BusinessWeek

COMPANIES May 8, 2009, 1:23PM EST

Why Is Russia's Productivity So Low?

Russian companies are still among the least productive in the industrial world, but the downturn could provide a catalyst for big improvement

By Jason Bush

On the face of it, Russia's economic performance over recent years has been impressive. But today, amid plummeting gross domestic product and sharp falls in industrial production, there's a new awareness that Russia's economy is also beset by deep-seated problems. Despite almost two decades of market reforms, the country's labor productivity, a key indicator of overall economic efficiency, remains one of the lowest among industrialized nations. Several studies have been published recently underscoring the scale of the problem.

According to one of the studies, by Strategy Partners, a Moscow management consultancy, Russia's average labor productivity is just 17% of the U.S. level. The amount varies by sector, from a low of 6% in machine building to a high of 22% in the natural resource industries. But the room for improvement is colossal everywhere. "If, in Russia, a mere 10% of workers had the same level of productivity as in the U.S., Russia's GDP would increase by one and a half times," notes Alexander Idrisov, managing partner of Strategy Partners.

Similar conclusions have been reached by the U.S. consultancy McKinsey, which has also just published a report examining Russian productivity. McKinsey, which focused on six sectors, concluded that Russian productivity was around 26% of the U.S. level. That's an improvement on 10 years ago, when McKinsey estimated Russian productivity at 18% that of the U.S. But widespread inefficiencies remain. For example, it takes three times as many workers to produce a ton of steel in Russia as it does in the U.S.

Russia's productivity looks bad even in comparison with other emerging markets. In 2007, the World Bank estimated that revenues per worker in Russia were only around $7,000 per head per year. That's around 20% lower than in India, and 40% lower than in China. The figure is especially troubling when you consider that Russia's labor costs are about double the level in either India or China.

OUTDATED TECHNOLOGY

Why is Russian productivity so low? "Why should it be high?" asks Boris Kuznetsov, chief researcher at the Higher School of Economics in Moscow. "Let's look at the history. Very few big enterprises were constructed in the last 20 years, so the technology is old. In China, you have very cheap labor and up-to-date technologies because they were imported recently."

But though outdated technology is often a problem, many experts emphasize that it isn't the actual root of Russia's productivity woes. "It's a big myth that we have low productivity because we have old technology," says Idrisov from Strategy Partners. "In general, the major factor is very ineffective business processes and organization."

For example, he notes that big Russian carmakers today produce around 85% of their own components. Such in-house producers are geared to one customer, so they are too small to reap the benefits of economies of scale. The lack of competition also means they have little incentive to innovate or improve quality.

Other Soviet relics are found in areas as diverse as worker compensation, sales and distribution, and accounting. In its recent report, McKinsey attributes just one-third of the productivity gap in the Russian steel industry to outdated manufacturing technologies. The remaining gap is caused by inefficiencies such as poor work organization, low levels of IT and automation, and bloated middle management.

WIDE RANGE OF EFFICIENCY

But this prevalence of inefficient methods also provides some solace, implying huge potential for improvement. Another finding of recent research is just how much variation there is between firms in the same industry. McKinsey notes that despite the low sector average, the best Russian steelmakers have productivity that is almost as good as their U.S. peers.

Such variations are the norm in every industry. In a recent industrial survey, the Higher School of Economics found that, depending on the sector of the economy, the productivity of the top 20% of Russian firms is between 6 and 12 times higher than the productivity of the bottom 20%. "In any industry in Russia, you can find quite good and competitive firms, and very bad and uncompetitive firms," says Kuznetsov. That suggests that, properly managed, even companies in depressed industrial sectors have the potential to become competitive.

True, better management alone won't solve all of Russian industry's problems. Another finding of the Higher School of Economics' research is the key importance of geography in explaining the productivity gap. The worst-performing factories are typically located in small towns, often remote and with just one or two big employers. And in Russia there are many such towns. "Most inefficient enterprises can't be modernized. It would probably be better just to close them," says Kuznetsov. "But that is not very easy because it creates social problems."

The prevalence of single-company towns helps explain why Russia's politicians are often reluctant to allow factories to go bankrupt. As with governments in other countries, Russia has provided bailouts during the economic crisis (most notably a $1 billion package in April for Avtovaz (AVAZ.RTS), Russia's largest carmaker).

BEYOND BAILOUTS

But in general, economists have been pleasantly surprised by the government's relatively hands-off approach to industry during the crisis. "The good news is that the government is saying, 'Stop asking for money,' " says Sergei Guriev, rector of the New Economic School in Moscow. He says that instead of bailing out inefficient enterprises, the government should fund retraining, small business creation, and labor mobility to mitigate the consequences of factory closures.

Another way the government can help is by improving Russia's overall investment climate. The analysts agree that foreign direct investment will be an especially important catalyst for industrial modernization. According to Strategy Partners' analysis, no less than 75% of productivity improvement in emerging markets is the result of FDI. In Russia, too, the most efficient industries tend to be those, such as the brewing industry, that have the highest share of foreign direct investment. Russian companies that have enhanced their efficiency invariably say foreign partnerships have been a crucial stimulus to change.

That's why the issue of Russia's industrial competitiveness can't be separated from the wider question of Russia's investment climate and image. Foreign investors are routinely put off by legal uncertainty, corruption, and bureaucracy. "If Russia had better institutions—competitiveness in a broad sense—it would be faster to react to the crisis and faster to restructure," says Guriev. "What needs to happen is for the crisis to change the mentality of policymakers and bureaucrats."

Under pressure from the crisis, Russian companies are beginning to change their inefficient habits. Perhaps the big question now is whether the crisis will also compel Russia's government to embrace reforms, now more essential than ever to support the transformation of the Russian economy.

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