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Why favor large incumbents?
A note on lobbying in transition

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Abstract

Why do new, small, and potentially more market-oriented businesses still face such great difficulties in Russia? What makes the business environment for SMEs so cumbersome at the regional level? This note attempts to present and discuss possible answers in light of current economic theory. Lobbying models, the one proposed by Baldwin and Robert-Nicourt 2002 in particular, are brought up as potentially extremely useful in understanding the interplay between firms and politicians leading to uneven economic playing field.

Key words: lobbying, Russia, SME

Introduction

Russia's economic performance during the 1990s disappointed many – not least ordinary Russians. Despite great hopes, early attempts at privatization and liberalization failed as a recipe for growth. Instead, declining GDP was accompanied by increased unemployment and poverty. No one, it seemed, predicted transition would precipitate such declines in living standards and life expectancy. Moreover, the public sector (especially the federal government) ran sizeable deficits until 2000. When positive GDP growth returned after the August 1998 crisis, it was based largely on increased capacity utilization, an undervalued currency, and high oil prices. Russia's present industrial landscape remains dominated by large, formerly state-owned enterprises. New domestic companies and foreign-owned firms are still rarities. Small and medium-sized businesses employ only about 10% of Russia's workforce, compared to an average of 50−60% in advanced industrial countries.

In contrast, small businesses are today the engines of growth in successful transition economies in Central and Eastern Europe (World Bank 2001). Moreover, international experience shows medium-sized businesses (the petit bourgeois) often form the cornerstone for continued support of economic and political reforms. It is thus at least arguable that until the small and medium-sized enterprise (SME) sector starts to grow, stable, long-term growth of Russian economy stable will be impossible (Berglöf et al., 2003). Russia's old, large enterprises have shown little inclination or talent for restructuring and innovating themselves. The international competitiveness of Russian industry is low by any standard and there is now a very real possibility of Russia becoming a dual economy dominated by a few oil companies.

One can attribute Russia's dismal economic performance to many causes, but poor institutions and cumbersome bureaucracy are increasingly mentioned as main culprits. SMEs, in particular, tend to regard public sector activities as more of a hindrance than help in setting up and running their businesses. The transition of the public sector from Soviet-era regulator to a market-supporting institution clearly has not succeeded − it is even questionable whether this goal was ever seriously targeted during the 1990s.

The Russian government – especially at regional and local levels – is often described as a "grabbing hand" government (Frye-Shleifer, 1997). Shleifer argues that transition of government is an important determinant of successful transition and that government transition may well involve major changes in both structure and personnel. In contrast to the more successful transition economies, Russia's bureaucracy has changed little. There are more bureaucrats, yet little improvement in the quality of governance.[1] Many Soviet-era practices continue, corruption has become an even bigger problem, and politics still have a huge influence on economic activities. Regional politicians and large firms regularly collude to e.g. avoid bankruptcies or optimize tax payments. SMEs and foreign-owned companies, in contrast, tend to rate tax administration, government regulations and inspections as their major headaches.

Although we are finally hearing arguments that administrative reform and promotion of small and medium-sized business need to be part of any proposed Russian economic reform program, the initial results from president Putin's recent reforms aimed at reducing bureaucratic measures offer little promise. A recent World Bank−CEFIR survey on administrative barriers to small business development in Russia revealed (new federal laws notwithstanding) that the number of inspections had actually increased. Businesses

[1] Goskomstat reports that, between 1994-2000, the number of "executive" bureaucrats increased 15% at the federal level and 20% at the regional level.

continuously need close contacts with regional and local governments to alleviate their regulatory burden. There is also some survey evidence that the economic playing field is tilted in favor of large (former) state-owned enterprises and against smaller de novo firms, especially at the regional level (Frye 2002).

Why do new, small, and potentially more market-oriented businesses still face such great difficulties in Russia? What makes the business environment so cumbersome at the regional level? We can also rephrase these questions theoretically: Why should politicians prefer an equilibrium that is clearly sub-optimal from a welfare standpoint? This note attempts to present and discuss possible answers in light of current economic theory.

Decision-makers

There is little formal modeling of decision-maker behavior in a transition environment. The classic paper of Shleifer-Vishny (1994) discusses the relationship between decision-makers and firms, but the analysis uses exogenous assumptions on the objective functions of the decision-maker.

One possible reason for favoring large incumbent firms over smaller start-ups may be the structure of Russia's tax system. Regional level accounts for nearly a half of the public sector's total outlays, yet regions have very few of their own revenue sources. Virtually all regional revenue comes from central government grants and shared taxes (mainly enterprise profit tax and also formerly VAT). Regions cannot decide on their tax bases and their autonomy in determining tax rates is restricted to a relatively small bracket of the profit tax (Pirttilä-Solanko 2002). Thus, a revenue-maximizing decision-maker has little incentive to enlarge the tax base by e.g. promoting SMEs.

In China, in contrast, local governments rely on new semi-private businesses for most of their tax revenues. Chinese bureaucrats thus have a strong interest in fostering new start-ups. This motivation, described by Gordon and Li (1997), assumes politicians wish to collect unofficial revenue either for their private use or for informal budgets. The writers demonstrate that where new firms are more difficult than old ones to tax or new firms form only a tiny share of total revenues, they are also seen as poor sources of informal revenues. In theory then, it is more profitable for a Russian regional decision-maker to favor established large enterprises as the main sources of formal and informal tax revenues.

The mismatch between considerable expenditure requirements and the lack of own revenues at the regional level also results in peculiar forms of public goods provision. In their analysis on Russian fiscal federalism, Lavrov, Litwack, and Sutherland (2000) argue that regions and localities in Russia favor large incumbent firms capable of providing public goods. As cash-constrained regional and local governments must provide classic public goods such as education and health care, local administrations have an incentive to cooperate with local enterprises in providing the statutory public services.

One channel for informal budget operations is where large firms contribute directly to provision of some public services such as school maintenance or health care. In exchange, regional governments tolerate large tax arrears with no expectation of ever being paid back.[2] At the regional level, everyone is happy; firms roughly pay in some form most

[2] Tax collection is the duty of federal tax ministry, but local tax offices have considerable power in implementing tax rules as supervision and guidance from the higher-level tax administration has been rather weak. Employees of regional and local branches of the tax ministry often depend on regional or local governments for their premises, transportation, communications, office

of the taxes they would have to pay, consumers get some public services, and regional leaders have independent discretion over budget operations. The obvious loser here is the federal government, which is effectively deprived of its share of tax revenue. As SMEs are unlikely to get involved in providing school repair or highway construction, regional decision-makers probably seen no immediate benefits in fostering their growth. Of course, it is an open question as to how widespread the in-kind provision of regional public goods is in fact. Empirical study of this question, despite the magnitude of the challenge, certainly merits urgent attention.

The local level in Russian government has even less fiscal autonomy over revenues and expenditures than its regional counterpart. Besides regional capitals and a handful of large industrial cities, local governments are fully dependent on regional budgets.[3] Regional administrators also have fairly good possibilities to monitor local level activities. Consequently, the opportunities for local officials to run informal budgets and hide revenues from regional level decision-makers are rather limited. Ironically, local governments may have fewer private incentives to favor large firms over SMEs.

A much less Russia-specific way to analyse the phenomenon is naturally offered by political economy models. One illuminating example is offered by a model on the political incumbents' concern for their own future along the lines of Acemoglu – Robinson (2002). They argue that changes in institutions or new technologies (e.g. a growing SME sector or FDI contributions) may erode the power of the elite. In other words, fungible political elites will seek to resist change even when it benefits society as a whole. Not coincidentally, Russia's powerful interest groups, including regional politicians and entrepreneurs with vested interests in the status quo, are often mentioned as major hindrances to economic reform. Acemoglu and Robinson (2002) further show that only when political competition becomes intense or the elite's position is secure will elites choose to innovate. Otherwise, political elites favor the status quo. In the Russian context, the status quo is an economic landscape dominated by large state-owned or formerly state-owned enterprises i.e. incumbent firms.

Federal decision-makers may be in positions secure enough to promote change. At the city-level, in contrast, political competition is often intense, cruel, and orchestrated from above. The elites in most Russian regions neither face intense competition or full security. Interestingly, regions besides the resource-rich regions attracting FDI are those where the regional leaders have a firm grip on power, e.g. Novgorod, Moscow, Saratov, and Samara.

In the model of Acemoglu – Robinson (2002), the resulting inefficiency is generally higher the weaker the civil society and the rule of law, and the greater the stakes of being in power. On these criteria, one might reasonably assume Russia has done worse than some of the CEE countries.

equipment, etc. This creates an informal system of dual subordination that may allow regional and local governments to influence decision-making by local tax offices. For more on tax administration, see Penttilä et al. (2001) and Kourliandskaya et al. (2001).

[3] For a recent overview of fiscal federalist relations in Russia, see Solanko-Tekoniemi 2002.

Incumbent firms

The above considerations focus on the motivations of regional decision-makers for favoring certain types of firms. It is probably in an incumbent firm's best interest to maintain close connections to regional administrators and lobby for favors. Large firms have the wherewithal to lobby for additional benefits for themselves (favorable tax treaties, access to state orders) and measures that harm potential competitors (e.g. increased inspections, licenses).

Notably, the academic discussion about the public-private relations in transition economies has recently shifted away from the grabbing hand (i.e. leviathan government) to the wider issue of state capture, whereby a society, or at least some sectors of it, is subject to powerful oligarchs who influence government decisions. Hellman, Jones and Kaufman (2000) contrast state capture and influence with administrative corruption. The first term refers to situations where firms affect the content of laws and regulations either through private payments or without, whereas the latter term refers to what is commonly understood as corruption (i.e. bribery to affect implementation of rules). Citing survey evidence from 23 transition economies, the writers conclude that in many transition countries a capture economy has emerged. Typically, insecure property rights and weak firm performance characterized these economies. Thus, it seems worthwhile to investigate the objectives of both politicians and incumbent firms.

In a separate survey, Frye (2002) argues that characterizing business-government relations in Russia as state capture is overly simplistic. Successful lobbyists, or "captors" in the terminology of Hellman, Jones and Kaufman (2000), also bear a higher regulatory burden than other firms. Frye believes that the relationship might better be called "elite exchange," where both parties benefit at the expense of the rest of the economy. This view of the interaction between politicians and firms coincides with much of the literature on lobbying.

Most lobbying models feature a single politician (government) deciding taxes and subsidies and multiple lobbying groups offering direct contributions to the politician in exchange for favors. The literature has been widely used in analyzing the formation of trade policy outcomes such as export taxes or subsidies. As a lobbying model might help clarify how "elite exchange" works, we look to the recent model suggested by Baldwin and Robert-Nicourt (2002) (henceforth B-RN). They modify and extend the classical lobbying model of Grossman-Helpman (1994) to analyze effects of free entry on the lobbying game's equilibrium.

The classical Grossman-Helpman framework endogenizes lobbying decisions and offers explanations on how lobbying and trade policies are formed. The initial distortion in the economy – the non-benevolence of politicians – is an exogenous assumption backed by rich empirical evidence. Politicians are assumed to value lobby contributions (e.g. campaign financing, private benefits). Politicians then maximize an objective function with two distinct components: political contributions by lobbies and aggregate social welfare. Please note that the Grossman-Helpman model does not assume politicians demand bribes. Rather, the ability of politicians to set trade taxes and subsidies induces profit-maximizing firms, organized themselves into pressure groups, to prefer a lobbying approach. Industries take into account government's objective function when offering politicians a menu choice, i.e. a mapping from subsidies to contributions. Politicians then set trade policy and collect the announced contributions. Maximization of the politician's objective function results in the equilibrium trade subsidies set according to a modified Ramsey rule.[4]

Unlike the Grossman-Helpman model (and lobbying literature generally), foreign trade in the B-RN model is a non-issue. Instead, firms produce only for local markets and firms may decide to lobby for an *ad valorem* price subsidy for their product. [5] Lobbying industries are characterized by monopolistic competition implying a fixed entry cost and non-negative operating profits.[6] The rest-of-the-economy sector (ROE) produces a numerare good under perfect competition. We assume ROE sector lacks the capacity to lobby, as well as resources and capacity to organize into lobbying groups. The identical consumers in this model derive utility simply from consuming the goods produced. The politician maximizes an objective function with two distinct components: contributions by lobbies and aggregate social welfare.[7] Social welfare is assumed to depend directly on total production i.e. total consumption. Lobbying industries take into account this objective function when offering politicians a menu choice, i.e. a mapping from subsidies into contributions. Finally, the politician decides price subsidies and collects the announced contributions. To keep the model simple, it is assumed that subsidies are financed via a lump sum tax on consumers.

In a model specification with no entry, the Nash equilibrium of this lobbying game is characterized by all n industries lobbying and receiving subsidies. It can easily be shown that, compared to a social optimum, subsidies are set too high and thus the resulting equilibrium is characterized by an income transfer from consumers to industries. Next, the B-RN model enlarges the framework by allowing demand fluctuations and free entry to the lobbying industries. With free entry, lobbying for price subsidies becomes unprofitable for the industries facing high demand. Positive price subsidies (i.e. higher producer prices) lead to operating profits above their equilibrium value. New firms will thus enter the market until profit levels return to "normal." While lobbying does not increase industry profits under high demand, if an industry faces (temporary or permanent) negative demand shock, lobbying continues to be profitable. Low demand drives industry profits below the equilibrium level, wiping out incentives for new entry. In such a situation, increasing profit levels by lobbying for price subsidies is a profit-maximizing strategy. Thus, when there is free entry, only losers lobby.

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[4] Under the Ramsey rule, optimal commodity tax rates depend negatively on demand elasticities. In the Grossman-Helpman framework, industries with high import demand or export supply elasticity will have smaller export taxes and subsidies in the equilibrium. Using US data, Gawande-Bandyopadhyay (2000) find empirical support for the Grossman-Helpman result.

[5] The model dynamics do not change if the firms lobby for a cost subsidy, e.g. cheaper energy or lower wage taxes. A cost subsidy, as well as a price subsidy, allows the competitive monopolist to lower its consumer price and increase sales while retaining monopoly profits.

[6] In markets characterized by monopolistic competition, a low level of strategic interaction accompanies market power in that the strategies of any particular firm do not affect the payoff of any other firm. Monopolistic competition was first suggested in Chamberlain (1933), see also Dixit-Stiglitz (1977).

[7] The weights politicians attach to the two components are not necessarily equal.

The results of this kind of a lobbying framework can be summarized as follows:

1. Lobbying leads to an excessive subsidy level from social welfare standpoint, resulting in a transfer of money from consumers to lobbying firms.
2. Lobbying distorts pricing making products of the non-lobbying sector relatively more expensive.
3. With free entry governments subsidize only "losers" since it is in those firms' interest to lobby.
4. When new entry is not allowed, all industries capable of lobbying do lobby for and receive additional subsidies.

Lessons for Russia?

Is there anything to learn from these highly simplified lobbying models when looking at the Russian case? The B-RN model first suggests that regional decision-makers in Russia will continue to subsidize large, incumbent firms, since it is in the interest of such firms to continue lobbying for subsidies. Lobbying allows lower consumer prices than otherwise possible for the lobbyist's products. Under non-controversial assumptions, this fact, together with decreasing net incomes as the lump sum tax increases, induces increased demand for subsidized products and decreased demand for ROE sector products. As a consequence of lobbying, the relative share of competitive sector in the economy decreases. As the competitive sector does not lobby, governments have no private interest in promoting the competitive sector.

How does our theoretical competitive ROE sector compare to Russia's SME sector? As noted above, the SME sector's share in total production and employment is minor. SMEs are typically new start-ups in services, trade, or transport. As the come in a great variety, coordination is difficult. Indeed, the number of SMEs in any single branch within a region is probably so small that their combined resources are insufficient for efficient lobbying. Clearly, SMEs have less lobbying power than most established industries, further suggesting they are unlikely to lobby.[8] Since the SME sector producing under perfect competition has no resources to lobby, regional governments have no private interest in promoting SMEs. Further, as they contribute only a tiny share of total production, their share in the welfare of an average Russian consumer is also likely to be tiny.

There is, as mentioned, empirical evidence that lobbying (or state capture) and an uneven playing field are problems in Russia, especially at the regional level. Nothing in our model explains this phenomenon. One possibility is that it is easier to organize industry-wide lobby groups at regional or local levels than at the federal level. Only a few sectors (e.g. car manufacture, oil and gas) are sufficiently concentrated and financially endowed to lobby nationwide, i.e. lobby the federal government. These industries typically lobby for benefits in foreign trade policies (e.g. higher import taxes or lower export taxes).[9] On the other hand, lobbying at the local level is likely to bring only limited benefits for any

[8] Here we refer solely to lobbying, not bribery or administrative corruption in which SMEs certainly engage.

[9] Using a model of trade policy formation, Mitra (1999) shows it is precisely those industries with large capital stock, inelastic demand, concentrated ownership, and geographically proximate production that get organized in equilibrium.

industry. Local governments are highly dependent on regional governments for their financing and they have virtually no economic policy tools at their disposal. Further, several Russian localities are in fact company towns, dependent on a single industry for most of their budget revenue (excluding transfers). In a company town, a welfare-maximizing politician would favor the incumbent even in the absence of lobbying.

By comparison, regional governments have substantial *de facto* autonomy in their economic policies. On paper, Russian regions control nearly a half of the consolidated state budget (with the rest determined at the federal level). During the 1990s, regions could decide fairly independently on regional subsidies. Indeed, they decided on regional trade barriers and tax practices to such an extent that it provoked a discussion on emerging industrial feudalism in Russia (Ericson, 2000). The typical regional economy in Russia is characterized by a limited number of large enterprises, representing a handful of industrial sectors. These incumbents have inherited the connections and social capital needed in lobbying the regional government. There is a considerably larger pool of industries capable of lobbying the regional than the federal government.

If the B-RN framework applies in the Russian case, should non-SME industrial sectors be characterized as free-entry or closed sectors? Without excessive simplification, one can imagine both "open" and "closed" sectors within Russian industries. The high barriers to entry of the closed sectors imply entry will likely be very expensive and slow (due e.g. to high fixed costs, limited access to fixed factors of production, and large inherited capital stock of incumbents). For instance, many branches within Russia's metallurgy and other heavy industries fall into this category. Entry to the open sectors (e.g. many branches within foodstuffs, transport, construction materials etc) is possible and potentially profitable at least in good times. Briefly then, we should expect three types of firms:

i) SME sector firms without organized lobbying,

ii) Open-sector firms that lobby when they face low demand, and

iii) Closed-sector firms that always find it profitable to lobby.

The economic environment may be quite hostile to SMEs at the regional level, given that it is in the interest of incumbent firms to continue lobbying for special benefits as long as they face no credible threats from new entrants.

From a policy perspective, it may be that if the federal government wants to promote SMEs and decrease informal or indirect subsidies to incumbent firms, it must change either the incentive structure of regional decision-makers or the incentive structure of lobbying firms. The model predicts that demolishing regional barriers to trade and entry may be a way to influence the lobbying decisions of incumbent firms. Such policies might also other benefits, as well. Empirical results from transition economies suggest that high barriers to new business entry and soft budget constraints on incumbent firms are significant institutional factors engendering corruption (Broadman-Recanatini 2002).

Firms in this framework only maximize profits, while political decision-makers seek to maximize their personal benefit and social welfare. If they clearly value their private benefit over social welfare, it may be in their interest to encourage lobbying contributions as much as possible. In the model framework, politicians could only decide on direct taxes and subsidies. If entry barriers (i.e. fixed entry costs) would also be among the policy tools available, the outcome could be much gloomier. Firms in the open sector may find it profitable to lobby for both increasing entry barriers and subsidies. Moreover, a selfinterested politician would always find it profitable to control and direct new entries to maximize lobbying contributions. Influencing incentives has proven an enormous task in Russia. Experience globally suggests strong rule of law, democracy, and civil society are among the most efficient factors limiting politicians from pursuing their private benefit.

A word of caution is in order here. “Only losers lobby” is not the only equilibrium in the B-RN lobbying model. If incumbents in high-demand sectors would for some reason decide to lobby, that would lead to inflow of new firms in their sector. As soon as the number of firms increases beyond the “no lobby” equilibrium, the end of lobbying would reduce the value of those firms. Thus, equilibrium also occurs in the situation where all lobby in the free-entry framework. Although firms facing high demand are typically indifferent to lobbying, everyone would strictly prefer the “only losers lobby” outcome when demand is low. With free entry “all lobby” is clearly a dominated strategy, but the possibility of a bad equilibrium exists.

Concluding remarks

This short note discussed possible approaches to the mystery of slow emergence of small and medium-sized enterprises in Russia. We suggested that the Baldwin&Robert-Nicourt (2002) lobbying model allowing for free entry might provide valuable insights to this issue. Admittedly, the Baldwin&Robert-Nicourt (2002) model as well as other models referred to in this paper are static in nature, which may not be particularly meaningful in a rapidly changing transition environment. If, in the medium term, new SMEs tend to grow faster than large incumbent enterprises, a decision-maker with perfect foresight should have a strong interest in fostering SME growth. Rapid SME growth would lead to rapid increases in consumer welfare, thus increasing the opportunity cost of favoring only lobbying sectors. A valid counter-argument is that it is precisely in an uncertain environment where the decision-makers rarely have perfect foresight or long time horizons.

One possible reason for why lobbying and state capture hamper new business development in Russia more than in many other CEE transition economies may be found in Russia’s federal structure. Apart from the fairly small group of oligarchs, business lobbying and extremely tight connections between government and businesses seem to concentrate on the regional level. During recent years, in fact, the influence of big business in regional politics and economics has grown. As argued above, Russian regions have broad *de facto* (if not *de jure*) powers in designing the business climate of their jurisdiction. They have, however, few formal means to influence their own revenues. This mismatch between decision-making authority and fiscal responsibility may create an environment well suited to decision-makers interested in pursuing their private benefit along with public welfare.

Therefore, where changing the incentives of lobbying firms (by decreasing entry barriers to sectors capable of successful lobbying) is not feasible, giving the regional decision-makers a greater direct interest in SME development may help. The striking difference between Russia and China indicates that linking regional tax revenues to the success of new firms can create powerful incentives for favoring those firms. Even if the incumbents continue lobbying, the emergence of a new SME sector as an important regional revenue source could greatly level the economic playing field.

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