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Economic development of a peripheral region: the case of Karelian timber industry

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Economic development of a peripheral region: the case of Karelian timber industry

***Abstract:** This paper focuses on current patterns of restructuring in Russian Karelia's timber industry, which constitutes the backbone of the regional economy. In particular, the paper investigates the relationship between an increased export orientation of this industry and a notable worsening of its output structure, combined with a lack of technological innovations. This situation results in a general instability of Karelian economy, which is increasingly dependent on fluctuations of international timber prices, as well as on exchange rate policy of the Russian government and central bank. This results in a decline in Karelian living standards, especially in remote rural settlements, which are crucially dependent on export of raw timber. Moreover, the current business climate in Russia strengthens Karelia's specialisation in export of raw timber and deters investment in higher-added-value timber-processing industries. The paper discusses this relationship and suggests that the Republic should start to stimulate the development of domestic-market-oriented timber-processing industries on account of an active inward investment promotion strategy.*

Economic policy of the Russian leadership resulted in the orientation of the Russian economy towards foreign market of raw materials (extraction and environmentally harmful primary processing). No great efforts have been needed either from the enterprises or from the state leadership to settle in this market which is easily available to Russian enterprises. The Republic of Karelia specialised in utilising the available natural resources in the past as well. Before the market reforms started, the Republic focused on supplying forest products to the European part of the USSR. Liberalization of foreign economic activities gave enterprises an opportunity to use the advantages of the region's border position, and to rapidly increase exports while home market reduced markedly.

Foreign trade volume decreased in 1992 but started rapidly growing further on. In the 1990's Karelia began to actively cooperate with the neighboring countries, particularly with Finland. The reforms led to a considerable production recession in processing industries (approximately 10-fold in mechanical engineering and light industry). At the same time production recession in extracting industries was not so great (*Tables 1 & 2*). After losing the market in Russia metallurgy and timber industry enterprises began to work for European market. Karelian timber turned out to be closest to European customers which allowed minimal transportation costs. As a result about 65% of all industrial products are exported.

Table 1. Structure and development of timber industry in the Republic of Karelia, % (Shmelev 2001).

	1990	1992	1994	1996	1998	2000
Industry of the Republic	100	100	100	100	100	100
Logging industry	11.5	12.6	10.7	10.6	12.6	13.3
Woodworking industry	8.9	11.7	7.1	4.5	3.3	5
Pulp and paper industry	18.3	23.1	23.5	26.9	25.9	37.5

Table 2. Gross industrial output indexes by industry branch in Karelia, 1990 = 100 (Shmelev 2001).

	1998	2000
Industry in the Republic	48.3	63.5
Extracting industry	74.3	82.6
Processing industry	40.6	56.8
Logging industry	63.7	78.3
Woodworking industry	20.3	44.7
Pulp and paper industry	50.8	72.1

As a result, the drop of production amounted to 25% in the extractive industries by 1998 and to 36% in the lumbering industry. At the same time, while the volume of production was down 60% in the entire processing industry, it was down 80% in the woodworking industry.

The structure of exports from Karelia is dominated by raw materials and stooks (*Tables 3*). The largest share in the structure of export is occupied by pulp and paper (36.6%), timber and its products (26.3%), metals (13.3%) and iron-ore pellets (9.4%). As compared with 1990 there occurred notable increase in the exports of paper (by 3 times), metals (by 7 times), pulp (by 24 times), raw forest materials (by 5 times) and iron-ore pellets (by 5 times). The export of machines and equipment is negligible, some types are not exported at all (e.g. woodworking machines).

Table 3. Export of forestry products from Karelia (Shmelev 2001).

	1990	1992	1994	1996	1998	2000
Roundwood, 1000 m ³	748	398	793	1945	3034	3218
Sawn timber, 1000 t	789	200	344	178	190	320
Pulp, 1000 t.	2,5	4,09	19,8	31,1	25,3	51,8
Paper, 1000 t.	162	168	354	396	313	501

Several factors in the relatively low cost of domestic production strengthen the competitive power of Russian enterprises. First of all, they include relatively low rents in comparison with those

in developed countries. They secure a competitive position for primary sector enterprises, which potentially makes them highly profitable.

Stumpage prices are much lower in the Russia than in developed countries. In 2000, the mean forest tax in Russia amounted to 18 rubles compared to 650 rubles in Finland and 400 rubles in Estonia (Druzhinin, 2003).

On the one hand, it stimulates the illegal export of raw timber, which is rather a profitable business: it brings approximately 300 rubles from 1 cubic meter of timber, but for all this, some of the border lumber farms in Karelia are loss-making. Moreover, at forest auctions near automobile border checkpoint, the stumpage price also amounts to 300 rubles per cubic meter. According to experts' assessment, the illegal sale of timber from Far-Eastern regions, mainly to China, brings up to \$450 mln a year (Druzhinin, 2001).

On the other hand, a low rent helps support wood-working enterprises, which receive raw materials at a relatively low price. The state compensates for insufficient budget receipts by means of export duties paid by lumber companies.

Apart from a low rent, there are some other factors that strengthen the competitive power of domestic enterprises; although they are less characteristic for Karelia. The cost of energy in the Russia is much lower than that in the European Union. The export-oriented pulp-and-paper industry belongs to energy-intensive ones; in the Republic of Karelia bordering on the EU, the share of fuel and power in production cost exceeds 17%. In some branches, including pulp-and-paper industry, Russian enterprises use obsolete technologies and environmentally unsafe equipment, which cause massive emissions of pollutants. This also allows them to have lower costs: the less the share of amortization and maintenance expenses, the lower are the production costs. Skilled labor, the work of researchers and inventors, as well as intellectual property on the whole, are rather undervalued in Russia.

We can single out four key factors influencing competitive power but increasing production cost in the Russia. The competitive power of Russian enterprises is to a great extent connected with high taxes. Low incomes of the population do not provide sufficient budget receipts. That is why the taxes on legal entities are much higher than those in the EU. For example, according to expert estimates, corporate taxes and budgetary payments connected with labor compensation are twice as high in Russia as they are in Finland. Some expenses, which are charged to operation in the EU, here are financed from profit, including those for research and development. In recent years, we have witnessed some easing of the tax burden, but at the same time, investment allowances were abolished. As a result, the budgetary payments of actively investing companies have not considerably decreased.

The bureaucratic (nontax) burden also exerts a substantial influence on the competitive ability of enterprises. It starts from the moment of the state registration of a company. To register a company in Karelia you have to visit different state clerks offices 158 times and successively submit 22 documents only at a local level. According to Soyuz, the Karelian union of entrepreneurs, all sorts of certifications and agreements consume 10–12% of profits, and the number of state inspections varies from 25 to 659 a year.

Decisions of federal and local authorities often entail losses for enterprises. All sorts of limitations are placed on export activities: the increase in customs tariffs, the raise of transportation rates for exports, the introduction of all kinds of duties. The export aspen tax imposed in 1999 (aspen is not popular in the RF, but has to be cleared under the threat of penalty) led to the virtual stoppage of its export. In 2002, the customs intended to close the simplified checkpoints through which timber had been exported for decades. As a result, the transportation costs of border enterprises could have grown considerably and either some of them would have been forced to close or they would have had to reduce the establishment. When a project to establish a Finnish woodworking company in the southeast of Karelia was under discussion, the list of numerous additional conditions included the construction of a bomb shelter and the creation of a fire-fighting unit on the premises. On the whole, approximately 10–15% of the companies' expenses are the expenses for all sorts of bureaucratic procedures, and the load on business does not tend to decrease.

A big problem faced by domestic enterprises is their obsolete equipment and old-fashioned technologies, which results in low labor efficiency (which is, in turn, compensated for by low pay) and the poor quality of products. Innovation activities weakened in the 1990s, and its slight revival in 1999–2000 did not appreciably influence the situation. In the 1990s, the innovation process accelerated in developed countries, which made the gap between them and Russia even more apparent. Russia needs investments and innovations, but for them to be efficient, we must solve the problem of their management.

The softening of the Russian economy and the inefficiency of investments are to a great extent connected with poor management. The volume of investments in the early 1990s was much higher than in recent years, but the rate of slump increased. A large part of investment did not pay back. Only a small number of enterprises preferred rapid adaptation to the market and reformed their structure in accordance with its requirements. Surveys have shown that poor marketing and insufficient consumer-orientation are still typical of many companies of the branch. However, the appearance of efficient owners and trained managers in the 1990s as well as the retraining of former administrative staff, and the creation and the development of new companies began to reverse the situation. In contrast to the beginning of the 1990s, the efficiency of investments has increased—the output of production is growing; moreover, new and more competitive products have appeared. This process is complicated, since the reform of enterprises, the reorganization of their facilities for the production of new and competitive products at a lower cost, and the introduction of new technologies undoubtedly foster production efficiency, but at the same time lead to a decrease in employment, to a change in its structure, and to the increase of the share of qualified and skilled workers in the workforce. Nevertheless, the level of management in the Russia has been on the rise.

The state can lessen the influence of the first two factors on the competitive power of domestic enterprises; whereas owners and managers can control the latter two. Moreover, the level of their involvement and the number of implemented innovation projects in branches also depend on the state policy. If the cost gap compared with developed countries is too big, no innovations, or change of technologies or managers in the branch will secure a competitive position for an enterprise because of the enduring tax and bureaucratic burdens. In this case, the activity of owners will manifest itself only in the requirements to set new barriers to imports. If the gap is not big, the

reform of the enterprise and its changeover to new technologies will increase its competitive power and make its owners interested in the implementation of innovation projects.

In the late 1990s, the timber industry developed quite successfully. The Karelia yielded in the volume of timber exports to three northwestern regions, whereas in the volume of production it did only to Arkhangelsk oblast, and in the output of production per cubic meter of cut wood to Leningrad oblast. The share of Karelia in the Russian export in newsprint is approximately 1/3 and in round timber 1/7. The raw timber is mainly transported for processing in Finland, and the local wood-processing firms are left without raw material step-by-step. The Finnish corporations can pay 1.5-2 times more than the Russian ones without delay.

A lot of foreign enterprises were being organised in the Republic in the early 1990s but the process slowed down as certain privileges were abolished. In the beginning of 2000, 417 enterprises with foreign investments were registered in Karelia (55% - Finnish). Their major activities include timber industry and trade. In the structure of the investments, industrial production of logging accounts for about 13 %, paper industry for 80 % and woodworking industry for 4 %

After the ruble devaluation, the activities of woodworking companies revived. This mainly concerned the border regions and the regions that have ports for the exports of timber. The woodworking industry is mainly represented by lumbermills (75% of the volume of production), the share of cabinet-making is only 3%. However, to work steadily either for foreign or domestic markets, we need to use new technologies. Moreover, the intensive modernization of pulp-and-paper enterprises allows them to improve product quality and to find new markets providing 99% of net profits for the Karelian economy.

Being close to European countries allows Karelian lumber companies to transport their products to these countries at a relatively low cost. That is why they can sell timber at higher prices. For example, in the late 1990s, Karelian timber prices were twice as high as in Russian inland regions, and 30–50% higher than in other timber-exporting regions like Komi, Arkhangelsk oblast, and Vologda oblast. The analysis of the production cost of the north-western lumber companies showed that in the border companies it is 30%–60% higher than in companies situated farther from the border. Moreover, the production costs in the north are higher than in the center or in the south, while the outlays on state-financed branches are approximately 30% higher, hence, local taxes are higher, too.

After the ruble devaluation, companies' incomes shot up. In the fourth quarter of 1998, the profitability of Karelian lumber companies topped 85%. The average forest tax in the Karelia was only 30 rubles per cubic meter in 1999, and on the auction it was 100 rubles. However, auction sales accounted for only 312000 cubic meters of timber (3.5% of the periodic yield), and 70% was given to former state timber industry enterprises, inefficient companies with tax arrears.

The faster growth of the expenses of woodworking companies in the Karelia is due to the high cost of raw materials. The border position, which means remoteness from the Russian market, made Karelian timber too expensive and far less competitive in the domestic market. That is why a considerable number of Karelian lumber companies were driven out of the internal market. Consequently, the traditional Karelian products manufactured from local expensive timber are getting too expensive for the Russian market.

On the whole, less than 15% of Karelian industrial production is exported to the Russia. While the share of timber in production cost decreases, the competitive ability of Karelian products on the domestic market grows.

The ability to make profit with high raw material costs allows the RK to have the highest rate of development of the calculated felling area: almost 72%. In the border regions, the felling area is almost fully cut down, even when timber is sold at auctions at 200–300 rubles per cubic meter. Karelian lumber companies can afford higher expenses for logging, road construction, and the development of remote and inconvenient areas. High prices of Karelian timber exported to Finland yield good profits. That is why the ratio of the wood used to forest crop amounts in Karelia to 54%, which is quite close to the figures of Finland and Sweden (in Russia this share is equal to 12%).

The proximity of Karelian lumber companies to the border increases their competitive power. It is clear that it is much more profitable to export raw materials from Karelia: the greater the level of processing, the higher is the price of Karelian products. However, at some point this difference gets less significant.

The state can influence competitive ability in different ways. The first one was applied in 1998: the ruble devaluation and the skimming of excess profit from raw materials exporters at a low rent in the form of export duties. But the short-term effect of this approach creates additional problems for sustained long-term development. Another kind of state influence is connected with the gradual reduction of the load on business.

The situation will probably get worse because of restriction on the import of timber to the EU, connected with ecological standards. Finnish companies may return to the use of domestic raw materials, which will increase the production cost, but their losses will not be great. But because of that a great number of Karelian lumber companies, which did not enter the vertically integrated structures, will not find other markets for their products.

Thus, in the present conditions, raw materials branches in Karelia are profit-making, and actually they are not interested in the lowering of production costs, the reform of enterprises, and the introduction of new technologies. The improvement of high-level processing of raw materials and the development of high-technology facilities are not profitable: there are no legal competitive advantages, intellectual property is ignored, etc. At the same time, the reduction of tax and bureaucratic burdens (accompanied by the growth of the rent and the decrease in customs duties of raw materials) provides for a great number of companies the reform effect, the improvement of their management, and the implementation of innovation projects. When rent growth is accompanied by a simultaneous reduction of customs duties, state incomes will be formed by tax receipts, rather than customs duties.

Mutual efforts of the owners of companies (the reform of enterprises, their modernization, the creation of integrated structures, the improvement of their management), regional authorities (the support of innovation infrastructure and the simplification of the state registration of a business) and federal authorities (the strengthening of the control over business, the change of the tax system, the stimulation of innovation) will lead to the increase in the quality of woodworking and strengthen the competitive power of woodworking companies.

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