

# **How competitive is Russian economy?**

## **Introduction**

The Russian economy has been studied by numerous international organizations, academics, and other analysts. And consequently there are strongly divergent views about the state of Russian competitiveness. Strong economic growth, fiscal surpluses, and reforms in some areas of the business environment are compared with huge continuing challenges in doing business in Russia as well as rising government intervention in the market, especially in energy. This mixed evidence has been interpreted very differently. Within Russia (including many foreign companies operating in the country), there is optimism about the progress of the nation's economy. Outside of Russia, there is deep scepticism about whether the current economic success of Russia extends beyond high oil prices, and whether the increasing concentration of economic (and political) power in the central government has changed the course of Russia's reforms for the worse. There is some truth in each of these perspectives, but a deeper analysis is needed to truly understand where Russia stands and to guide future policy.

In this coursework it will be proved that modern Russia has no inherent reason for not entering a period of high and sustained growth and that it can join the ranks of the most competitive economies in the world in the near future.

The coursework is organized in three sections. First, the assessment of Russia's current competitiveness is presented, highlighting the roles of the country's legacy, its broad economic context, microeconomic conditions, and current market structure. Second, the evaluation of Russia's economic performance on micro level is introduced with description of current market structure's effect on business environment. This part also introduces overall performance assessment. Third, the competitiveness of Russian economy on the global arena is presented and broadly evaluated.

# 1. Theoretical background to the market structure and competition

## 1.1 Concept of competitiveness and competition

**Competitiveness** can be defined at the firm level, the industry level, and the national level. At the firm level, competitiveness is the ability to provide products and services more effectively and efficiently than relevant competitors. This includes sustained success in international markets without protection or subsidies.

At the industry level, competitiveness is the ability of the nation's firms to achieve sustained success versus foreign competitors, without protection or subsidies.

At the national level, competitiveness means the citizens' ability to achieve a high, and constantly rising, standard of living. In most countries, the standard of living is determined by productivity, which deploys national resources and the output of the economy per unit of labour and/or capital employed.

**Competition** in economics is the rivalry between two or more businesses to gain as much of the total market sales or customer acceptance as possible. It helps to maintain reasonable prices, provides consumers with new and improved products, forces businesses to operate efficiently and results in a wide selection of products from which to choose.

Competition was described by Adam Smith in *The Wealth of Nations* (1776) and later economists as allocating productive resources to their most highly-valued uses and encouraging efficiency. Smith and other classical economists before Cournot were referring to price and non-price rivalry among producers to sell their goods on best terms by bidding of buyers, not necessarily to a large number of sellers nor to a market in final equilibrium.

Later microeconomic theory distinguished between perfect competition and imperfect competition, concluding that no system of resource allocation is more Pareto efficient than perfect competition. Competition, according to the theory, causes commercial firms to develop new products,

services and technologies, which would give consumers greater selection and better products. The greater selection typically causes lower prices for the products, compared to what the price would be if there was no competition (monopoly) or little competition (oligopoly).

## **1.2 Models of Competition**

Economists classify markets according to conditions that prevail in them. They determine market structure, or the nature and degree of competition among firms operating in the same market. Economists have names for these different market structures. They are Pure Competition, Monopolistic Competition, Monopoly and Oligopoly.

### *Pure Competition*

Pure competition is a market scenario that includes a large number of autonomous and knowledgeable buyers and sellers of an identical product. Yet none of which are capable of influencing the price. There are five major conditions, which characterize purely competitive markets.

1. There are a large number of buyers and sellers. No single buyer or seller is large enough or powerful enough to affect the price of the product.
2. Buyers and sellers deal with identical products. Therefore buyers do not prefer one seller's merchandise over another's because there is no brand names, and no need to advertise.
3. Each buyer and seller acts autonomously, there must be no collusion. If such a situation occurs, sellers would compete against one another for the consumer's dollar. Buyers also compete against each other and against the seller to obtain the best price.
4. The buyers and sellers are knowledgeable about the items for sale. Because all products are exactly the same, customers would have little reason to remain loyal to one seller.

5. The buyers and sellers are free to get into, conduct, and get out of business; thus making it difficult for a single producer to keep the market just to itself.

### *Monopolistic Competition*

Since we live in a society where the five elements of pure competition are not available to us, then we are clearly operating in a state other than pure competition. Instead we operate under a different model of competition known as monopolistic competition. Any time the elements of pure competition are not met the existing model is monopolistic competition.

The fundamental difference between a pure competitor and a monopolistic competitor is that the latter refrains from selling identical products. By employing product differentiation, the monopolistic competitor is trying to establish a comparison between its product and another competitor's product.

*Oligopoly* – a few large sellers dominate and have the ability to affect prices in the industry. Because of the fact that in an oligopoly there are very few firms, whenever one firm does something, the others follow suit. Since all the firms have considerable power and influence, firms tend to act together. There are times when the interdependent behaviour of the firms results in a formal agreement to set prices; this is termed «collusion». Price-fixing, a type of collusion, is the action taken by an oligopoly to charge the same or similar prices for a product. The firms must also agree to divide the market so that each is guaranteed to sell a certain amount. Yet collusion is against the law because it restrains trade. Price wars are also common in oligopolies. When one firm lowers prices, it leads to a series of price cuts by all producers that may lead to unusually low prices in the industry. Raising prices is also risky unless the firm knows that rivals will follow suit. Otherwise, the higher priced firm will lose out on sales. An example might be Coca Cola and Pepsi which dominate the soft drink market.

*Pure Monopoly* exists when a specific person or enterprise is the only supplier of a particular commodity. Thus, the main characteristics of monopoly include profit maximizing orientation; a monopolistic enterprise decides the price

of the good or product to be sold; there are tough barriers to entry – other sellers are unable to enter the market of the monopoly. As in a monopoly there is one seller of the good which produces all the output, the whole market is being served by a single company, and for practical purposes, the company is the same as the industry. A monopolist can change the price and quality of the product. He sells more quantities charging fewer prices for the product in a very elastic market and sells less quantities charging high price in a less elastic market.

### **1.3 Russia's endowment**

Russia faces complex endowments that create unusual challenges for competitiveness. These challenges—some of them unique to Russia given its recent history while others which are typical for many countries at this stage of development—must be confronted head on in economic strategy. Otherwise the performance of the country will remain below its potential and the political sustainability of economic reforms will suffer.

#### *Legacy*

Russia's history as a planned economy left the country with an economic legacy that still reflects political decisions instead of economic efficiency<sup>1</sup>.

Companies grew up at locations that were determined according to political and security considerations – not by the concept of the efficient economic geography. Company units were often too large in terms of productive capacities at a given stage of the value chain, but too small in terms of presence and capability across the value chain.

Population and with it demand patterns also reflected political decisions, not individual choices. With citizens strongly influenced to live in the far north and east as well as in rural regions and smaller cities, a substantial population reallocation was inevitable<sup>2</sup>. Greater urbanization has important potential economic and social benefits for Russia, but the transition will be painful.

Russia's Soviet past, however, left the country with important assets that it can build upon. The general skill level of the population is high, and education is held in high respect. The science system consists of a large number of research institutions employing a significant number of highly educated scientists and engineers, especially in natural sciences and technologies related to military uses. The basic physical infrastructure of the country also provided a good base to build upon, though it is now increasing inadequate.

Unfortunately, Russia's early steps towards economic reforms, especially the privatizations of the mid-1990s, has left the population with a deeply cynical and biased view of the market economy. In Russia, the market economy has become associated with private monopoly, not competition.

Private ownership and wealth are seen as the result of political connections and criminal behaviour, not entrepreneurship and value creation. This is one of the reasons why the population is strongly in favour of government actions that intervene and reign into the power of business. Unfortunately, there is little public support or pressure for the government to create more room for private entrepreneurship or ensure equal treatment of all companies.

### *Geography*

Russia's huge geographic area creates the need for effective regional governance structures to improve the business environment at lower levels of geography.

Russia's location between Europe and Asia puts it in a potentially beneficial position alongside major trade routes. However, the inaccessibility of Russia as a transit country in the past and the weaknesses in its current business environment has left this opportunity untouched. Most global trade flows are far away from Russia. Russia is also a country with only a limited share of its population in coastal regions that could easily connect to the global economy.

Russia's neighbours are largely former Communist countries that share many of the same challenges that Russia is facing now. But Russia also borders to the European Union (through borders with Finland, the Baltics, and – through

Kaliningrad – Poland) and China; countries offering interesting economic opportunities if Russia can take advantage of them. So far, relationships with neighbours have been mostly negative instead of seeking opportunities for win-win economic collaboration.

### *Natural Resources*

Russia's significant natural resource wealth has facilitated rapid wealth extraction but created political and economic challenges. Russia's oil exports per capita were at \$935 in 2005, and oil production per capita at about \$1290<sup>3</sup>.

Russia has proven reserves of about 74m barrels oil (6.5% of total global reserves) and 48trill m<sup>2</sup> natural gas (equivalent to 300m barrels oil; 26.7% of total global reserves),<sup>4</sup> and these reserves represent an annual value of \$3,900 per capita for the next 50 years assuming an average oil price of \$75 and a stable population.

This level of resource wealth is substantial, and has fuelled a boom since 2000. However, even this level of resources will not itself make Russia a wealthy country.

At the same time, economic volatility, due to unpredictable changes in world commodity prices and upward pressure on the real exchange rate, can easily undermine business investment and the emergence of a vibrant private sector outside of natural resources.

Moreover, natural resource wealth of this size creates huge incentives to capture and utilize the power and wealth that resource abundance provides, putting pressure on Russia's fragile political structures and government institutions.

## **2. Russia's microeconomic environment**

### **2.1 Engendered structural dominance**

At the national level, the degree of concentration of industrial output in Russia does not indicate that the lack of competition is a structural problem. The four-firm concentration ratio<sup>5</sup> in many industries averages about 60 percent, which is similar to that in the United States, and the largest Russian manufacturing enterprises (measured by number of employees) are not unusually large, compared with U.S. firms. However, this analysis of structural dominance masks three underlying attributes of Russia's industrial landscape.

First, large Russian enterprises tend to be organized as single, integrated, multiplant establishments often located in or near the same city, whereas enterprises in industrial countries usually have multiple establishments at several different locations domestically and, often, abroad as well. Thus, the establishments of the largest Russian enterprises are, on average, significantly larger (in terms of number of employees) than their counterparts in other countries, including the United States. Although the existing level of horizontal integration in Russian manufacturing is largely a legacy of Soviet central planning, such integration appears to be increasing. The increase is due not to new corporate expansion, however, but to mergers and acquisitions.

Second, many of the dominant enterprises in Russia are also highly vertically integrated (or have exclusive buyer-seller relationships). To be sure, putting successive stages of production under one corporate roof can result in economies of scale and reduce transaction costs. But in most industries, such vertical efficiencies exist only up to a certain point. Indeed, in many product markets throughout the world, it is increasingly cheaper for a firm to buy inputs (or sell outputs) on the open market than to produce them internally.

In Russia, because the enforceability of contracts still cannot be taken for granted, there are strong incentives for vertical integration. The uncertainties and

chronic shortages of the old Soviet supply system encouraged a high degree of vertical integration, which has persisted, in part, because of inertia. Moreover, vertical integration, like horizontal dominance, is increasing—again, usually through mergers and acquisitions rather than expansion. Importantly, excessive vertical integration superimposed on horizontally concentrated product markets can hinder the entry of rival firms.

Third, significant political and economic power is wielded by regional authorities in Russia, a feature of other large transition economies, such as China. This is evident in the tight control of important economic activities within a region. Such control, in combination with vertical integration, helps freeze the high degree of structural autarky that appeared under the Soviet system, when producing consumer goods was a local responsibility and enterprises served only local markets. Worse, it strengthens administrative—as opposed to economic—geographic market boundaries and fosters the regional segmentation of the Russian economy, hampering the establishment of a unified economic space, strong interregional competition, and natural economies of scale.

Local authorities engage in a variety of practices to limit the interregional movement of goods and services, including charging duties on the «import» or «export» of certain alcoholic beverages; maintaining regional price controls on some agricultural products; imposing registration fees on workers from other regions; granting tax or credit preferences to support the building of local «business champions»; and supporting arbitrarily exclusive licensing. In this regard, it is telling that in recent years some of the most frequent violations dealt with by the Ministry of Antimonopoly Policy and Support for Entrepreneurship have been anticompetitive actions by local governments.

## **2.2 Russian economic performance**

The most important single element explaining a country's medium-term growth performance is productivity. While economic growth can be based on

many sources, for example capital accumulation or population growth, it is sustainable only if complemented by an increase in productivity. With a GDP per capita of US\$10,521 in 2010 (international \$15,806 in purchasing parity terms), over the 2000–09 period Russia achieved a relatively high GDP growth rate of 5.5 percent, which put the country on the path toward convergence with Organisation for Economic Co-operation and Development (OECD) levels (see Figure 1).

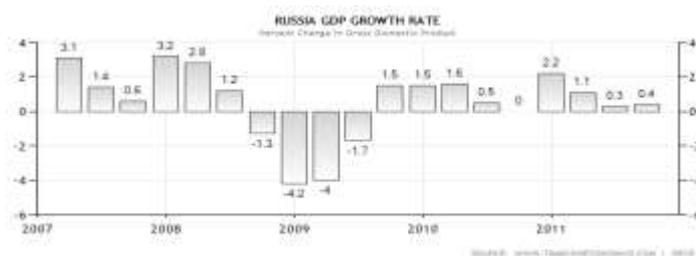


Figure 1: Russia GDP Growth Rate

However, despite this positive development over the past decade, the gap between Russia and OECD economies in terms of GDP per capita remains sizeable, amounting to about 47 percent.

Although some structural factors—such as demography, the employment structure, and above all the number of hours worked per person—contribute to closing the gap, the large difference in prosperity can be clearly attributed to differences in labour productivity (see Figure 2).

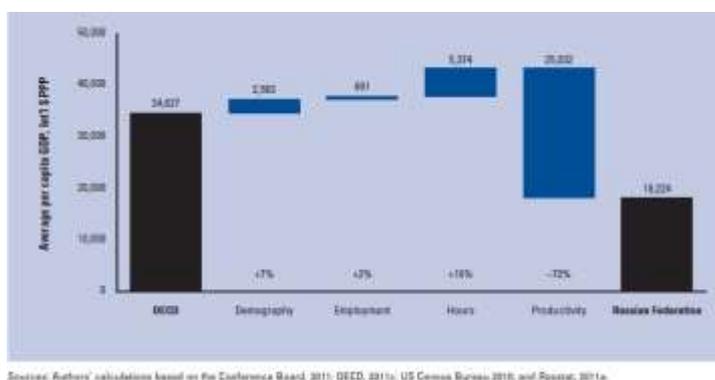


Figure 2: Disaggregation of difference in GDP per capita in the Russian Federation and the OECD, 2010

Indeed, Russia's solid GDP growth over the past decades has been accompanied by growing productivity. In transition economies, productivity growth is often a reflection of increasing capacity utilization; this is also the case in Russia.

However, after correcting for capacity utilization, out of the 6.5 percent growth achieved on average during 1999–2005, about 4.15 percent was attributable to gains from resources that were used<sup>6</sup>.

Much of this growth in productivity has been the result of efficiency gains within sectors rather than reallocation among sectors. Overall, productivity growth that took place within the firms—that is, growth that occurred through greater efficiency in production processes, the shedding of surplus labour in the course of the privatization process, and better organization of administrative functions—explains the largest share of efficiency gains, accounting for about 30 percent of total manufacturing productivity growth from 2001 to 2004.<sup>2</sup> Much of this was a result of labour shedding in the initial transition period.

Although the shrinking of the manufacturing sectors is a process that most transition economies have undergone, the decline of Russian manufacturing beyond the initial transition period remains a worrying trend for a number of reasons.

The most important is that, while the number of jobs in manufacturing is declining, employment in the government sector is growing, pointing to a move toward a growing role of the state that is built on the redistribution of resources rather than creation of value. Furthermore, the Russian Federation is well positioned to be competitive in high-end manufacturing sectors. It could aim at improving the business environment and creating favourable conditions for the development of these industries.

A number of studies show that the decline in manufacturing competitiveness in Russia is due to the combination of an increase in real wages and shortcomings of the business climate<sup>7</sup>, which puts Russia at a disadvantage in international comparison.

Although productivity in the country is higher than in India and China, high Russian salaries mean that for each dollar of wage, a Russian worker produces half the output of his or her Chinese or Indian peers. Competitiveness enhancing reforms will improve the business environment, strengthen efficiency, and align manufacturing productivity better with international wage-productivity ratios. This will make Russia more attractive as an exporter of goods and tradable services as well as a destination for foreign direct investment (FDI).

### **3. Global competitiveness assertion**

#### **3.1 The state of Russian competitiveness according to the Global Competitiveness Index**

Russia ranks 66rd out of 139 countries covered by the GCI 2010–2011 (See figure 3). The country lags behind the OECD member countries on average (on a scale of 1 to 7, Russia achieves a score of 4.2 against 4.9 for the OECD) as well as the BIC economies (score of 4.5)<sup>8</sup>. The country remains stable compared to the previous year, keeping the same rank.

However, in the course of the past five years, Russia's performance in the GCI stagnated and the country remained in the 5th deciles of the GCI sample. A considerable improvement was observed prior to the financial crisis (in the 2008–09 edition), although it deteriorated the following year.

Among the challenges that Russia will have to address in order to raise productivity are above all the poorly functioning institutional framework, as it belongs to both public as well as private institutions.

In addition, competition and demand conditions do not contribute to the efficiency of goods markets to the same degree as in OECD and BIC economies. Furthermore, financial markets trail the two comparator groups in terms of efficiency as well as trustworthiness and confidence.

Last but not least, the country's business sector is significantly less sophisticated than enterprises in peer economies or OECD member states. The following sections of the chapter explore in more detail the competitive strengths and weaknesses of the Russian Federation identified by the GCI analysis as the key areas for policy reform.

They can be summarized in a simple «three-plus-five formula» – building on three strengths and addressing five priority challenges, the Russian Federation could reap considerable productivity gains. Improvements in these five areas by

2030 would lead to improved competitiveness by this time, which would correspond to a significant increase in prosperity in Russia.

### **3.2 Russian growth in detail: exploring performance at the industry level**

The productivity gap between Russia and the OECD countries is determined by the level of productivity in individual industries and the variation in industry structure. When we take a closer look at the industry structure, three groups of industry sectors can be determined: basic, supporting, and infrastructure sectors.

Basic sectors are agriculture, mining, manufacturing, and software development—that is, those industries that produce goods that are traded globally and therefore often face real competition. Supporting sectors are the market sectors that either facilitate the distribution of goods (such as wholesale and retail trade), support production (for example, business services), or produce goods and services that can be traded only locally (construction, real estate, hospitality, etc.). Infrastructure sectors are non-market services and production, such as government services, education and health, utilities, transport, and communications<sup>9</sup>.

If to explore growth in the Russian economy between 2003 and 2009 according to sector groups, the analysis shows that growth was higher in those sectors with a greater intensity of competition (Figure 4). Productivity in supporting sectors (which are mostly market services) grew faster than in many basic sectors (where the government is the main proponent and owner) and in most infrastructure sectors (which are non-market services). In basic sectors—both manufacturing and resources—productivity grew moderately while employment declined. Infrastructure sectors did not grow in employment, while productivity grew slowly.

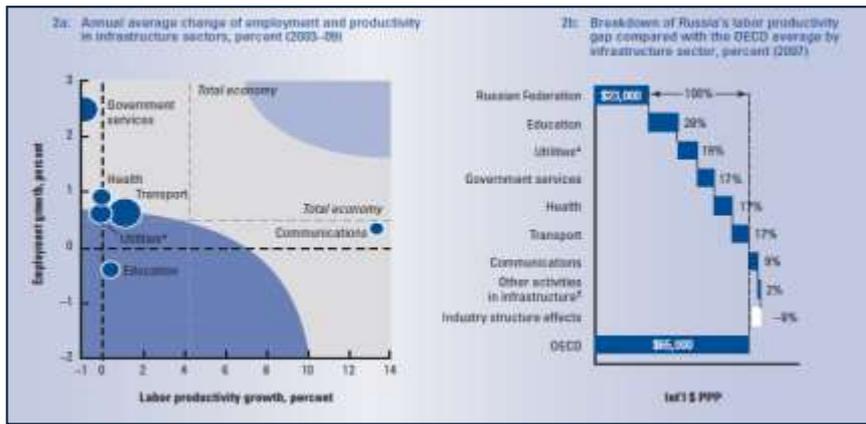


Figure 3: Productivity and employment growth; source: Global Competitiveness Report 2011–2012

Overall, infrastructure productivity in Russia was three times lower than it was in OECD countries. In recent years, productivity growth has not been realized in Russian infrastructure sectors. Furthermore, the government share in total employment was constantly growing (Figure 5).

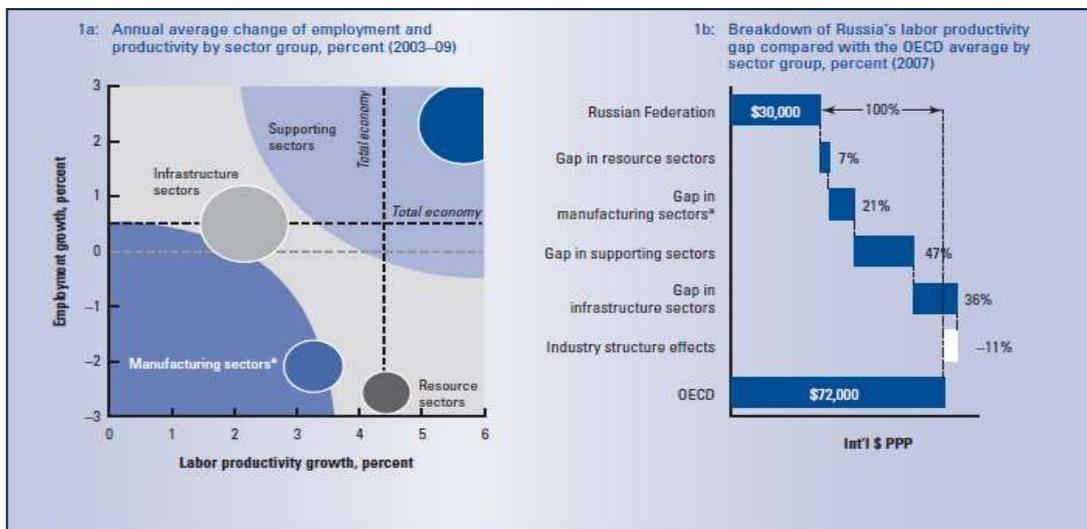


Figure 4: Productivity and employment in infrastructure sectors; Source: Global Competitiveness Report 2011–2012

Structural transformation is not occurring in any infrastructure sector, and such fundamental change is essential for further development of these sectors.

Supporting sectors were fast growing in both productivity and employment, with finance leading the growth (Figure 6). This sector has been, and is still,

emerging and its growth fills an «empty space» and promotes the underdeveloped distribution function in the economy. The productivity gap in supporting sectors remains large (47 percent of the total gap) and further rapid growth is necessary for productivity improvements. More than half of this gap is determined by low productivity in the labor-intensive construction and real estate sectors. Productivity is gradually improving there but many problems still persist.

Most basic producing sectors in Russia demonstrated some growth in productivity and decline in employment (Figure 8). Resource sectors raise productivity but do not create net new jobs. Among the manufacturing (including software) sectors, the best performing were computer activities, fabricated metal products, and rubber and plastic.

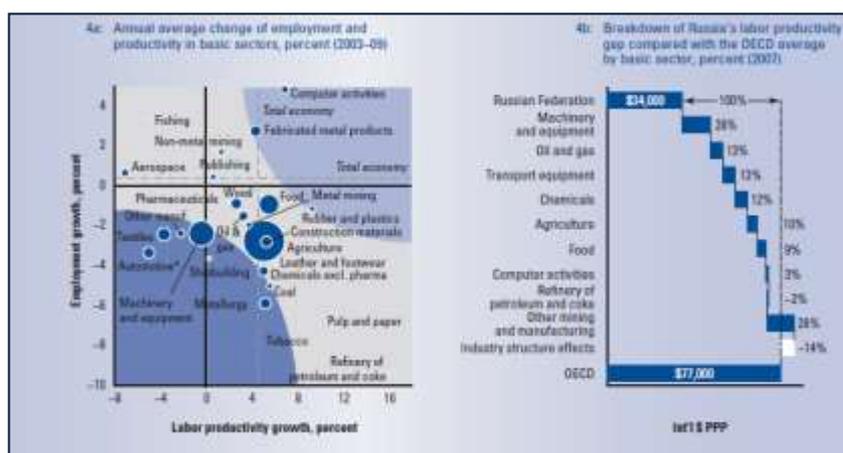


Figure 5: Employment and productivity in basic sectors; Source: Global Competitiveness Report 2011–2012

Productivity also grew rapidly in oil and gas refinery, metallurgy, coal mining, food processing, chemicals (except pharmaceuticals), tobacco, and pulp and paper. Most of these are characterized by intensive market competition.

In machinery, equipment, and transport equipment, both employment and productivity decreased. These sectors were the most seriously affected by the economic crisis of 2008–09. The government is the most important player in these industries.

Productivity gaps in machinery and equipment and transport equipment account for 40 percent of the total productivity gap between basic sectors in Russia and those of the OECD countries. Another 40 percent is the result of lower productivity in the oil and gas, mining and refinery, chemicals, and agriculture and food sectors.

There are different perspectives on the development of basic sectors. Some experts propose abandoning manufacturing and instead using natural resource rents for the development of sophisticated market services; others insist that industry development, especially manufacturing, should be the highest priority. Statistics and cross country analysis, however, show that the truth is somewhere in the middle: manufacturing still matters for economic development and countries create new jobs in competence-driven manufacturing.

According to statistics, as countries proceed to the next stages of development, per capita manufacturing value-added increases. This is proportional to per capita GDP. Although it is well known that the employment share in industry tends to decrease after some critical point, the employment decline is compensated by productivity gains. These gains include both an increase in productivity at the individual industry level and the shift up the value chain to sectors that depend less on natural resources and are more competence based.

### **3.3 Place in the world**

The **Russian Federation** drops three ranks to 66th position this year<sup>10</sup>. The drop reflects the fact that an improvement in macroeconomic stability was outweighed by deterioration in other areas, notably the quality of institutions, labour market efficiency, business sophistication, and innovation. The lack of progress with respect to the institutional framework is of particular concern, as this area is likely to be among the most significant constraints to Russia's competitiveness.

Strengthening the rule of law and the protection of property rights, improving the functioning of the judiciary, and raising security levels across the country would greatly benefit the economy and would provide for spill over effects into other areas. In addition to its weak institutional framework, Russia's competitiveness remains negatively affected by the low efficiency of its goods market. Competition, both domestic as well as foreign, is stifled by market structures dominated by a few large firms, inefficient anti-monopoly policies, and restrictions on trade and foreign ownership.

And despite many efforts, its financial markets remain unstable, with banks assessed very poorly (129th). Taken together, these challenges reduce the country's ability to take advantage of some of its strengths—particularly its high innovation potential (38th for capacity for innovation), its large and growing market size (8th), and its solid performance in higher education and training (27th for the quantity of education)<sup>11</sup>. The full information may be found in the Appendix 1.

So, there is no doubt that Russia is a country of great—and unrealized—potential. But despite its well-educated population, the abundance of its natural resources and its favourable geographical location it has not yet grown at the same pace as many other emerging markets.

## **Conclusion**

It was proved that there is no inherent reason why the Russian economy could not enter a period of high, sustained growth in coming years. It has a number of structural features which create the conditions for rapid growth: it is likely to benefit from gains in efficiency associated with the continued elimination of remaining distortions from its central planning past; it has an impressive natural resource endowment which is likely to stimulate continued and growing interest among foreign investors, particularly in the all-important energy sector. The human capital stock is on balance, a competitive advantage, and remaining skills shortages—while sharply limiting in many ways in the public sector—are gradually being addressed.

Russia has an impressive tradition of world-class research in the basic sciences, including seminal contributions to mathematics and physics. But the brain drain has been a blow to the country's ability to quickly move back to the outer limits of the technology frontier. The basic machinery to do so, in the form of higher education establishments that support scientific research, and the commitment to excellence that was the distinguishing feature of Russian culture and science during much of the past century will have to be revitalized.

Tight conditions in the global oil markets suggest that the external environment is likely to remain favourable to Russia, creating an ideal opportunity to push ahead with structural and institutional reforms. The alternative is to pursue these in the middle of an economic downturn or a crisis, a scenario that is traditionally more difficult.

The IMF is certainly correct in suggesting that a loosening of fiscal policy—particularly one aimed at boosting public sector wages and pensions, not investments in education, public health, and infrastructure, all of which would boost productivity and thus enhance the permissible level of real appreciation of the ruble—will «strengthen tensions between exchange rate and inflation objectives.»

But beyond these issues, it is put on the authorities to broaden their focus, and deal with a broad range of emerging stresses. Foremost among these are how to arrest the disturbing demographic trends, how to better utilize surplus public resources to enhance the economy's capacity for innovation, and how to put the country back on a path of world-class scientific and technological achievement, so that Russia may join the ranks of the most competitive economies in the world.

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