimately, learn to innovate strategies for success.

Our view and the conventional view of market structure are not mutually exclusive. In our view, the competition that a firm faces in the market for its goods provides its trading partners with alternate opportunities for trade. These alternatives reduce their risk of adjustment. Hence, the firm facing competition can perceive that its trading partners are not dependent on it, and might adjust in anticipation of, or in response to, their defection from the trading network.
The limit to this confluence of effects occurs only when competition becomes very intense. Adjustment entails a cost, which often includes a decline in short-term performance. In the absence of long-term bank loans, this cost must be financed out of retained earnings. As competition becomes more fierce, firms must price their products more competitively; hence, they have less internal resources to finance adjustment. Under these circumstances, adjustment might not be a feasible strategy for the firm.

To test our view, we analyze the results of a survey conducted with more than 150 enterprises in five provinces. We test a model of firm behavior, in which the decision to adjust is a function of managerial, enterprise, industry, market, and ownership characteristics. We classify strategies for adjustment based on the degree to which they focus on changing relationships within the firm and with other firms. We assume that decisions to change external relations are more radical than decisions to change internal relations because external changes often require or induce internal changes.

We find strong empirical support for our view of the role of market structure in the decision to adjust. Specifically, we find:

- Dependence on trading partners reduces the likelihood that an enterprise decides to adjust.

- Competition with Western imports increases the likelihood that an enterprise decides to adjust.

- Intense competition — measured as competition from imports from both the West and from formerly socialist economies — decreases the likelihood that an enterprise decides to adjust.

The negative effect of intense competition on the decision to adjust might be the consequence of one of two institutional features of the Russian economy. First, the institutions of bankruptcy and liquidation are very underdeveloped. As a result, many firms that would fail in a developed market economy simply fail to adjust in Russia. If exit in a market economy is greater in industries in which competition is intense, then this result suggests that the government facilitate the reorganization of enterprise assets by making bankruptcy and liquidation more efficient.

Alternatively, the negative effect of intense competition on the decision to adjust might be the consequence of the low level of development of market infrastructure in Russia. Market infrastructure consists of the set of institutions that support relations between firms by providing the
information, legal foundation, finance, and physical infrastructure necessary for trade. Problems in market infrastructure explain why many Russian firms are unable to identify and forge relationships with alternative trading partners, despite empirical evidence that potential alternatives do exist. They also explain why enterprises join organizations that help coordinate trade. In fact, we find:

+ Membership in enterprise associations increases the likelihood that an enterprise decides to adjust.

If problems in market infrastructure are preventing enterprises from undertaking appropriate adjustment, then these results suggest that the development of the systems of wholesale and retail trade, telecommunications, transport, storage, finance, and law is essential to further restructuring. The primary role of the government is to ensure that no policy barriers block the proper development of these institutions. A more active role for government depends on the degree to which the private sector is willing to invest in the development of these institutions. In addition, the government should consider maintaining a positive attitude toward enterprise associations, while monitoring them for cartel-like and other forms of anti-competitive behavior. Most likely, the associations now combine both pro-adjustment and anti-competitive behaviors. At this stage of the transition, it might be true that the positive effect dominates, but this situation might change as the transition progresses.

Our results do not suggest, in general, that advances toward the imposition of hard-budget constraints and free trade should be reversed. For the most part, competition has stimulated the decision to adjust. To the extent that the competition has been intense, its cost has already been borne by enterprises; it cannot be reversed by an easing of conditions. In fact, such a reversal of policy would punish firms that have successfully adjusted and undermine the credibility of government policy in the future. But, our results do suggest that the speed of future advances in reform be aligned with the capacity of the economy to support needed restructuring.

We also find:

+ Larger enterprises are less likely to decide to adjust than smaller enterprises.

This result might arise because adjustment is more difficult for larger, more complex organizations. However, it would also arise if larger enterprises have greater access to subsidies than smaller enterprises. Under these circumstances, larger enterprises might be using the subsidies to avoid the painful costs of adjustment.

Finally, we find:
Privatized enterprises are less likely to decide to adjust than state-owned enterprises.

We do not interpret this result to suggest that the introduction of private property in Russia has been a failure. Rather, we believe it suggests that an insufficient amount of time has elapsed since privatization for its positive effects to be felt. Privatization requires an investment of time and resources of senior managers into developing a strategy for privatization, leaving these managers with less time to invest in other activities, such as developing strategies for adjustment. Thus, privatized enterprises will initially lag behind state-owned enterprises in the adjustment process. In addition, the strategy for privatization might include a temporary delay of some forms of adjustment, such as firing workers, that might jeopardize the control of managers over their enterprises. Hence, our results might measure the short-term costs, but not the long-term benefits of the new ownership regime.

Alternatively, our results might reflect the fact that state-owned enterprises have better access to important resources for production and distribution than privatized enterprises. For example, other research indicates that state-owned enterprises have greater access to long-term bank loans than privatized enterprises. This interpretation suggests that barriers might be present that undermine the ability of privatized enterprises to adjust. To the extent that these barriers are created by government policies or practices, the government can stimulate adjustment simply by changing these policies and practices to remove the barriers.

A final possibility is that private ownership simply induces enterprises to be more risk averse than public ownership. This risk aversion might arise because directors of privatized enterprises are more likely to expect the government to let them fail than state-owned enterprises. If this is the case, then some aspects of the adjustment strategies adopted by state-owned enterprises might exceed the optimal level of risk.
THE ORGANIZATION OF MARKETS AND ITS ROLE IN MACROECONOMIC STABILIZATION DURING TRANSITION

Barry W. Ickes and Randy Ryterman

In the paper, we explain the ways in which the organization of markets influences the process of macroeconomic stabilization in countries in transition. First, we argue that aspects of market organization cause economic policies to have persistent effects over time. As a consequence, market organization influences the response of enterprises to macroeconomic policy and, so, the change in macroeconomic conditions that a given type of stabilization policy is likely to produce. In turn, these changes in macroeconomic conditions affect the ability of the government to sustain the policy, as well as introduce new policies to promote reform.

We focus in great detail on the way in which market organization causes policies to have persistent effects. We examine the role of market organization in stimulating investment and growth, and, ultimately, in improving a country's fiscal balance. We use an option-value approach to understand the process of investment, and find that market organization affects the investment process by influencing, primarily, its sunk costs, its downside risk, and profits foregone while waiting to invest. When incentives to invest are not adequate to stimulate growth, fiscal imbalances increase, and the likelihood of future macroeconomic instability rises. In this environment, excessively tight monetary policy can exacerbate the difficulty of stabilization. Instead of signaling "toughness," such policy might simply be viewed as not credible.

At the core of our more narrow argument are empirical questions concerning the relationship between market organization, investment, and growth. Therefore, we follow our theoretical analysis with an empirical analysis of this relationship. First, we provide cross-country evidence that market infrastructure in countries in transition is very underdeveloped and, in some aspects, might be deteriorating. The absence of adequate infrastructure suggests that the spatial structure of industry determines the types of investment that can most easily take place. Hence, we provide a cross-country comparison of patterns of industry location, with their implications for investment and job growth. All else equal, we expect inter-industry reallocation to be more sensitive to problems in investment than intra-industry reallocation. Finally, we demonstrate, using data from a recent survey of Russian enterprises, that market
organization, in fact, has led to a pattern of growth in which intra-industry reallocation is the dominant determinant of growth.

We conclude by discussing the implications of this relationship for stabilization and reform. The clear result of our analysis is that shock therapy programs are less likely to be successful when the incidence of vertical dependence among firms is great and market infrastructure is highly underdeveloped.