Evolution of Innovation Performance in the Russian Vodka Industry

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Abstract

The purpose of this paper is to understand the relationship between increased levels of competition – facilitated by market liberalisation – and innovation performance in the context of the Russian vodka industry. Through this understanding this paper subsequently develops a series of innovation policy considerations for transitional economies. In order to achieve this, this paper reflects on the existing literature surrounding innovation performance and competition; as well as the development of the Russian economy more broadly.

This paper finds that a state-controlled industry is capable of fostering innovation. However, once the presence of the state in an industry is reduced, innovation performance is enhanced. A recommendation is made that the state should not exhibit control beyond providing a legislative framework for competitiveness; where possible monopolies should be broken down; and private enterprise should be encouraged.

A number of the world's large economies find themselves in a state of transition, as such the development of an innovation policy that will allow transitional economies to realise their innovation potential in a sustainable way is imperative to the success of their ongoing transition. The Russian Federation has endured significant economic transition since the collapse of the Soviet Union, and the Russian vodka industry has been a constant throughout, it is therefore an ideal case in examining the evolution of innovation in a transitional context.

Paper Type: Viewpoint

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1. Introduction

Transitional economies - particularly Russia - owe much of their economic prowess to strong manufacturing and natural resource industries. As transitional economies develop the dependency on these sectors becomes less tenable; and so the development of sustainable economics through innovation performance becomes increasingly important. This paper will elucidate key trends and highlight the development of innovation performance in the Russian vodka industry, through the transition from Soviet state socialism, to the contemporary system based on 'free-market' principles that currently exists.

Observing the Russian vodka industry's changes and developments, in terms of innovation performance, allows for scrutiny of the successes and failures of Russia's broad innovation policy. Through these observations it is subsequently possible to develop a series of policy considerations for encouraging innovation performance in transitional economies.

This paper achieves an understanding of the emergence of innovation performance in the Russian vodka industry by evaluating the relationship between innovation performance and market liberalisation. Market liberalisation plays a central role in this paper as it can facilitate free-enterprise and subsequent increased levels of competition. To understand the emergence of innovation performance in the Russian vodka industry, one must therefore evaluate the relationship between innovation performance and competition.

In broad terms this paper suggests that, due to a lack of competition, innovation performance is not well-fostered in a Soviet-style closed market economy. Although a degree of innovation is possible in this system, it is found that a 'liberated' economy - based on 'free-market' principles - is more conducive to competition and this has a positive influence on innovation performance. This research recommends an innovation policy that encourages private enterprise; defines the role of the state; creates incentives for private sector innovation; encourages foreign investment; and tackles corruption.

1.1. Contextual Background

Under the system of Soviet Socialism private enterprise was largely forbidden, and it was generally deemed as a dishonourable practise of 'Western Imperialists' and the 'Bourgeoisie'. Soviet Socialism saw the state play a central role in business enterprise. State enterprises were not operated for profit, but rather as carriages of socialist policy, seemingly for the benefit of the public. The dominance of the state had two main implications with regards to innovation and competition; the first being that entrepreneurial activity - in the sense of individuals establishing their own businesses - was practically non-existent, meaning that industry competition was also practically non-existent. With the emergence of Perestroika, and various economic reforms in the early 1990's, entrepreneurial activity was permitted and competition was, to a degree, able to emerge.

2. Conceptualising Innovation Performance and Practical Implications

Schumpeter (1947) suggested that the entrepreneur - or the *Unternehmergeist* - is central to the innovation process. It is from the entrepreneur whom innovation and technical change stems, and a nation's innovation performance relies on the efforts of the entrepreneur. This immediately presents an issue in the context of Soviet Russia (Prior to 1992), which forbade entrepreneurial practises. One can justly then ask, with no entrepreneur how can there be innovation? Additionally, Schumpeter (1942) suggests that a competition intense industry is detrimental to innovation performance, and innovation performance will be augmented in a monopolised industry. Therefore, one might expect to find high levels of innovation performance in industries that were controlled by the Soviet state, as they often operated government monopolies.

Based on the two aforementioned positions of Schumpeter (1942, 1947), two main assumptions surrounding the reformation of the Russian economy can be made. Once private enterprise was permitted, entrepreneurial activity would increase, and so would innovation performance as a result. The second assumption is that the increase in entrepreneurial activity would subsequently lead to an increase in industry competition, which according to Schumpeter (1942) hinders innovation performance. By contrasting the two positions they appear to contradict one another, and are incompatible.

On one hand Schumpeter (1942) asserts that competition is unfavourable to innovation performance, while entrepreneurial activity is favourable to innovation performance. However, one might assume that an increase in entrepreneurial activity would also result in increased levels of competition as more entrepreneurs enter or expand into an industry. This creates an issue for further research into the reformation of the Russian economy, as both entrepreneurial activity and competition were permitted – if entrepreneurship has a positive influence on innovation; and competition is a negative influence, then how can one assess the impact of Russian economic reform on innovation performance?

2.1. What Schumpeter Doesn't Consider

It is firstly worth noting that there is little evidence in practise to support the notion that competition has a negative impact on innovation performance. With reference to studies conducted by Aghion et al. (2005), Vives (2008), Hashmi (2013) and Aghion et al. (2014) the contrary to Schumpeter (1942) is found; innovation performance is generally augmented by an increase in the level of competition. Although, according to Nicholas (2003) competition can hinder innovation, but only if competing firms have large discrepancies in their size and capabilities. On the basis of these studies, this would mean that through the facilitation of competition, innovation performance would be improved rather than hindered, so long as the competing firms were of a similar size.

Schumpeter (1942) focuses on the individuals' ability to exploit market opportunity through technical and/or organisational innovation as a definition of entrepreneurship. Even with this loose definition, entrepreneurship is often associated with free-market economics, and there is a tendency to assume that entrepreneurial activity did not

exist in Soviet Russia. Of course, entrepreneurial activity as it is known in 'The West' differs from the kind that may have existed in Soviet Russia. The existence of the black market in Soviet Russia was a testament to the entrepreneurship of Russians at the time. This special brand of entrepreneurship has been described, by Rehn and Taalas (2006), as an economy of favours in which individuals sold or traded products and services, of which they had a surplus, in exchange for other goods and services that they required. The practise was illegal in Soviet Russia, but it is a clear demonstration of individuals exploiting a market system through a form of organisational innovation. Recognising the kind of entrepreneurial activity that existed in Soviet Russia is essential to understanding entrepreneurship in contemporary Russia, and how it influences competition and innovation performance.

2.2. Considering Large Systems Change

The means to understanding the emergence of innovation performance in contemporary Russia can be found in the theory of Large Systems Change. Based on Waddell et al. (2015) – the conceptualisation of Large Systems Change - it can be reasoned that the economic reform that took place in early 1990's Russia can be described as transformational change that was, at least to a degree, forced. Meaning that the period economic transition was one of turbulent, fundamental systemic change resulting from pressure from stakeholders, in this case the Russian public and the international community. In terms of the implications this has on innovation and competition, individuals in Soviet Russia (Prior to 1992) endured a rather abrupt period of systemic change to which they had little time to comprehend and adapt to. It is possible that the rapidity of the systemic change did not allow for a transition of the existing entrepreneurial culture, leading to a rather obscure indefinable entrepreneurial culture.

Given the magnitude of change undergone by the Russian economic landscape (Post 1992), it stands to reason that an appropriate innovation policy is developed, ensuring that Russian firms, and government, are able to innovate in their rapidly changing economic environment. Of course, given the radical reformation of the Russian economy over the last three decades, this is far from a menial task.

3. Innovation in Contemporary Russia

Emerging from a rather clandestine system, entrepreneurial activity and innovation performance in contemporary Russia has taken on a rather obscure form, or at least obscure in comparison with a typical 'Western' style. Aidis et al. (2008) highlight that the Russian government implemented policies that, in theory, should facilitate improved innovation performance. However, the business environment in which Russian entrepreneurs operate is particularly hostile, with high barriers to entry and anticompetitive practises. The current, post-reform, system of enterprise rests on a network of informal arrangements, which can be described as an economy of favours. This informal system is thought to serve as a 'breeding ground' for corruption and unethical business practises which according to Habiyaemye and Raymond (2013) acts as a deterrent for innovation performance.

3.1. Complexion of the Contemporary Russian Vodka Industry

Following from a long period of transition, the Russian vodka industry, like many other Russian industries has become more liberalised and open to competition, at least in theory. During the economic reformation of the late 1980's and early 1990's, many of the state-owned vodka manufacturers were sold to private entrepreneurs, or Oligarchs. To an extent, the previously existing monopolies were broken; the potential for competition was augmented; and the capacity for improved innovation performance was augmented too. However, the complexion of the Russian vodka industry remains rather indefinable, with a mix of state-owned and privately owned producers.

The Kristall Distillery, Moscow, is one of the oldest and largest distilleries in Russia, producing a large variety of vodka brands: some traditional; and others more modern, such as Vodka Putinka – a highly popular vodka commissioned in honour of Russian President, Vladimir Putin. The distillery is now in private ownership after several decades of Soviet control. However, on the opposite end of the spectrum is FKP Sojuzplodo Import, a state-owned vodka producer. They are the producers of Stolichnaya and Moscovskaya vodka – two of Russia's most popular vodka brands. This indicates two issues: the level of dominance single producers hold over the industry, and the level of control the Russian government maintains in a liberalised industry.

The Russian vodka industry is host to a few large producers which are able to monopolise parts of the market, especially producers with state legislative backing. However, there is evidence of emerging, privately-owned, firms too: The Russian Standard Corporation, in 1998 launched their own vodka - Russian Standard Vodka - which has gained momentum and become a popular vodka in contemporary Russia and in the global market.

With reference to the development of an innovation policy, there are two main considerations for the state regarding their role in the industry; the state could opt for becoming an industry leader in innovation, setting a benchmark for other producers. Alternatively, the state could reduce its presence in the industry; selling off brands to private enterprises, and enhancing the intensity of industry competition. However, the likelihood of the latter being adopted is low, given the immense popularity of the brands produced by the state.

3.2. Limitations of Current Russian Innovation Policy

OECD (2011) is a review of Russia's current innovation policy and aspirations of the Russia 2020 innovation objectives. The OECD (Organisation for Economic Co-Operation and Development) found that the Russian government had made some considerable steps towards developing an economic environment that is conducive to a positive innovation performance.

However, the OECD largely found that Russian innovation performance is relatively poor, and its capacity for improving its performance is limited by a number of factors: largely systemic market failures inherited from the Soviet system, and policies

implemented during the 'transition' period.

Most notable of these inherited systemic failures, is the persistent role of the state in many industries, as evident in the Russian vodka industry. Additionally, the OECD found that privately-owned Russian firms lack an incentive for innovation. This is partly due to an inheritance of Soviet attitudes, in which innovation is not a priority for firms. Therefore, in terms of moving towards a progressive innovation policy, it seems that the role of the state should be reduced, firms need to be incentivised to learn and implement knowledge.

4. Implications for Innovation Performance

It is easy to assume that there would be little to no innovation in the Russian vodka industry under the control of the Soviet government, due to its strictly enforced rules on private enterprise. It is likely that innovation and entrepreneurship existed in some form. This will be from black-market entrepreneurial activity and methods adopted by state vodka producers to meet production quotas, and targets set out in the Soviet system of taut planning. That said, the situation of a market monopoly is what Schumpeter (1942) deemed to be ideal for the advancement of innovation performance, and one might expect high levels of innovation to be observed in the Soviet run Russian vodka industry, on that basis. However, the evidence in practice adheres to the opposite perspective, suggesting that innovation performance would be poor.

As Russia transitions towards a situation based upon 'free-market' principles, then the expectation is a vodka industry that is more intensely competitive, and subsequently innovative - based on Aghion et al. (2005), Vives (2008), Hashmi (2013) and Aghion et al. (2014). However, Schumpeter (1942) alludes to the opposite, suggesting that innovation performance is hindered by an intensely competitive market. That said, in the case of the Russian vodka industry, it seems particularly unlikely that the 'opening-up' of the industry would be incapable of encouraging intensified competition, and improved innovation performance. It also seems even less likely that in doing so, innovation performance would be negatively impacted.

Based on the aforementioned proposition, this research addresses the following objective:

Assess the dynamics of innovation in the Russian economy, through the transition from state socialism to a contemporary 'free-market' system, using the Russian vodka industry as a case, and subsequently develop an innovation policy for industries operating in transition economies.

5. Pre-Reform and Post-Reform Innovation

Under the Soviet system it could be assumed that the levels of innovation in the Russian vodka industry would be rather low. However, vodka producers in Soviet times would have been driven by a handful of objectives: maintaining the quality of the product, supplying the demands of the market, and keeping production costs down. For the most part, Soviet-produced vodka was of a very high standard, readily available, and affordable. The industry, under Soviet control, achieved this. It could be

said that under the innovative Soviet methodology of taut planning, that these aims were achieved, and they are exemplified by a limited product range; basic low-cost packaging; and a high-quality product. Furthermore, the production of vodka on the black-market suggests innovative production methods and component compositions.

A positive innovation performance might not necessarily be associated with an industry that maintains a high level of state control. However, innovative efforts are likely under the Soviet system. Although, once one considers the strict parameters imposed upon producers by the state - in terms of production costs and quotas i.e. taut planning - it becomes easier to rationalise the kind of innovation that the industry produced.

In contrast, the complexion of innovation in the contemporary Russian vodka industry appears to be structured on the foundations of intensified competition, resulting from the emergence of entrepreneurial activity. Intensified competition leads vodka producers to pursue a strategy based on cost leadership and/or quality, resulting in a conducive innovation strategy. Flavouring in vodka represents product innovation, resulting from the changing complexion of the vodka industry. However, due to the culture of vodka in Russia, pre-flavoured vodka has been fairly unsuccessful. Rather innovation is offset from the industry to the consumer, who would rather create flavoured vodka themselves at home.

6. Policy Considerations

On the basis of the aforementioned discussion, the following innovation policy considerations have been developed in attempt to ensure the maximisation of innovation performance for an industry operating in an economy that is enduring the transition process. It should be noted that these considerations have a broad spectrum of potential applications, and as such may require a degree of alteration, depending on the exact complexion of the economy to which it is applied.

Firstly, firms in a transition economy need to be as responsive as possible, in order to adapt to the dynamics of competitiveness in their respective industries and remain competitive themselves. Therefore, the state should actively encourage and communicate the benefits of an improved innovation performance.

Private enterprise needs to be encouraged; it is not enough to merely 'open-up' an industry to private enterprise. The state needs to establish incentives that will encourage entrepreneurial activity - it is through this that an industry will become more competitive, and in turn, innovative. The state also needs to limit the influence of monopolies, which create barriers to entry, and limits the innovative performance of the industry as a whole.

The role of the state in industry needs to be clearly defined: if the state is actively operating in an industry, it has two main options available: 1) The state could become an industry leader in innovation, setting a benchmark, and an opportunity for learning for other firms, *or* 2) The state could reign in its influence over the industry, privatise elements of its operations, and enhance the competitiveness of the industry as a whole.

The former option is initially most favourable, as it is a measure of influencing innovation directly by the state. It will also ensure a level of stability in the industry during its transition. However, as the innovation performance of the industry augments, the state may wish to reconsider its role and move towards the implementation of the latter option.

Investment from abroad - which results in a foreign presence in domestic industry - has the potential to drive-up competitiveness and innovation. Furthermore, the presence of foreign producers has the potential to bring new knowledge to an industry and creates an opportunity for domestic producers to learn. Foreign investment needs to be encouraged as part of a sustainable innovation policy.

Finally, governments should limit the capacity for corruption, as it is shown to damage the potential for innovation performance, and limit industry competitiveness. If governments are to harness the full innovative potential of an industry, it needs to level the playing field for firms by creating a series of legislative procedures that protect firms from corrupt practices. However, it should be noted that corruption is not as serious a problem in some transitional economies as it is in the Russian Federation, which ranks 119 of 167 in the 2015 Corruption Perception Index (Transparency.org, 2015).

7. Concluding Remarks

Referring back to the position of Schumpeter (1942), which argued that a monopolised market is best suited for fostering innovation, it seems there is relevant merit to this research; as under the Soviet system, there is evidence of innovation in order to keep production costs down; meet a standard of quality; and ensure adequate supply of vodka to consumers. There is also an argument to be made that the Soviet methodology of taut planning, is in itself an innovative practice. However, it appears that innovation under a monopolised system, particularly one as strictly enforced as Soviet Socialism, is limited largely by the restriction on private enterprise, which may allow for additional knowledge creation and subsequent innovation.

As the Russian vodka industry 'opened-up' along with the rest of the Russian economy, entrepreneurial activity, and subsequent competition that was previously absent, was able to emerge. In doing so, it seems that vodka producers had to look to innovate based on price and quality, in order to remain competitive in a market that was increasingly saturated. Furthermore, there may also be a degree of innovation based on product differentiation, as observed through the emergence of flavoured vodka. This refutes Schumpeter (1942), as the collapse of the state-dominated Russian vodka monopoly seems to have resulted in an eruption of entrepreneurial activity, as evident in the variety of vodka now available. In this case the work of Aghion et al. (2005), Vives (2008), Hashmi (2013) and Aghion et al. (2014) is further confirmed.

Further understanding of the evolution of innovation performance in transitional economies could be achieved through the utilisation of consumer's perspectives; the perspectives of industry professionals; or through the analysis of industry activity i.e. patents. These data sources create an opportunity for the contrasting of a state

controlled system against a liberalised system, in terms of their ability to foster greater levels of innovation performance. Through this contrast it becomes possible to re-develop a potentially more specific series of innovation policy considerations for transitional economies.

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