

## Introduction.

# Economic development in Russia

**S**tarting in the late 1980s, the Russian economy went through a painful transformation as it introduced institutions and practices associated with modern capitalism and market economy. Today, 24 years after the dissolution of the Soviet Union, the quality of the new economic institutions in Russia differs considerably from the vision advocated by the reformers of the early 1990s. The state still has a strong presence in the economy and “free market” mechanisms have not been a driving force of development. A façade of formal institutions of market economy conceals a reality in which the economy and politics merge in a complicated inter-play. Hence, mainstream economics and its dogmas can only provide limited insights on how the Russian economy actually works. Instead, other approaches can suggest viable pluralistic alternatives for studies of the contemporary Russian economy.

This section of *Baltic Worlds* contains one interview and six peer-reviewed articles devoted to the Russian post-Soviet economic transformation. The contributors were not confined to using a specific

methodology or theoretical approach and drew on disciplines such as political economy, economic sociology, financial economy, and political science.

The section opens with a peer-reviewed article by Anton Oleinik. He deals with the European countries’ lack of a united response to the 2014 conflict in Ukraine. He questions whether Russian power elites influenced the policy choices of EU member-states through the energy policy they put in place. Oleinik’s answer is that a constellation of interests of the European countries and Russia in the European energy market could define the

**“A façade of formal institutions of market economy conceals a reality in which the economy and politics merge in a complicated inter-play.”**

outcome. According to Oleinik, the Russian power elites’ strategy is to “wire” key European markets into Russian pipelines and to perform the functions of gatekeepers by providing access only to customers willing to further their interests.

**N**ext comes an interview with professor Andrei Yakovlev of the Higher School of Economics in Moscow. Yakovlev, a leading Russian economist, has a deep knowledge of the transformation of Russian enterprise throughout the post-Soviet time. In this interview, he puts the microeconomic perspective within a broad political economic context and evaluates the policy choices made by Russia’s political elites after the Arab Spring in 2011. Although he is quite pessimistic about Russia’s prospects, Yakovlev suggests that the new geopolitical situation and sanctions have created promising opportunities for the Russian economy. However, these opportunities can be used only if Russian elites achieve a new consensus regarding redistribution of economic rent.

In their article, Leo Granberg and Ann-

Mari Sätre provide a new perspective on economic and social developments in the small towns and villages of Northern Russia. Since the 1990s, these rural communities have struggled with the scarcity of economic resources and poverty. Based on long-term field studies and interviews in four regions, the authors suggest that local entrepreneurial initiatives can generalize trust and social capital. Their main conclusion is that such activities represent a type of moral economy, which cannot be described in terms of a rational market.

Olga Golubeva discusses the business climate in Russia from the perspective of Swedish investors. She based her research on the Business Climate Survey by Business Sweden, which was conducted in 2012 and 2014 among Swedish companies operating in the Russian market. Drawing on this data, Golubeva's main conclusion is that Swedish companies do not tend to abandon Russian market, notwithstanding such negative factors as corruption and increased political tensions with the West.

Susanne Oxenstierna analyses how the Russian leadership's pursuit of political goals has affected economic policy. Ideally, a comprehensive reform agenda would lead to better economic growth and improve the quality of institutions. Her main conclusion is that the lack of such an agenda starting in the mid-2000s has played a negative role in Russian economic development. After 2014, the tendency for the economy to slide into depression was reinforced by new factors such as geopolitical tensions, low oil prices, and economic sanctions.

Mi Lennhag used a comparative approach to study how ordinary Russian and Ukrainian citizens experience corruption in everyday discussions. Her research, which drew on interviews conducted in Kaliningrad oblast' and Ukraine in 2009 and 2014, enables her to show the

differences in citizens' anti-corruption demands. She also shows their attitudes toward the state's versus individuals' roles. Lennhag concludes that anti-corruption demands are strong in both Russia and Ukraine, but a more paradigmatic change took place in Ukraine after the events of the Maidan.

**A**lexander Radygin and Alexander Abramov in co-authorship with Maria Chernova investigate how compliance with financial regulation in Russia aligns with international trends in financial regulation and prudential supervision. In 2013, the Central Bank of Russia became a financial mega-regulator. Applying quantitative research methods, the authors found that the highly centralized integration of prudential supervision and regulation adopted in Russia does not take into account the level of institutional investors' development. This increases the risk of excessive administrative pressure being put on the non-banking financial sector and weakens its competitive environment.

**I WOULD LIKE TO** thank our authors, whose diverse research experiences enabled us to demonstrate that the Russian economic transformation is multidimensional. Many anonymous reviewers also contributed to this special issue. I hope that the Baltic Worlds' readership will enjoy the articles and be inspired to do further research on economic development in Russia and other post-socialist countries. ✕

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## Russian economy at the crossroads

“Business is not particularly concerned with democratic values but rather with the existence of stable rules of the game and secured property rights for investors.”

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# The price of opulence

## On a constellation of interests in the European market for natural gas

by **Anton Oleinik** illustration **Ragni Svensson**

**T**he question as to whether the preferences and behavior of power elites in the EU member-states are influenced by the Russian power elite by means of implementing a particular energy policy has not yet received a satisfactory answer. Journalistic accounts of this matter outnumber careful scholarly analyses. Specifically, a publication in *The Telegraph* blog section on European power elites' responses to the 2014 Russian military confrontation with Ukraine<sup>1</sup> set a stage for a lively public discussion without yet leading to more systematic studies.<sup>2</sup>

In my reasoning I will use the country as a unit of analysis. By country I mean its power elite – a group of individuals “in positions to make decisions having major consequences”.<sup>3</sup> A conventional definition of power says that the party in a position to impose its will on the other party despite the latter's eventual resistance has power.<sup>4</sup> The power holder changes the behavior of the other parties so they start to further the former's interests. If Russia manages to change the preferences and policies of European countries in a manner beneficial to Russia then de facto this country has power. In particular, a demonstration of Russia's power refers to some desirable reactions of the EU member-states secured by Russia to Russia's role in the 2014 military conflict with Ukraine. The EU member-states' unwillingness to impose severe sanctions on Russia serves the interests of the latter.

The purpose of this article is to explain Russia's upper hand in

relationships with EU member-states by the existence of a constellation of interests of Russia and the EU member-states in the European market for natural gas. The unveiling of Russia's power requires a re-examination of conventional perceptions of the market as a constraint on a power holder's discretion, namely in international relationships. Under particular circumstances that are arguably present in the European energy market (and in the national and regional markets in Russia<sup>5</sup>) the market becomes a pillar of domination instead of being a liberating force. Domination refers to the situation when power is exercised “repeatedly, systematically, and to the detriment of the dominated agent”.<sup>6</sup>

### Techniques of power

Force as a technique of power involves “the creation of physical obstacles restricting the freedom of another”.<sup>7</sup> In international politics the use of force amounts to a direct military invasion. Russia used its military force against Georgia (in 2008) and Ukraine while staying clear of relying on this technique of power in its relationships with the EU member-states.

Are the European countries coerced into adapting a softer position with regard to Russia's use of force against Ukraine? Coercion makes the use of force or the other negative sanctions optional. The coerced actor has a choice, however restricted this choice may be: either he or she obeys or the coercing actor applies negative sanctions.<sup>8</sup> Russia's willingness to cut natural gas supplies was demonstrated in January 2009 during unresolved payment disputes with Ukraine. Russia nevertheless values its reputation as a reliable natural gas supplier to the European Union and keeps repeating that it has never cut natural gas deliveries to its Western customers at will.

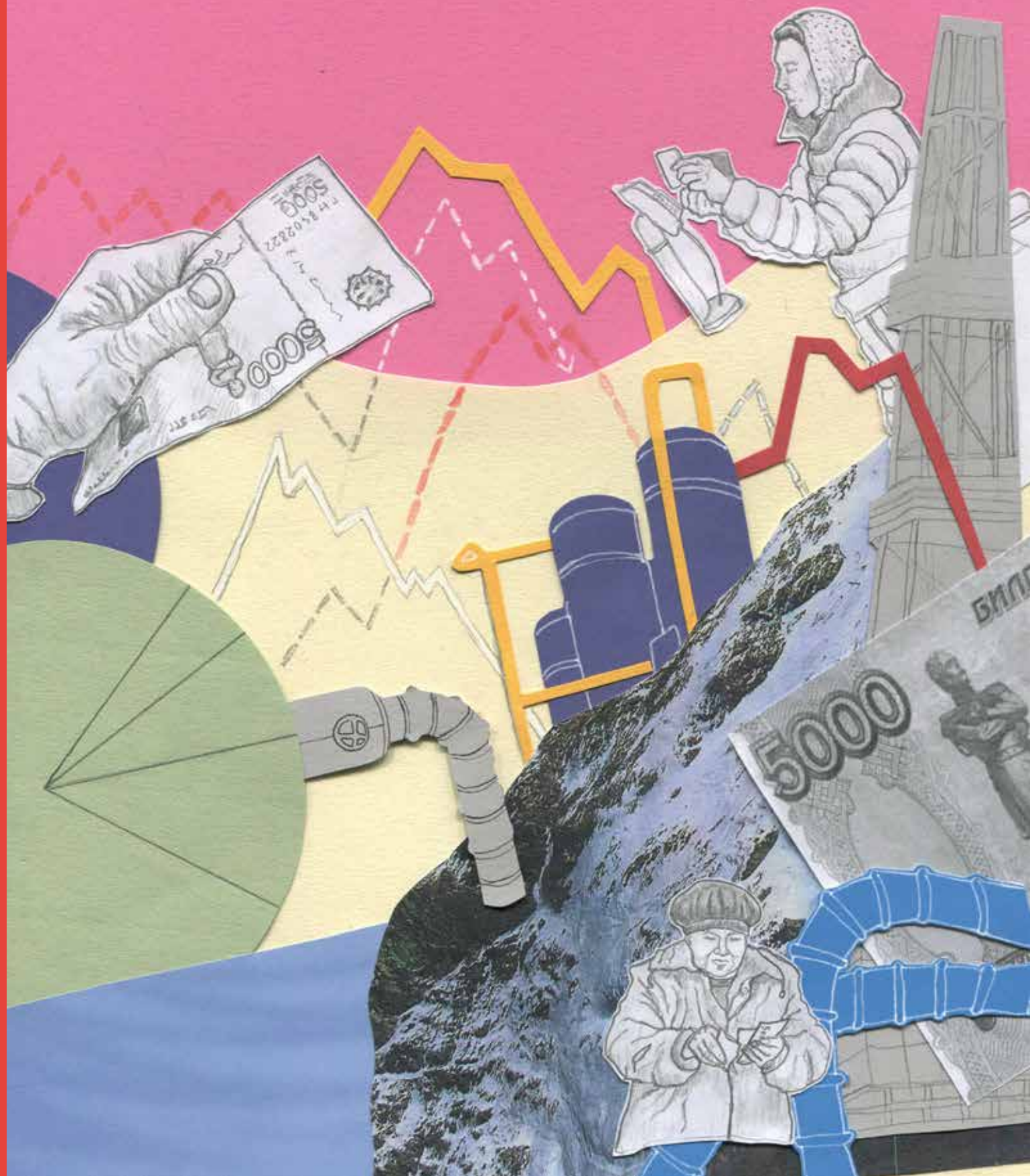
### abstract

This article discusses the reaction of the EU member-states to Russia's 2014 military conflict with Ukraine. The European countries' lack of united response and unwillingness to apply severe sanctions (restrictive measures) on Russia in a timely manner is attributed to a constellation of interests of the European countries and Russia in the European energy market. Max Weber's concept of domination by virtue of a constellation of interests and the related concept of the power triad set the general theoretical framework for the discussion. Statistical data on the energy dependence of the EU member-states on Russia inform it.

**KEYWORDS:** European energy market, Russia, Ukraine, military conflict, constellation of interests.







Maybe Russia manipulates the EU member-states? The technique of manipulation works through the limitation or selective determination of “the [manipulated] subject’s information supply, e.g. by withholding pertinent information not easily available to the subject from other sources”.<sup>9</sup> The Russian power elite has managed to impose tight control over the mass media, a key vehicle for disseminating information. This control was initially asserted at the national level<sup>10</sup> and, more recently, at the international level too – with the emergence of *Russia Today*, a global TV network heavily subsidized by the Russian government. Russia’s capacity to withhold pertinent information at the international level remains limited, however. *Russia Today* faces competition from a number of other, more established global TV networks.

Does Russia silence criticisms of its internal and foreign politics with the help of corruption? In this context corruption as a particular technique of power involves attempts to cause a decision maker to breach ethical and/or legal rules, which he or she is otherwise expected to follow, in the power holder’s interests.<sup>11</sup> In the case of corruption obedience pays: the corrupt decision maker receives a pecuniary compensation for deviating from the prescribed course of action. In contrast to force, coercion and manipulation, the dominated agent (the decision maker) has positive incentives for aligning his or her interests with those of the power holder (the agent offering the bribe). The use of corruption by members of the Russian power elite to promote their interests cannot be excluded.<sup>12</sup> There are precedents when the Russian power elite hired former high-ranking European officials offering them lucrative jobs, probably in recognition of their contribution to the promotion of Russia’s interests.<sup>13</sup> Nevertheless, the use of corruption can hardly explain the persistent and widespread refusal of the European countries to take a more critical and tougher stance on Russia’s actions. The mean 2013 Transparency International Corruption perception index for the EU member-states is 63.6 out of 100 (Russia has the score of 28; the lower the score, the higher the perceived level of corruption), which suggests a relatively low level of corruption in the operation of government.<sup>14</sup>

**THIS ARTICLE AIMS** to explore whether an often overlooked technique of power, namely, domination by virtue of a constellation of interests in the market, sheds new light on the European response to Russia’s internal and foreign policy, especially in its “near abroad” (Russia’s policy toward Ukraine is considered to be a case in point). Weber sets domination by virtue of authority, a well-researched topic in political sociology and political science, against domination by virtue of a constellation of interests without providing much detail. He simply notes that “because of the very absence of rules, domination which originates in

the market... may be felt to be much more oppressive than an authority in which the duties of obedience are set out clearly and expressly”.<sup>15</sup> I will focus more specifically on a possible constellation of interests of Russia and the EU member-states in the natural gas market.

The use of this technique of power involves reliance on the market but requires that the power holder creates structural imbalances that undermine the principles of free competition. The interests of the parties transacting in the non-clearing market form a constellation, which does not exclude one party having the upper hand and imposing its will on the others. If a rational agent acts under market constraints designed and imposed by

the power holder, then the former has an interest in accepting the latter’s upper hand. The dominated agent’s gain is positive. Its other alternatives prove to be poorer in the circumstances. A similar observation applies to an agent that does not deal with the power holder in a direct manner, but transacts with the first dominated agent. The second agent is dominated by the power holder as well, but also receives a positive gain. At the end of the day all the parties involved have interest in maintaining the status quo, i.e. the domination of one of them. The dominated parties are better off in not criticizing

the power holder than in challenging the latter and the system that it created.

**MY WORKING HYPOTHESIS** is that the stance of an EU member-state on the issue of the imposition of sanctions (restrictive measures) on Russia in the context of this country’s military conflict with Ukraine in 2014 will depend on the scope of the EU member-state’s reliance on natural gas supplies from Russia and the EU member-state’s position in intra-European trade. Natural gas supplies from Russia serve as a proxy for direct contacts between the power holder and the dominated agent. The indirect contacts are operationalized with the help of intra-European trade statistics. A country that does not buy natural gas directly from Russia may nevertheless benefit from having access to goods and services produced by the key customers of Russian natural gas. In other words, the interests of Russia as the key supplier of natural gas, its European customers and customers of products made with the help of Russian energy supplies are expected to form a constellation. This hypothesis will be formally tested using statistical data after I confront the concept of domination by virtue of a constellation of interests with the prevailing accounts of the European energy market at a theoretical level in the two next subsections.

## Markets versus empires

There are two popular approaches to theorizing the situation in the European energy market. The “Markets and Institutions”

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approach is derived from economic liberalism; it emphasizes the importance of energy markets and multilateral cooperation in international energy relations. The “Regions and Empires” approach is, in contrast, based on economic nationalist principles. It depicts international energy relations as a competition between blocks of states over the control of energy resources and energy markets”.<sup>16</sup> The first approach places emphasis on the invisible hand of the market and its role in resource allocation. The second approach highlights the visible hand of the people in control of governments, i.e. the power elites.

The scholarly discourse on energy policies in general and European energy policies in particular is currently framed in the “either-or” terms. Either the invisible hand of the market guides energy supplies or the visible hand of government or large corporations’ shareholders<sup>17</sup> takes precedence over the market play. The two hands operate independently from each other. As a matter of fact, the invisible hand of the market is believed to make the visible hand of government unnecessary and redundant and vice versa.

## “THE SOVIET UNION LEARNED HOW TO INCREASE ITS POWER AND TO BE LESS DEPENDENT ON THE MARKET.”

**PREDICTIONS AS TO** the situation in the European energy market made on the basis of the “Market and Institutions” approach sound overly optimistic. Even if the market falls short of the perfectly competitive ideal, it still has the capacity for self-corrections. The existence of a monopoly or oligopoly<sup>18</sup> (because the European market for natural gas has three key suppliers, Russian Gazprom, Norwegian Statoil and Algerian Sonatrach) does not necessarily mean that a monopolist or an oligopolist is able to impose his or her will on the other market participants.

*First*, all market participants win something: they receive a positive utility. Advocates of the “Market and Institutions” approach consider irrelevant the fact that a rent generated by a transaction might be unequally distributed.

*Second*, agents acting in an imperfectly competitive market develop a significant degree of mutual dependence. The European customers might depend on Gazprom, but Gazprom also depends on them. “Russia... find[s] [herself] substantially financially dependent on Europe, on the revenues generated by [her] export of oil and natural gas. Gazprom receives about 65% of its revenues from Europe, and directly generated 8% of Russian GDP in 2005”.<sup>19</sup> Mutual dependence causes a strategic convergence of interests of Russia and the European countries that even major geopolitical conflicts do not undermine. The European countries continued to supply Russia (in the shape of its predecessor, the Soviet Union) pipes, binding tapes, drills and bits even during the economic embargo following the Afghan invasion, and credit terms remained favorable.<sup>20</sup> Advocates of the “Market and Institutions” approach see it as a proof of the prevalence of “win-win” transactions in the market, however imperfect competition might be.

*Third*, in the conditions of restricted supply customers may

also decide to form a countervailing monopsony. Proposals to move in this direction are being actively debated in the European countries<sup>21</sup> without yet leading to practical changes, however. The existence of a bilateral monopoly limits structural preconditions for capturing the rent generated by a transaction and increases the importance of the strategies used by the parties involved. A party’s bargaining power refers to its ability to select the strategy of negotiation to maximize the share of the rent captured by the party.

Dowding differentiates luck and power in this respect.<sup>22</sup> Luck derives from structural factors that enable one party to impose its will on the others. Narrowly defined power refers to a strategic component. The strategic component of power involves selecting a strategy, a technique for imposing one’s will on the others.

Are Russia’s positions of power in the European energy market due to luck alone? I argue that the structural imbalances that currently characterize this market have to be made endogenous to our models. In addition to exploiting its position of power to its advantage, Russia also invests heavily in infrastructural projects that will

further enhance structural components of its power (namely, the *Blue Stream*, *Nord Stream* and *South Stream* pipelines<sup>23</sup>). And European countries seem to be willing to accept Russia’s continuous expansion in the European energy market.

The recent developments in the New Institutional Economics, the NIE, help better differentiate the market for natural gas from the other segments of the European energy market. The NIE add a third element to the dichotomy of the market and the organization (government being one of them): hybrid forms or relational contracting. “The parties to [hybrid modes of contracting] maintain autonomy, but the contract is mediated by an elastic contracting mechanism”.<sup>24</sup> Claude Ménard describes the contracting mechanism in the terms of authority, “that is, the conscious and deliberate delegation of the capacity to make a subset of decisions to a body in charge of coordinating”.<sup>25</sup> The important role that authority as a particular case of power plays in the operation of hybrids deserves mentioning. The visible hand of authority complements the invisible hand of the market.

Transactions between the key oil and gas companies in the European Union and Russia take the form of long-term contracts with in-built mechanisms of adjustments (“authority”) to external shocks. Attempts to increase the share of transactions on the spot market (these transactions involve no long-term commitment of any party) have been unsuccessful so far, especially in the natural gas market. Gazprom clearly prefers signing long-term contracts and strategic bilateral agreements with its European customers.<sup>26</sup>

**THE PREFERENCE** for relational contracting has an economic rationale. The New Institutional economists explain the choice between alternative forms, the market, the firm and relational



contracting, in the terms of asset specificity.<sup>27</sup> Specific assets cannot be redeployed without a loss of value. They produce the most when being employed only in a particular transaction. The specificity of assets has several components: site specificity (bilateral dependency results from location constraints), physical specificity (assets that use specific inputs such as customized computer programs), dedicated assets (large investments made for satisfying the needs of a particular customer), human assets (firm-specific knowledge and skills), brand name capital and temporal specificity (lock-in among parties involved in a technological process).<sup>28</sup>

The three first components are present in the case of the natural gas market (the degree of asset specificity in the market for oil is also high, but tends to be lower than in the natural gas market). Major natural gas fields in Europe are located on Russian territory, which makes its delivery to non-European markets more expensive (“site specificity”). The cheapest way to transport natural gas over the long distances is in compressed form through a large diameter pipeline (“physical specificity”). Its construction requires substantial investments (“dedicated assets”).<sup>29</sup> The development of the market for liquefied natural gas (LNG) also requires investment in specific assets (cargo ships and terminals).

**HYBRID FORMS INCORPORATE** power only in a weak form: they involve delegating a “subset” of decisions, whereas the rest of their activities are still coordinated by the conventional visible hand, i.e. the Russian government in the case of Gazprom. Parties maintain their autonomy and avoid relationships of subordination. So in the end, the concept of hybrids is of little assistance in explaining the eventual transformation of the market into a tool for enhancing power. We observe just the opposite: how authority as a particular type of power relationships helps maximize the output of specific assets in the market environment.

In contrast to the optimism of the “Market and Institutions” approach, the “Regions and Empires” approach leads to mostly pessimistic conclusions. Specifically, the latter approach predicts that power play will take place of market play. In market play, all parties involved win. In power play there is one winner whereas the others lose. The winning party achieves this outcome at the expense of the other parties.<sup>30</sup>

When applied to the European energy market, the “Regions and Empires” framework suggests that Russia will use energy supplies as a lever for securing unilateral gains, pecuniary or geopolitical. “From the perspective of ‘Regions and Empires’, the EU’s energy relations with Russia (and other third states) are understood as a geopolitical power struggle”.<sup>31</sup> Advocates of this approach produce numerous examples that, they believe, confirm its validity. The Soviet Union entered to the European energy market in the 1960s. Initially supplies of oil had an irregular character. For instance, the Soviet Union sold crude oil in exchange for various products that the Soviet economy failed to produce in sufficient quantities. In order to enter the market, the Soviet Union set ask prices sometimes two times lower than

the market price at that time.<sup>32</sup> In other words, the European countries had power over the Soviet Union as a new entrant to the European energy market. The situation later changed. The Soviet Union learned how to increase its power and to be less dependent on the market. Gaidar claims that the Soviet leadership in the 1970s actively participated in manipulating the European crude oil market by contributing to the prolongation of the “oil war” of Arab countries against the Western countries. Relevant operations of its ally, the People’s Liberation Front of Palestine, were instrumental in this regard.<sup>33</sup>

**THE SOVIET UNION** was also an exclusive supplier of oil and natural gas to the East European market (now a part of the European market). This country was able to impose additional – mostly geopolitical and political – conditions for receiving its oil and gas. For example, “in exchange for a guarantee on energy exports the Soviet Union may demand that Eastern Europe as a whole follows a cautious line on economic reform, more in tune with its own conservative program” or limits contacts with the West European countries.<sup>34</sup> At that time, however, the energy weapon played a secondary role in Russia’s repertoire of techniques of power, supplementing rather than substituting for force (military presence and control).

Russia, which succeeded the Soviet Union’s role as a key supplier of oil and natural gas to the European market, strengthened its position of power even further. Now this country imposes conditions for receiving its oil and gas not only on East European countries, but on West European countries as well. An analysis of voting patterns of a Parliamentary Assembly of the Council of Europe (PACE) resolution and a PACE recommendation criticizing Russia’s military conflict with Georgia August 2008 show that Russia succeeded in demanding that customers of its energy products take a more neutral stance.<sup>35</sup> The course of action chosen by Russia less than one year later, in January 2009, further confirms arguments of advocates of the “Regions and Empires” approach. Russia used cuts in gas supplies to Ukraine to strengthen its bargaining position in a dispute with this country.

The representation of the two prevailing approaches in the opposite terms certainly facilitates the understanding of the underlying rationale: the market and power relationships are the alternative foundations of the European energy policy. At the same time this black and white take on the issue does not allow a more nuanced picture: namely, can the two hands, the invisible hand of the market and the visible hand of government, operate in concert instead of one excluding the other? Speaking more practically, can the power elite of a large energy supplier transform the market into a tool for enhancing its power without renouncing the centrality of the market? If the answer to this research and practical question is affirmative, then a combination of the “Regions and Empires” approach and the “Market and Institutions” approach may provide a better fit to the observed patterns in European energy policies.



## Market-based empires

The concept of the power triad paves a way to considering both structural and strategic components of power within a single theoretical framework.<sup>36</sup> This analytical tool aims to highlight the eventual transformation of strategic components of power into its structural components and vice versa. Russia's efforts to embed the European natural gas market into an infrastructure that facilitates the further strengthening of its positions of power result from conscious choices made by the Russian power elite. The European countries' power elites also make conscious choices when accepting Russia's expansion: in 2011 Russia provided 21.23% of total energy supplies (natural gas, crude oil and

solid fuels combined) to the EU member-states, 3.44% more than in 2004 (Table 1). The awareness that a high degree of dependence on energy supplies from Russia can be and actually has been used by this country as a tool for promoting its geopolitical objectives is outweighed by some other considerations, apparently. The concept of the power triad helps unveil these additional considerations.

**THE POWER TRIAD** includes three agents: a gatekeeper (C), an agent enjoying a structural advantage (A), for instance, facing limited competition, and an agent transacting with A, who has no structural advantage (B). C plays a key role within the power

**Table 1: Energy dependence and its stance on sanctions on Russia**

	Coefficients of total energy dependence on total energy supplies (crude oil, natural gas and coal) from Russia, member-countries of the EU*			Average share of natural gas supplies from Russia in total net supplies	Average total trade turnover with Russia as a % of GDP	Open Europe's Dove/Hawk scale (5 refers to a strong support, -5 – to a strong opposition)
	2011**	2006***	2004***	2010–2012****	2010–2012*****	2014*****
Austria	23.433	22.312	21.351	60.00	1.7	-1
Belgium	20.081	18.295	16.75	0.30	3.1	4
Bulgaria	62.585	38.705	37.504	88.85	13.8	-5
Cyprus	0.05	n.a.	n.a.	0.00	12.4	-4
Czech Rep.	45.088	26.124	24.653	57.50	7.3	1
Denmark	6.613	5.635	5.67	0	1.7	3.5
Estonia	11.640	15.55****	13	100.00	26.2	4
Finland	44.081	36.896	40.882	100.00	10.2	-0.5
France	13.604	10.614	8.025	16.00	1.3	0.5
Germany	24.679	23.024	21.525	37.30	2.9	-1
Greece	25.968	23.634	23.678	55.60	3.0	-4
Hungary	44.759	51.089	48.699	79.90	10.8	-2
Ireland	0	0	0	0	1.0	3
Italy	17.647	17.145	22.336	28.85	3.1	-3
Latvia	23.396	37.28****	67.701	100.00	47.9	4
Lithuania	136.073	64.191	47.168	166.40*****	22.0	5
Luxemburg	3.958	n.a.	n.a.	24.10	0.4	-4
Malta	0	n.a.	n.a.	0	34.4	0
Netherlands	30.287	13.971	11.3	5.20	14.1	-0.5
Poland	26.318	30.361	27	58.60	7.7	5
Portugal	2.250	0.054	3.791	0	0.6	0
Romania	3.792	19.611	22.28	24.30	3.1	4
Slovakia	77.875	52.56	53.702	83.50	14.7	-1
Slovenia	8.039	6.475****	7.288	60.20	4.6	-3
Spain	10.174	10.968	9.235	0	1.0	-3.5
Sweden	22.858	11.269	8.288	0	2.6	3.5
United Kingdom	6.254	6.343	2.7	0	1.3	4
EU-27	21.23	18.72	17.19	23.43	9.37	0.33

Legend: \* The coefficient of dependence equals the sum of products of the share of a particular source of energy in total energy consumption, the share of import in its consumption and the share of supplies from Russia in its total imports; \*\*\*\* Data on crude oil are missing; \*\*\*\*\* including re-export.

Sources: \*\* European Commission, EU Energy in Figures: Statistical Pocket-book 2013 (Luxemburg: Publications Office of the European Union, 2013), pp. 165–219; Eurostat (<http://epp.eurostat.ec.europa.eu/portal/page/portal/eurostat/home>, extracted on July 9, 2014) and the author's calculations; \*\*\* Anton Oleinik, Market as a Weapon: The Socio-Economic Machinery of Dominance (New Brunswick: Transaction Publishers, 2011), p. 9; \*\*\*\* Eurogas, Statistical report 2013 (Brussels: Eurogas, 2013), p. 6; Eurogas, Statistical report 2012 (Brussels: Eurogas, 2012), p. 6; Eurogas, Statistical report 2011 (Brussels: Eurogas, 2011), p. 8; \*\*\*\*\* Open Europe, 'Divided we stand: Where do EU states stand on further sanctions on Russia?' (<http://www.openeurope.org.uk/Article/Page/en/LIVE?id=19876&page=FlashAnalysis> accessed July 10, 2014); \*\*\*\*\* Federal State Statistics Service. Rossiya i strany Evropeiskogo Soyuz – 2013 [Russia and EU member countries – 2013], Table 14.7 at p. 248 ([http://www.gks.ru/bgd/regl/b13\\_65/Main.htm](http://www.gks.ru/bgd/regl/b13_65/Main.htm)); Federal State Statistics Service. Rossiya i strany Evropeiskogo Soyuz – 2011 [Russia and EU member countries – 2011], Table 14.7 ([http://www.gks.ru/bgd/regl/B11\\_65/IssWWW.exe/Stg/14-07.htm](http://www.gks.ru/bgd/regl/B11_65/IssWWW.exe/Stg/14-07.htm) extracted on July 10, 2014) and the author's calculations.



triad. C erects barriers – technical, institutional, geographical or financial – to market entry. With their help C controls entry to the market. To get access to the market, A must accept C's conditions: either to pay the price of the entry ticket or to further C's interests in some other manner. In the exchange, A gets the privilege of acting with fewer competitors: only few of them manage to enter the market. Many (A'-type agents) saw their access to the market denied as a result of restrictions imposed by C. B enters the market without restrictions, but has to buy goods or services from A, who either charges a higher price in conditions of imperfect competition or demands from B other favors that further A's interests. It has to be noted, however, that B has an interest in buying goods or services from A since the available alternatives are poorer in the terms of their utility.

C benefits most from the existence of the power triad. C decides the number of A-type agents to be admitted to the market, maximizing the rent that he or she captures. The barriers represent a structural component of C's power. C's decisions with respect to the ratios of the number of A-type agents to the number of B-type agents and to the number of A'-type agents refer to a strategic component of C's power. A also captures a rent as a result of acting in the conditions of limited competition (a part of A's profits is subsequently transferred to C in compensation for the latter's gatekeeping). B buys goods and services that he or she would not otherwise be able to buy at a better price or to buy at all. C, A and B maintain their formal autonomy. Neither A nor B enters into relationship of formal subordination to C. C imposes his or her will on A and B "from behind the scenes". C's activities remain mostly invisible for A and especially for B (B does not enter in direct contact with C). As a result of this lack of formalization, A's and B's duties of obedience are not set out clearly and expressly, as observed by Weber.

C, A and B all gain from participating in the power triad, however unequal their gains may be. C's, A's and B's interests form a constellation in the market with restricted access, which lays the foundation for C's and A's domination by virtue of a constellation of interests. This constellation contributes to the strengthening of C's and, to a lesser extent, A's power. C's power within the power triad is embodied in two hands: the visible hand of the gatekeeper and the invisible hand of the market with structural imbalances created by the gatekeeper. A needs one hand, invisible, to impose his or her will on B. In other words, in order to make sense of how the power triad works, one needs to combine assumptions of both the "Markets and Institutions" approach and the "Regions and Empires" approach.

Compared with more conventional models of power relationships, the power triad may seem to some as an excessively complicated construct. For instance, Dowding insists that by

focusing on "a simple bilateral bargain between state actors and business" we could gain as much insight. According to him, the introduction of a third party into the model is simply unnecessary.<sup>37</sup> Do we really need to take into account all three actors, C, A and B, when discussing power reproduced and enhanced through the market?

If one considers "a simple bilateral bargain", then the set of options available to its parties remains an exogenous factor to the transaction. Dowding agrees that "changing the choice situation of people is... an important way of altering their individual and collective power" without showing how the choice situation can be subject to a bilateral bargain.<sup>38</sup> To say that we have the available options "by virtue of the circumstances", as Dowding suggests, is to acknowledge their exogenous character. The concept of the power triad aims to show how the choice situation can be changed and by whom. C, the gatekeeper, determines the choice situations of A and B. This concept also explains the acceptance of C's and A's

power despite the unequal distribution of gains from the transaction. Even B, whose gain turns to be the smallest, does not object to the existence of the power triad.

## The 2014 Ukrainian crisis

A study of the reaction of the European countries to the 2014 Russian military confrontation with Ukraine further illustrates the usefulness of the concept of the power triad. The crisis started after Ukrainian protesters in Kiev ousted Viktor Yanukovich, a pro-Russian president, from office in February 2014. Profiting from the weakness of the Ukrainian state at these turbulent times, Russia first seized Crimea and then started to support pro-Russian separatists in Eastern Ukraine (in the regions of Donetsk and Lugansk) supplying them with arms, including heavy, financial and human resources (Russia sent "volunteers" and military personnel to fight on the separatists' side).

Details of the Ukrainian crisis and its internal dynamics are of no concern here. I will concentrate instead on the reaction of the European countries to Russia's role in the crisis. One could have expected an immediate and strong condemnation of the violation of Ukraine's territorial integrity by Russia. *First*, Ukraine is geographically a part of Europe and has land borders with the four EU member-states (Poland, the Slovak Republic, Hungary and Romania). *Second*, one of the reasons behind the 2013–2014 Ukrainian protests refers to the desire for

**"THE BIGGER THE SHARE OF NATURAL GAS SUPPLIED FROM RUSSIA IN A COUNTRY'S TOTAL NET SUPPLIES, THE LOWER THE LEVEL OF SUPPORT FOR TOUGHER SANCTIONS ON RUSSIA."**



**Table 2: Summary of the result of the regression analysis**

Results of Statistical (Method = Enter) Multiple Regression to predict stance on sanctions against Russia in the first half of 2014 (Y) from Coefficient of total energy dependence on total energy supplies (crude oil, natural gas and coal) from Russia (Lg10), average share of natural gas supplies from Russia in total net supplies (SQRT), average total trade turnover with Russia as a % of GDP (Lg10), average GDP per capita in current US\$ (SQRT), average intra-EU27 trade balance (without raw materials) as a % of GDP and geographical location (dummies for common borders with Russia and Ukraine, for countries of Northern, Southern, Western and Eastern Europe), standardized (Beta) coefficients, 2010–2012.

Model	1	2	3	4	5	6	7
2011 coefficient of total energy dependence on total energy supplies (crude oil, natural gas and coal) from Russia (Lg10)(a)	0.031 (0.155)						
Average share of natural gas supplies from Russia in total net supplies (SQRT)(a)		-0.038 (-0.19)	-0.151 (-0.64)	-0.249 (-1.23)	-0.455 (-2.56)*	-0.533 (-2.22)*	-0.419 (-1.96)*
Average total trade turnover with Russia as a % of GDP (Lg10)(a)			0.213 (0.9)	0.193 (1)	0.098 (0.54)	-0.103 (-0.44)	-0.130 (-0.55)
Common border with Ukraine (dummy)				0.441 (2.32)*	0.276 (1.7)^	0.042 (0.22)	
Common border with Russia (dummy)				-0.09 (-0.41)	-0.025 (-0.14)	0.255 (1.24)	
Western Europe (dummy)				0.252 (1.02)	0.516 (2.37)*	0.185 (0.62)	0.211 (0.74)
Southern Europe (dummy)				-0.099 (-0.4)	-0.294 (-1.39)	-0.673 (-2.74)*	-0.799 (-3.34)**
Northern Europe (dummy)				0.805 (2.79)*(c)	0.875 (3.7)**(c)	0.297 (1.03) (d)	0.384 (1.42) (d)
Average GDP per capita in current US\$ (SQRT)(b)					-0.761 (-3.25)**	-0.824 (-2.49)*	-0.858 (-2.87)**
Average intra-EU27 trade balance (without raw materials) as a % of GDP(e)							-0.274 (-1.57)^
C (unstandardized coefficient)	0.127 (0.09)	0.485 (0.48)	0.104 (0.09)	-1.791 (-0.91)	7.808 (2.32)*	11.464 (2.78)**	11.577 (3.3)**
R <sup>2</sup>	0.001	0.001	0.034	0.588	0.740	0.568	0.585
R <sup>2</sup> <sub>adj</sub>	-0.039	-0.038	-0.046	0.436	0.625	0.376	0.431
F-statistic	0.24	0.36	0.425	3.876**	6.414***	2.956*	3.818**
Observations	27	27	27	27	27	27	27

Legend: ^ significant at  $\alpha=0.1$ , \* significant at  $\alpha=0.05$ , \*\* significant at  $\alpha=0.01$ , \*\*\* significant at  $\alpha=0.001$ . (c) with the Baltic states, (d) without the Baltic States (they are included in Eastern Europe).

Sources: (a) see Sources of Table 1; (b) World Bank. World Development Indicators (<http://data.worldbank.org/data-catalog/world-development-indicators>, extracted on July 9, 2014); (e) European Commission, Eurostat. Table ext\_lt\_intratrd ([http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=ext\\_lt\\_intratrd&lang=en](http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=ext_lt_intratrd&lang=en), extracted on July 14, 2014)

greater integration with the European Union.<sup>39</sup> *Third*, the Russian involvement undermined a principle that has historically underpinned the European geopolitical constructions, namely, the balance of Europe. “The balance of Europe primarily meant the impossibility of the strongest state laying down the law to any other state”.<sup>40</sup> *Fourth*, Russia’s role in the crisis highlighted the need for enforcing (as opposed to merely declaring) norms that restrict the use of force in international relationships (namely, Chapter VII “Action with respect to threats to the peace, breaches of the peace, and acts of aggression” of the Charter of the United Nations).<sup>41</sup>

**THE EUROPEAN COUNTRIES** responded by imposing individual sanctions (restrictive measures) on a number of mid-level Russian officials and leaders of the separatists.<sup>42</sup> So called “sectorial” sanctions, i.e. sanctions affecting Russian banking system and industries, were considered at a very advanced stage in the military conflict. The “sectorial” sanctions were not consistently and fully applied, however.

The issue of sanctions was a source of controversies and debates among the European power elites. Instead of producing a united and univocal response to Russia’s seizure of Crimea and her destabilizing role in Eastern Ukraine, the European Union turned out to be divided among a group of countries favoring a “soft” response and a group of countries supporting tougher measures against Russia. Experts of Open Europe, a European think-tank, labelled the former groups as “Doves” and the latter group as “Hawks” producing an ordinal-level assessment of the intensity of support for tougher sanctions on Russia (Table 1).<sup>43</sup> Can the variation in the level of support for tougher sanctions on Russia be explained in the terms of the European countries’ dependency on energy supplies from this country? Does the concept of the power triad shed additional light on this issue?

A power triad exists in the European natural gas market. Within this power triad, Russia, C, controls access to its pipelines delivering gas to the European customers represented by national energy companies. As a condition of access to a reliable source of relatively cheap energy (compared to the other sources), C expects that A will further C’s interests, pecuniary or non-pecuniary, including geopolitical. The European energy companies with privileged

access to the pipeline, A, have a structural advantage over the national companies with no direct access to the pipeline, A'. As a result, the national economies of the European countries with direct access to the pipeline get a competitive advantage over the other European national economies. A produces goods and services at relatively lower costs (the price of gas is directly or indirectly – via the price of electricity – included in cost calculations for most goods and services), which makes them more competitive in the European market. Consumers of these goods and services, B, benefit too: they buy products for a better price (compared with domestically produced goods and services),<sup>44</sup> all other things being equal.

C, A and B all receive a positive gain. Their interests form a constellation in the European natural gas market embedded in the network of pipelines either inherited from the Soviet era or built recently. In these circumstances C's power has both components, structural and strategic (the latter refers to Russia's efforts to set prices in a selective manner in relation to how a particular customer furthers Russia's interests and to promote new infrastructural projects that will further enhance its gatekeeping ability).

If the European natural gas market operates as the power triad so described, then several predictions can be formulated and empirically tested. Namely, the bigger the share of natural gas supplied from Russia in a country's total net supplies, the lower the level of support for tougher sanctions on Russia (in other words, A's and C's interests tend to be positively associated). Also, the bigger the share of natural gas supplied from Russia in a country's total net supplies, the more positive the country's trade balance (C's, A's and B's interests tend to be associated). B buys A's goods and services, thus a negative trade balance serves as a proxy for playing B's role.

**TO TEST THESE PREDICTIONS**, I ran several OLS regressions of a EU member-state's level of support for tougher sanctions on Russia on the coefficient of its dependence on total energy supplies from Russia, the share of natural gas supplies from Russia in net total supplies, the total trade turnover (export and import combined) with Russia as a percentage of GDP, GDP per capita, the intra-European Union trade balance without raw materials as a percentage of GDP<sup>45</sup> and several dummy variables specifying the European country's geographical location.<sup>46</sup> I used 3-year average values of the ratio-level variables (2010-2012) to eliminate possible fluctuations and the impact of the inauguration of Nord Stream's first line in November 2011.<sup>47</sup>

The European country's stance on the sanctions is used as a proxy for Russia's interests as C within the power triad. Only a non-pecuniary, geopolitical dimension of these interests is taken into account in my model. I operationalize the degree of the

European country's dependence on energy supplies from Russia through two variables, the aggregate coefficient of total energy dependence and the share of natural gas supplies from Russia. The higher their values, the more chances that a particular European country plays A's role within the power triad. The European country's trade turnover as a percentage of its GDP represents the other dimension of its economic dependence on Russia. It should be noted that of these three indicators of the European

country's economic dependence on Russia, the share of natural gas supplies refers to the most specific assets (pipelines, storage facilities and the other transport infrastructure) whereas the trade turnover relates to the least specific.

The intra-EU trade balance serves to operationalize A's and B's interests: A's interests if the particular country's balance is positive and B's interests in the opposite case. A's and B's interests have a pecuniary dimension in my model. A and B's motivation is pecuniary and their

choices rational in the circumstances. A control variable – GDP per capita – is also entered to test the assumption of A's pecuniary interests.

**TABLE 2 SUMMARIZES** results of the regression analysis. Models 1 and 2 show that, taken separately, neither the coefficient of total energy dependence nor the share of natural gas supplies from Russia explains the variation in the level of support for tougher sanctions on Russia. The addition of the trade turnover with Russia in Model 3 does not change the situation. Outcomes of the regression become statistically significant with the addition of several dummy variables specifying the European country's geographical location in Model 4: namely, the North European countries and the countries sharing land borders with Ukraine support tougher sanctions to a greater extent than the other countries. The entry of GDP per capita significantly improves the quality of the model (Model 5) and makes the impact of the share of natural gas supplies from Russia significant. The control variable, GDP per capita, "is discovered to be the mediating factor through which an independent variable [the share of natural gas supplies] has its effect on a dependent variable [the stance on sanctions on Russia]".<sup>48</sup> This finding turns out to be relevant to my argument about A's pragmatic interest in accepting C's power.

**THE UNCERTAINTY AS TO WHERE** to place the Baltic States (Lithuania, Latvia and Estonia) – some sources include them in Northern Europe, whereas the other consider them to be a part of Eastern Europe – led me to run regressions using two versions of the dummy variables for Northern and Eastern Europe. Model 6 is identical to Model 5 except in relation

## **“THE NATIONAL ECONOMIES OF THE EUROPEAN COUNTRIES WITH DIRECT ACCESS TO THE PIPELINE GET A COMPETITIVE ADVANTAGE OVER THE OTHER EUROPEAN NATIONAL ECONOMIES.”**



to the Baltic States (now included in Eastern Europe). The negative impact of the share of natural gas supplies becomes even stronger. At the same time the positive impact of sharing land borders with Ukraine almost disappears: the original relationship is “shown to be false through the introduction of a test variable”,<sup>49</sup> GDP per capita. In these circumstances I decided not to enter the two dummy variables for countries with common borders with either Ukraine or Russia in Model 7. Instead, I entered the intra-EU27 trade balance. This variable has a negative – and marginally statistically significant<sup>50</sup> – impact on the dependent variable. In other words, the European countries with a positive intra-EU27 trade balance tend to adopt a softer position on sanctions on Russia. A converts its privileged access to Russian gas pipelines into competitive advantages in the intra-European trade. B, a customer of A's products, has a negative trade balance. B buys more products from A, but receive relatively fewer benefits from the existence of the power triad than C and A. B-type countries tend to concentrate in Southern Europe: Italy, Spain, Portugal and Greece all have negative intra-EU27 trade balances. Model 7 explains slightly more than 43% of the variation in the European country's stance on sanctions on Russia.

## The price of comfort and opulence

In the final account, the hypothesis about the existence of the power triad in the European natural gas market turns out to be tentatively confirmed (it would be necessary to run more comprehensive tests using a longer list of indicators, especially with respect to B's interests, before making any definitive claims). Russia, C, provides European countries with relatively cheap natural gas. Compared with the other sources of energy (namely crude oil and coal), the market for natural gas can be manipulated relatively more easily since its infrastructure includes highly specific assets (pipelines and storage facilities) that may possibly be transformed into a structural component of power.<sup>51</sup> Russia's power elite seized this opportunity by developing a second component of power, strategic. The strategic component of Russia's power consists in getting the key European markets “wired” to Russian pipelines and in using the strategy of gatekeeping, i.e. providing privileged access to the pipelines only to those customers who willingly further the Russian power elite's interests.

The reaction of the EU member-states to Russia's military confrontation with Ukraine in 2014 is a case in point. The Russian power elite got what its members wanted, i.e. the refusal of the European power elites to impose tougher sanctions on Russia. The concept of the power triad shows that fears that Russia will arbitrarily cut gas supplies to European customers or, even worse, use military force against them have little basis. C has an interest in building and maintaining the reputation of a reliable supplier provided that A and B accept C's rules of the game. C has power by virtue of a constellation of A's and B's interests with C's interests. C does not “buy” or corrupt A in a conventional sense of this word. C simply changes A's and B's choice situation in such a manner that they pragmatically decide to support C's endeavors.

The concept of the power triad also suggests that it would be a mistake to explain the European response to the Ukrainian crisis in the terms of bilateral relationships only. The interests of European countries, including those outside the reach of Russian pipelines (at least so far), form a constellation. Focusing on bilateral relationships overshadows the fact that B-type agents, customers of goods and services produced by the countries with privileged access to Russian pipelines, lose in relative, but not in absolute terms.

Neither A nor B has an interest in changing the status quo, i.e. in taking serious steps undermining the power triad in the European energy market. In these circumstances the considerations of “mutual solidarity”<sup>52</sup> and even duty (the United Kingdom accepted the role of guarantor of Ukraine's unity and territorial integrity in 1994)<sup>53</sup> become irrelevant. A's and B's pragmatic interests turn to be more powerful drivers of their behavior. It means that the power triad will likely continue to exist in the European energy market. ✖

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- 30 The "Market and Institutions" approach can be described in the terms of "pure collaboration" games, whereas the "Regions and Empires" approach refers to zero-sum games. In the "pure collaboration" game the players win or lose together, having identical preferences regarding the income. The zero-sum game represents their opposite, see Thomas S. Schelling, *The Strategy of Conflict* (Cambridge, MA: Harvard University Press, 1960), 84.
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- 32 Egor T. Gaidar, *Gibel' imperii: uroki dlya sovremennoi Rossii* [Collapse of an Empire: Lessons for Modern Russia] (Moscow: ROSSPEN, 2006), 109.
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- 45 The distribution of these variables was visually inspected prior to regression analysis. This "eyeballing" suggested that the normality of distribution condition was not significantly violated.
- 46 Outcomes of Levene's Test of Equality of Variances show that the assumption of homogeneity of the variance in the dependent variable, the European country's stance on sanctions on Russia, is met for all the dummy variables.
- 47 Croatia joined the European Union in 2013, which explains its exclusion from the present analysis.
- 48 Earl Babbie and Lucia Benaquisto, *Fundamentals of Social Research* (Scarborough, ON: Nelson), 436.
- 49 Babbie and Benaquisto, *Fundamentals of Social Research*, 434.
- 50  $p=0.13$ .
- 51 The entry of the coefficient of total energy dependency into the regression models instead of the share of natural gas supplies from Russia shows that the latter variable has a weaker predictive power: the models' quality decreases.
- 52 Schmidt-Felzmann, "EU Member States' Energy Relations with Russia".
- 53 As per Budapest Memorandum on Security Assurances of December 5, 1994. Two other guarantors were the United States and the Russian Federation.

# The Russian economy at the crossroads

## Before and beyond the Ukrainian crisis

An interview with Andrei Yakovlev

by Ilja Viktorov

**A**ndrei Yakovlev is head of the Institute for Industrial and Market Studies at the Higher School of Economics in Moscow. His research on Russian industrial policy, corporate management, state-business relations, and the political economy of the Russian transition has garnered much attention, and Professor Yakovlev has an extensive list of publications in international academic journals. Ilja Viktorov met Yakovlev in Moscow in the spring to discuss Russia's economic development and its mechanisms and challenges. A poor business climate is commonly cited as one of the main systemic factors that impede Russia's economic development. Ilja Viktorov asked Yakovlev, first, to explain the fundamental reasons for this institutional disadvantage:

"The poor investment climate in Russia is deeply rooted in the price formation inherited from the Soviet economy. It also depends on the particular circumstances of the transition to the market economy in the 1990s. The fundamental reasons are closely interrelated with the rent-seeking behavior from both state agents and Russian business. Most of the business models developed in Russia since the late 1980s rested on rent-seeking mechanisms when quick and exclusive enrichment was secured for a limited number of insiders. Unfortunately, Russia experienced more opportunities for such rent-seeking behavior than most of other postcommunist economies. Historically, the planned economy, with its price distortions, lasted longer in the Soviet Union than in countries in Eastern and Central Europe. This means that the disproportion between higher prices on consumer durables and investment goods, on the one hand, and lower prices on raw materials, electricity and transport costs, on the other, was stronger in post-Soviet countries. This created an illusion that investment projects like huge industrial plants in remote places in Siberia and in the Far North were economically effective. As soon as the Russian economy was opened and foreign trade was quickly liberalized, exports of raw materials became a source for rent-seeking, simply because of the price gap on raw materials between the domestic and the world markets. The period of liberalized, uncontrolled export was very short, and a highly selective group special exporters started to control the lucrative export flows by the mid-1990s. This export mechanism was the main source of rent-seeking behavior and pursuit of wealth for economic and state agents in post-Soviet Russia."



Andrei Yakovlev, professor and head of the Institute for Industrial and Market Studies at the Higher School of Economics in Moscow.

Yakovlev continues:

“Paradoxically, the scale of the economy and the availability of abundant resources made the Russian situation worse than that of Central European economies. Here, the stakes were much higher, and the size of the pie to be divided was greater. From the business’s point of view, the potential gain from distortion of competition and violation of unclear rules of the game were higher in Russia. This in turn led to institutional distortions that accompanied the development of the nascent Russian market economy from the beginning. The business environment that emerged from this process was characterized by a lack of genuine competition and a violation of property rights.”

**Did the privatization of the 1990s play an important role in this negative outcome?**

“It certainly did. Privatization proceeded in different ways and was the result of complex arrangements and compromises between the old Soviet enterprise managers and the new Russian political elite. Boris Yeltsin’s privatization minister Anatoly Chubais and his team had the clear political goal of making privatization irreversible, so the state assets became private during what was, historically, a very short period – three to four years, in the early 1990s. This political goal was achieved, but at a price. These several years were completely lost in terms of economic growth since the new private owners were not interested in investments but rather mostly in asset-stripping and the subsequent bankruptcies of their companies that resulted. Only in the late 1990s did the owners start to think about development of their businesses in Russia.

“And there were also a third, very controversial part of the story, the loans-for-shares scheme, which put the most lucrative state assets under control of a handful of insiders, the future oligarchs. At first glance, this was better from an economic point of view, since these companies quickly underwent restructuring and started to grow, as happened in the case of Norilsk Nickel and Yukos. But there was

**“THE LOANS-FOR-SHARES SCHEME PUT THE MOST LUCRATIVE STATE ASSETS UNDER CONTROL OF A HANDFUL OF INSIDERS, THE FUTURE OLIGARCHS.”**

the other side of the coin, namely social injustice and the lack of legitimacy of this kind of privatization. Through the loans-for-shares program, these large companies were sold at a much-discounted price; they were practically given away. Unfortunately, the new owners had to learn the consequences of this lack of legitimacy when the Russian people supported the state attack on Yukos in 2003 and 2004. Strategically, Russian big business lost the battle because the population never trusted the new entrepreneurs and new businesses. This depended to a great degree on the dramatic drop in the standard of living for the majority of the population after 1991.”

**Yes, the situation was alarming in the mid-1990s. In 1998, the economic crisis altered the situation even more. But then, in the aughts, the standard of living started to increase again?**

“That’s true, but the population did not understand this to be a result of Russian capitalism’s development but rather as an outcome of Vladimir Putin’s rule. And that corresponded to the real state of affairs to the degree that his governments acted quite rationally by redistributing part of the national income in favor of the population as a whole. The narrow circle of Putin’s friends was never forgotten in terms of enrichment, of course, but the mass electorate was and continues to be the real social basis for Putin’s presidency.”

Professor Yakovlev adds that this situation is not unique to Russia; similar tendencies could be observed in autarchic regimes throughout the world, such as in Latin America and Asia. Such hybrid regimes restrict democratic institutions and freedoms but at the same time need to appeal to the population at large for their political survival, he notes. He returns to the Yukos affair: He suggests that the outcome of the Yukos affair was the key element of the new political-economic regime that gradually emerged under Putin in the two-thousand aughts. It was not only about the personal conflict between Mikhail Khodorkovsky and Vladimir Putin, but it also reflected a more fundamental conflict between the oligarchs and the federal bureaucracy over the control of rent flows. The top bureaucratic elite needed additional resources to support political stability by redistributing natural rent in favor of deprived regions and parts of the populace to compensate for the imbalances brought about by the initial economic growth that followed the 1998 devaluation. Yakovlev comments that, naturally, not all of these resources were used to support the population, but this moment was still a very important part of the story. Before the Yukos affair, the largest resource-rich companies rejected the sharing of rent flows with the state.

“Unfortunately, both sides in this conflict, Russian big business and the federal bureaucracy, demonstrated a very restricted mode of thinking. Russian capitalism was perceived rather as a marriage between the state and big business, a model, so-to-speak, of oligarchic capitalism similar to what existed in South Korea between the 1960s and the 1980s. The only difference concerned who would control the rent flows. The dismantling of Yukos meant that the federal bureaucracy won this battle. A new set of informal rules emerged that presupposed the presidential administration’s ultimate informal control over big business. At the same time, private owners were able to retain operative control over their corporations and were still permitted to receive a quite substantial part of the rent income. This model of institutional compromise brought about some stability and enabled economic growth during Putin’s first two presidencies. Foreign investments also started to flow into Russia. This is because business is not particularly concerned with democratic values, but rather with the existence of stable rules of the game and secured property rights for investors.”

**The global financial crisis and the Arab Spring of course had an effect on the Russian economy, and fears were raised among the Russian ruling political class. What did the global financial crisis demonstrate regarding Russian economic development?**

“The 2008–2009 crisis revealed that this post-2003 authoritarian model that resembled the South Korea of the period between the 1960s and 1980s did not work. The set of informal rules inherent in this model created a highly centralized system, the famous power vertical, that reacted quite poorly to the global financial crisis. The reaction to the crisis was delayed, the panic was not prevented; in terms of financial resources spent on minimizing the negative effects of the crisis, as well as the results these financial injections produced, Russia was one of the worst performing economies in the G20 Group. The 2008–2009 crisis reversed the trend of positive expectations of economic agents. The ensuing pessimistic stance continues to this day. The crisis demonstrated that those in power did not completely comprehend what was actually happening in the economy. This was dangerous, since it called into question the legitimacy of the Russian political decision makers. The latter understood it quite well; they initiated a new dialogue with the business and expert community which entailed, among other measures, discussions during 2011 of the Strategy 2020. This dialogue re-

**“BUSINESS IS NOT PARTICULARLY CONCERNED WITH DEMOCRATIC VALUES, BUT RATHER WITH THE EXISTENCE OF STABLE RULES OF THE GAME AND SECURED PROPERTY RIGHTS FOR INVESTORS.”**



sulted in a number of institutional reforms aiming to ease the bureaucratic pressure on the Russian business and entrepreneurial class, including the establishment of the Agency for Strategic Initiatives, the introduction of an entrepreneurial ombudsman, amnesty for entrepreneurs sentenced for economic crimes, and other initiatives that potentially would further the interests of Russian business.”

**Did these initiatives produce visible results?**

“Unfortunately, this tendency towards liberalization and creation of a new model of economic development was interrupted by the events of 2011. The street protests in Moscow did not actually play the most decisive role in this respect. It was rather the Arab Spring and its outcome that spread fear at the top of the Russian bureaucracy. The anti-Western stance that finally resulted in the aggressive media campaigns during the recent Ukrainian crisis first started in 2012 and originated in this fear. This change affected both foreign and domestic policy, entailed repressions against opposition, and finally left a very negative impact on the Russian economy.”

“The creation of the conservative anti-Western think tank, the Izborsk Club, in 2012, illustrates this tendency. Izborsk Club relied on the initial support from the Presidential Administration and united a quite broad circle of people under its umbrella, including some famous economists like Presidential Adviser Sergey Glaz’ev and Mikhail Delyagin, but also some radical anti-Western persona such as the writer Alexander Prokhanov. Unofficially, the first deputy prime minister, Dmitry Rogozin, is also affiliated with the Club. Their message is expressed in their Manifesto, and appeared on their website in January 2013, both in Russian and in English. This document is quite logical and straightforward. Its first main thesis is that during the next five to seven years the world will face the Third World War, started by global financial oligarchy, and directed against everybody, but first and foremost against Russia, because Putin was one of the few who attempted to resist the hegemony of this oligarchy. This provision is not discussed but presented as a self-evident truth. The second thesis deals with the mobilization of the Russian economy and society similar to the previous historical mobilizations under Peter the Great and Stalin. The rest of the document, including the practical suggestions, such as the reform of the state apparatus and so on, rests on these two provisions. Izborsk Club envisions Russia as a beleaguered fortress that would be in conflict with the rest of the world. This vision is actually not favored by the powerful, since until recently the Russian political and economic elites have been extremely pro-Western. They keep their money in Swiss banks, their children study in the UK or the US, and they do not wish to partake of the increased confrontation with the West, especially with Europe. The initial support that Izborsk Club received from the presidential administration eventually decreased. But the very fact of its appearance reflected both the fear of and search for new ideology inside the Russian political elite.

Professor Yakovlev suggests that what has happened during the last year, since the outbreak of the Ukrainian crisis, is historically unprecedented.

“Putin is de facto the Russian leader. His decision to unleash a period of open confrontation with the West challenged the fundamental interests of Russia’s ruling class that was and continues to be pro-Western. At the same time, this radical change has not so far entailed a radical change of the Russian political and economic elite. This is a contradiction that entails a possible inner conflict, and this conflict has not yet been resolved. That is why I would claim that Russia is currently at a crossroads.”

**Is there any feasible liberal alternative that would compete with the ideologies advocated by such think tanks as the Izborsk Club?**

“Unfortunately, the liberal expert community has so far not been unable to formulate something new that would appeal to Russian society. The 2020 strategy was in reality not a strategy at all, just a compilation of some ideas and policy measures. Russian liberals continue to reproduce the old visions about democratization, liberalization, and the like, rooted in the 1990s political reality. These visions are correct in and of themselves, and many effective economies in the world are based on these values. But the probability that all these concepts can be realized in Russia in the coming years, or even decades, is almost non-existent. This means that the liberal expert community should think about the formulation of alternative models that could be reconciled with the current political, social, and economic realities in Russia. It is clear that the Russian population supported the Crimea accession in 2014.

**“REAL PREREQUISITES FOR THE DEVELOPMENT OF AUTHENTIC DEMOCRACY WILL NOT EXIST FOR MANY YEARS. INSTEAD, THE REAL CHOICE IS BETWEEN STATE-LED AUTHORITARIAN MODERNIZATION AND CHAOS.”**

Those in power who started this wild propaganda in the state-controlled media, they use this public mood to receive social and political support.”

**THE PROBLEM, ACCORDING TO** professor Yakovlev, is that the model of liberal capitalism attempted in Russia in the 1990s promised great opportunities and freedoms for the majority. In reality, however, only a tiny minority could enjoy these freedoms and use those opportunities. This is one of the reasons why the anti-Western mood among the Russian population started to grow as early as in the 1990s, especially during the war in Kosovo, he notes. And the liberal reforms of the 1990s are closely associated with Western influence.

“There are objective reasons for the current propaganda. The Russian ruling class did not invent this mood; they just used it for political mobilization purpose.”

He underlines that it is very important to understand that Russia does not currently face an alternative between democracy and authoritarianism.

“To be realistic, real prerequisites for the development of authentic democracy will not exist for many years. Instead, the real choice is between state-led authoritarian modernization and chaos. It is crucial that the Russian elite achieve an inter-elite consensus about informal rules of the game, about redistribution of rent flows, to make the alternative of the authoritative modernization feasible. This consensus should rely on a broader coalition of interests, beyond the federal bureaucracy, oligarchs and the security services, and include representatives from the middle-level business sector and public sector alike. The character of anti-Western media propaganda and its cynicism, the dramatic ruble devaluation in December 2014, and the killing of one of the leading oppositional politicians, Boris Nemtsov, just outside the Kremlin in February 2015, among other things, have demonstrated that the current political and economic system in Russia does not work properly. The alternative, chaos and disintegration of Russian society, is quite realistic.”

**The negative consequences of the Ukrainian crisis in terms of sanctions and counter-sanctions are currently being widely debated in academic literature. Can you identify any positive effects for the Russian economy since the start of the sanctions?**

“It is beyond question that the isolation entails great challenges; those are apparent to everyone. At the same time, this new situation provides additional opportunities that should be used by Russian business. Take the example of the Russian counter-sanctions of the food embargo. It might seem ridiculous, that we’re just punishing ourselves with it. Yet the embargo provides new growth opportunities for Russian agriculture, and the businesses involved have started to make quite good profits from it. The recent dramatic ruble devaluation makes Russian goods even more competitive in the domestic market. High-quality cheese, which previously was mainly imported from the EU, was almost absent in Russia before the counter-sanctions were enacted. However, I believe that quite soon, probably in one to two years, high-quality Russian cheese will appear, because there is a strong demand for it. After the 1998 ruble devaluation, it was impossible to buy yogurt in Moscow, because until the 1998 financial crisis all yogurt was imported from Germany. Yet the demand from the population led to the emergence of reliable Russian yogurt producers, and since then we have no shortages of this particular product. Such effects could be potentially used for economic development and growth. However, the current political uncertainty may impede the development of these positive consequences. In a number of branches and industries like metals and chemicals, Russian entrepreneurs make substantial profits due to sanctions and counter-sanctions. Yet they face a dilemma: to invest these new profits to expand their businesses, or to convert them into foreign currency and withdraw them from Russia to offshore accounts. That is why the capital outflow from Russia was as high as USD 150 billion in 2014.”

**“IN A NUMBER OF BRANCHES AND INDUSTRIES LIKE METALS AND CHEMICALS, RUSSIAN ENTREPRENEURS MAKE SUBSTANTIAL PROFITS DUE TO SANCTIONS AND COUNTER-SANCTIONS.”**

**THE POST-CRIMEAN** political reality made the 2014 changes irrevocable, according to Yakovlev. It is apparent that any full restoration of the pre-2014 relations between Russia and the West is unrealistic, he notes, and predicts this to be true for the foreseeable future:

“The current situation with Russia’s economic isolation will persist for many years, probably decades, and it does not depend on any particular person, Putin or somebody else, occupying the presidency. We need to learn how to live in this new situation and to formulate new economic strategies based on the new reality.” ✕

Ilija Viktorov, PhD, researcher, Department of Economic History, Stockholm University.

# Agency & development in Russia

## Using opportunities in a local context

by **Leo Granberg** and **Ann-Mari Sätre**<sup>1</sup>

**A**fter the dramatic transformation and collapse of economic structures in the early 1990s, all progress in the Russian countryside and small towns seemed to come to a standstill. Society was frozen in a state of collapsed economy and abandoned former production sites, where one could see ruins of buildings which were under construction in the 1980s and never finished, sport fields which could no longer be used in their original function – sad memories of the Soviet empire. In metropolises and central parts of regional capital cities, the modern market economy was already progressing and state funds were used to polish their appearance. In the countryside nothing similar happened; agriculture was not taken into the hands of farming families after the *sovkhozes* collapsed, buildings were not renovated, roads not reconstructed, and garbage was not collected and transported out of villages and towns. Several municipal leaders and local experts were asked for their explanation for this situation as part of the Ladoga Initiative project in 2012.<sup>2</sup> Passivity was recognized by many interviewees to be general in the countryside and some of them gave as the reason the ‘*kolkhoz* mentality’<sup>3</sup> or ‘consumerist attitude’ among the rural population: “The majority of the population occupies the consumerist position: if we have a government, it should provide us with this or that in our district.”<sup>4</sup> However, at that time signs of change were also noted in rural areas and small towns: new buildings, new-born children, modern guest houses and cafés.

The aim of this article is to list and analyze different types

of local action in the light of case studies in four regions in Russia. Our focus is a part of the wider question of the role of people at the local level in social change. We examine whether ongoing local activity is leading to local and wider development in Russia. For this purpose we divided action types into two main categories: Coping with everyday problems is aiming to survive from one day to another, while strategic agency is attempting to change the situation in qualitative sense. On the basis of our material we later added the third category to describe activity which does not lead to any direct personal benefits but facilitates the emergence of common goods such as meeting places and sport fields, among others.

The writers of this article have studied local development in Russia since early 2000, and since 2012 have started explicitly to analyze different actions of local people aiming to improve their lives. In some places we have followed the development systematically every year and in other places less frequently. We hope to identify such tendencies that could increase our understanding

of what the situation might look like for a large section of the Russian population.

In order to understand what is happening now in Russia, one important starting point is to identify the basic nature of Soviet economic system. It has been defined by Kornai and Davis as “economics of shortage”,<sup>5</sup> with dramatic differences between priority and non-priority industries<sup>6</sup> and these features still seem to have a strong impact in Russia after socialism.<sup>7</sup> Also, the writers find the institutional approach useful as developed

### abstract

The writers study the effects of agency in relation to the institutional structure in Russia. Different types of action in Russia aim at reaching better livelihoods and living conditions. The study is based on qualitative interviews in small towns and villages in four Russian regions. Actions by local inhabitants, organizations and local administrations are studied. Action types are divided into three main categories: Coping with everyday problems aims to survive from one day to another, while strategic agency is an attempt to change the situation in the qualitative sense. Thirdly, action may facilitate collaboration within the local community. All three types are based on individual initiatives and capacity as well as on different political programs. The relation between agency and local development is discussed. Interpretations of development are connected by qualities like emancipation and empowerment of individuals, generalized trust and social capital, as well as equity and democracy.

**KEY WORDS:** Russia, other Russia, agency, local development, TOS.

**Table 1: Examples of different types of action in Russia in the 2010s**

With whom?	Coping	Facilitative Action	Strategic Agency
Individually and with family	Plot farming Taking extra job		Education Entrepreneurship Migration work
Informal groups and voluntary organisations	Borrow from a neighbor	Foster family club Cultural house	Entrepreneurs' club
State	Getting support from social worker	Funding for building a village house	Program for young specialists Foster family program

by Douglass North<sup>8</sup> and others, differentiating between formal and informal institutions. However, the question of agency is partly open in this approach. Amartya Sen's<sup>9</sup> (1984) capability approach, originally worked out in studies about developing countries, is helpful in this respect.

## Local society and "other Russia"

Russian local society is the object of centralized state and top-down planning and control by authorities. It is also a recipient of the patriarchal cultural heritage, the successor to the patriarchal society<sup>10</sup> of the past. The centralized structure of society has often left local people facing a deficit in relation to their basic material needs, which is precisely the reason why the local population has been forced to act locally from time to time to solve urgent problems of livelihood. However, formal civic organizations have been under pressure before, during and after socialism and therefore networking in Russia is based less on formal associations and more on personal relations than in Western Europe.

Today, local authorities in Russia bear an increased responsibility for job creation and survival at the local level. This is one effect of Russian reforms and has been supported by a new law on local government from 2006 and various national programs for local development. In effect this also means that it is now up to the local level to find their own ways to deal with problems of development. The local measures are developed against the background of socio-economic change. The present paper is based on material from Northern and Central Russia and aims to highlight some development trends in these regions, first and foremost in "other Russia". "Other Russia" refers to: society outside of political or business elites and high priority sectors of economy, such as energy production, international relations and the defense industry.<sup>11</sup> Economically, the local societies studied are dependent in different ways on local resources. Culturally people are excluded from high politics and national decision-making on distribution or redistribution of the nation's economic resources. Many of them experience the feeling of being an outsider and a lack of interest in politics. This research also studies otherness in the context of transition. "Other Rus-

sia" refers to local people in low-priority sectors, having to adapt themselves in the transition process.

Therefore, although the places studied offer little access to profits from priority branches, these are places with a relatively high level of freedom in terms of interference from the central level: 'You just have to be active and try, and try again, not to let bureaucracy get you down'.<sup>12</sup> Sometimes decentralization without allocation of resources from the central level is referred to as centralization, therefore in fact arguing that local space has diminished. In the present paper we pay attention to the opposite tendencies. There are now new possibilities for individuals and local firms thanks to an access to resources, along with central funds for local development and social programmes, to which the local level can apply for resources. We will argue that from time to time a space for development opens up. Specifically, the aim is here to analyze possible strategies at the local level to benefit from such openings and to raise the quality of everyday life in other Russia.

The situation in local societies in 2002–2009 was characterized by job losses and outmigration of the younger generation. Governmental subsidies to rural areas were inadequate and local authorities did not have the resources to support local development. Few civic associations were found at local level (female clubs being most remarkable exception), and few individual people were socially active. Changes to local governance were under way and have been implemented since 2006.

New local governance seemed to contribute to the changing situation. Another part of the picture are the state programs, as described later in this text. We noticed during our field trips after 2010 that the degree of activity by local administrations and their subordinate levels varied considerably. In some administrations, activity was rather low, while others were trying to take part in as many programs as possible. One community leader calculated that they take part in 54 programs.<sup>13</sup>

Actors in local administration have different backgrounds. In one urban village the former head of police was in charge. He was able to mobilize local entrepreneurs to contribute the required materials for renovating local roads, for repairing the roofs on the house of culture, for the construction of two ponds and for the building of new private houses.<sup>14</sup> In some other places women in administrative positions, with skills to write applications, created new possibilities.<sup>15</sup> There was also a difference between communities in terms of their experiences of external support and participation in international projects.

## The Russian state's active role in social welfare

At the end of the 2000s, the Russian Federal State started a large-scale program to reform social structures, called "National Priority Program", or "Presidential Program." The program has been implemented since 2007 and is composed of four main areas: health, housing, education and agriculture. Many parts of the program concern the countryside and small towns. The worrying health situation and decreased life expectancy (in 1990–2002, from 68 to 59 years for men), the need for new and





A new school bus, financed from presidential programme, a village in Archangelsk oblast.



Village road in Archangelsk oblast.

repaired houses as well as the school system, teachers' living conditions, children's school transportation etc. were addressed by state's new initiative. Even if agricultural programs were developed mainly for large-scale agriculture, they also included support for small farming and included opportunities to improve socio-economic conditions in rural communities.

These programs have a large number of sub-programs, such as "Sustainable development programs of rural areas" (2008–2013 and 2014–2020) and "Social development of rural communities till 2013".<sup>16</sup> Some more concrete examples of tasks in these umbrella programs are: to encourage non-agricultural activities in rural areas; to improve housing conditions for people living in rural areas, including young families and young specialists; to develop social and technical infrastructure; to arrange pilot projects; and to grant support for initiatives to ameliorate living conditions.

Funds are promised, among others, to local needs. The question of implementation remains: to what extent do these plans really have an impact at local level.

## Gathering local experiences of getting out of poverty

The empirical data of this article is based mainly on interviews made 2012–2014 in villages and small towns in four Russian regions. A total of 151 semi-structured interviews were recorded, while another 27 semi-structured interviews were unrecorded during eleven separate field trips. The original purpose and course of interviews varies slightly, because they are connected to one of two different projects. One set of interviews (45 recorded and 20 unrecorded interviews) is connected to monitoring of long-term results of a development project by the Swedish International Development Agency (SIDA) in the Archangelsk oblast' (region) in the early 2000s. Another set of interviews (43 recorded and seven unrecorded interviews) was made to test the results of a rural policy experiment: the Ladoga Initiative in the Republic of Karelia and Leningrad oblast' (region) 2011-13. The main set of interviews focused explicitly on local experiences of

getting out of poverty; the data was collected first and foremost from Nizhnii Novgorod oblast' (63 interviews) but also in the course of interviews in other regions.

Interviewed persons were chosen, with the exception of Ladoga Initiative, applying the snowball method, firstly on the basis of professions (civil servants, entrepreneurs, local administrators) and recommendations concerning active persons or such persons who might be able to inform about local development, as well as persons working in jobs where they assist others in one way or another. In addition to this data, our earlier data from 2002–2011 and the newest data from March 2015 also give background for our considerations. Observation and informal discussions are also used in all regions. In Karelia, focus group meetings were a part of the field research.

To study this question, the following section shows a typology of local action, after which the results from the field research are presented. Then, action targeted to getting out of poverty is analyzed in Nizhnii Novgorod oblast'.

## Typology of action: copying and solving

The data collected shows three main types of action which local people take, each type with different consequences for their personal well-being and for local development. The two main types of action are coping and (strategic) agency. In principle, coping is a reaction to every-day difficulties, the consequences of poverty, by low-income people who are trying to overcome their daily difficulties but have no prospect of escaping their situation. Agency refers here to activity which is at least trying to find a permanent solution for daily troubles, to raise incomes and/or reach a better life quality.

In the Table 1 a third possibility is also marked, which contributes but does not give a direct solution to the actors' situation. Facilitating communication and collaboration, e.g. through the creation of common meeting places, refers to action which produces social capital, or which creates favorable circumstances for producing social capital. This type of action may increase

future opportunities for strategic agency. Taking an example from infrastructure, when a village community builds a cultural club, the inhabitants get a public space to meet each other, to communicate and to get advice from each other for individual efforts, as well as an opportunity to work together to plan some joint efforts to improve their lives. The same space might be used to arrange training courses, to assist some of them to find ways out of poverty.

For individuals, the most common strategies of agency are studying, starting a business and changing work. Studying is typically a next-generation plan: Parents and grandparents in Russia do often much to arrange an opportunity to study for their children and grandchildren. Establishing enterprises has been difficult, but possible, for some individuals. When successful, it puts an end to the family's poverty. The Russian labor market still follows the old Soviet track of relatively safe jobs and low salaries.<sup>17</sup> In priority industries and in Moscow or other metropolises much higher salaries are possible, making *vakhtovy* method, a period of high-salary work away from the home settlement, a common method of raising material living standards. State programs can be used for agency among others by teachers, who may get generous assistance towards arranging housing in rural settlements and small towns after their academic studies. The third form of strategic agency is networking and collaborating. A new form of this agency is to establish a local TOS, which we will return to later. In the following we take a look at the effects of the SIDA and Ladoga Initiative local development projects.

### Enterprises as outcome of the SIDA project from 2002

The Swedish International Development Agency, SIDA, implemented a development program in three communities in Archangelsk oblast' in early 2000s.<sup>18</sup> The goal for this project was to help individuals to start their own businesses in a local context in Russia. 15 persons took part in this project, which involved education in business development, including assistance in developing business plans in 2001, law, and a study visit to Sweden, where they visited individual entrepreneurs within the same business sphere. This project gave training for local people to start an enterprise and also included a many-sided information exchange on regional level. An outcome of the project was that some individuals succeeded in starting small enterprises.<sup>19</sup> In 2014, three of the women were still running their businesses, although two of them in their daughter's name. One of the men, who had been able to set up a Swedish-Russian timber-cutting firm in 2003, was out of business in 2008 but back again in 2012. Some of the others who had tried were running their businesses without being registered. Others could use their experiences in administrative positions and, naturally, some others did not succeed. Three of the women had engaged in local politics, of whom in 2014, one was a vice-mayor in one of the communities and another was a head of administration at the lowest political level in another community. A longitudinal follow-up study gave evidence of the importance of Soviet experiences for local women as a kind of school for entrepreneurial capacities to work



The building of a guest house, an example of TOS-project in a small village in Archangelsk oblast.

in non-priority industries like tourism, food production and the garment industry.<sup>20</sup>

SIDA's project clearly demonstrated that local agency is possible in Russia, even in a small, peripheral community, and that there are local people who are willing to catch the opportunities when they get access to the know-how and small resources needed to start their activity. Small seeds in the sand have in some places led to further flourishing in the local sphere in mutually enforcing processes of development. The project had another, unexpected consequence, namely, it was the spark that started TOS activities in the Archangelsk region.<sup>21</sup>

### Active civil society during the LADOGA initiative 2011–2013

A Finnish university department, Ruralia Institute, ran a project with Russian partners in Ladoga area 2011–2013. The project was part of the EU's "Neighborhood Program" (ENPI) and was funded by the EU and Russia. The project aimed to experiment with the LEADER approach. LEADER is European Union's main means of rural development. It is ideally based on local bottom-up initiatives, which are supported in their development into small-scale projects. This process is steered by setting up a local development program: the priorities of each program are settled in village meetings and put together by a district level LAG (Local action group). For the Ladoga Initiative a Local Initiative Group (LIG) represented the local rural population and its composition followed the partnership principle. Partners were from administration, entrepreneurs, and local people and their groups or NGOs.<sup>22</sup>

The projects got minor funding for material needs, and nothing for salaries. Funds were directed during 2012 to 30 local projects, contributing some or all of the finance required to build or renovate seven children's playgrounds, three sport



A new playground, built by a TOS group, central village of rural community in Archangelsk oblast.

fields, a village sauna, a museum roof, and two club houses. Some projects organised cultural events and the collection of local historical memories, and also developed a brand for local handicraft makers.

As mentioned, some Russians we interviewed believed in the passivity of local population as one of the reasons of weak rural development. Western scholars and opinion leaders, on the other hand, tend to underline the weakly developed civil society in Russia, which is often indicated by the low number of NGOs.<sup>23</sup>

In this project, however, the local civil society worked well during project activities. A good number of active people were found to lead the mini projects, as well as many more participants to plan and work on voluntary basis to implement them. The most active persons were school and kindergarten teachers and cultural workers. Participants were more often women than men, and partners for projects were found both among local entrepreneurs and in the local administration.<sup>24</sup>

Independently of the project plan, the funding became a problem when EU and Russian book-keeping practices did not fit together. The projects reacted to the problem in varying ways; some were stopped until the solution was found, others prepared to finalize the project rapidly after funding and some even organized the work and collected small cash funds from the local population. In this group was a children's playground, where volunteers cleared the playground on Saturdays and made play equipment for children from trees and rubber wheels. The coordinator told us that in Russia, they are used to problems with funding.<sup>25</sup> In this case civil society was strong, even if not permanently organized. In another case, an ice skating area was built in a small town by the local school. Funding only covered part of the cost; the other part was received through volunteer work. Interviewed activists stated that they were surprised that funding came from EU; later they applied more funding from the Russian

authorities. According to the project leader, the project led to a sense of empowerment, increased self-confidence and activation of the people involved. A year later, many plans around this skating area were implemented and lively sporting activity seems to be emerging in the area.<sup>26</sup>

## Effects on entrepreneurship, social capital and integration

In the EU and SIDA projects bottom-up activity had a strategic role. Local activists made proposals for the projects; they also ran the local projects themselves. They negotiated with municipal and district authorities on the rights to use certain areas for a playground or sports field, or which building they could rent for the purposes in question.

The main priority of SIDA's project was to improve livelihood among others by creating entrepreneurship; one LEADER mini-project also supported the local entrepreneur (hair salon). In four cases out of fifteen, the entrepreneurs succeeded in making the breakthrough and the side-effects on the local environment were clearly positive.

Some of those involved in the SIDA-project contributed to local development by helping others to start their own businesses or in other ways, promoting an improved quality of life through activities at the House of Culture and the like.

Most Ladoga-projects created common goods. Children's playgrounds and sport fields and the renovation of cultural clubs and museums create public space. It is an important common good which facilitates face to face communication, leading in positive cases into increased trust and social capital among local inhabitants and potentially producing empowerment on individual level. Also, negative aspects emerged – like breaking the play equipment – and the overall outcome depends on how successfully such behavior is handled and corrected.

Several projects worked on identity. Grandchildren gathered their grandmothers' memories; a symbol for local producers were developed; the local museum's roof was renovated. And of course sports fields support identity formation. A sense of local identity is an important antidote to frustration when outmigration and unemployment have been part of every-day life for years. It may also support processes of empowerment.

## Russian development policy and federal state funding

Russian Federal funding has been flowing down to local level in several ways. Over a period of more than five years, building activity has experienced a boost in many small localities, including family houses and larger buildings for veterans and workers. A lot of new houses have been finished, and still more renovations are under way. Also, building areas on e.g. former state farm land is being planned. Roads and sidewalks are being repaired; schools and cultural houses are getting their share of increased state funding.

Some social policy programs have been especially important for local development. Young professionals get remarkable subsidies when they settle down in rural areas – including central



settlements.<sup>27</sup> The “Foster Family Program” has enabled many married couples to take foster children and to earn moderate incomes in relation to local conditions, to renovate and often extend their houses.<sup>28</sup> Also, kindergartens are being built again in small towns and villages, after a 20 years’ break.<sup>29</sup>

The increase of funding took place after National Priority Programs were launched in 2007 and have continued until 2014, after which new estimations are needed because of the critical situation of the Russian economy. In North-Western Russia, however, no signs of crucial change were to be seen on the local level during field trips to the Archangelsk Region in September 2014 and the Republic of Karelia in September 2014 and April 2015.

## TOS: Social movement & social innovation

TOS is a ‘self-managed local association’ (*Territorial’noe Obshchestvennoe Samoupravlenie*), which can be very informal or formal, not registered or registered. A TOS is based on common will to implement a concrete project together, and is organized by defining the task, listing the persons included, and nominating a chairperson. TOS is a special legal form of local collaboration mentioned in Russian law. There were only a few before 2009 but in recent years they seem to be mushrooming, perhaps most of all in the Archangelsk Region. According to an information bulletin on ‘Pomorians TOSs’<sup>30</sup>, 721 TOS projects were already formed there by 2013. In an interview in the Ministry in September 2014<sup>31</sup> an even higher total figure was given (880), which could be compared with the number of NGOs: 1,200–1,300.

The Archangelsk Region accepts TOS to apply funding for local projects; each can get a fixed sum of money for material needs. In practice, the local authorities of each district (*raion*) take care of the organization and allocation of funding. Archangelsk oblast’ has also renewed its governmental structure to answer to the needs of local development efforts. The ‘Archangelsk Regional Ministry for Local Government and Domestic Politics’<sup>32</sup> (*Ministerstvo po razvitiyu Mestnogo samoupravleniya Archangel’skoi Oblasti*) aims to support the work of local TOSs.<sup>33</sup>

In view of the rapid increase in the number of local projects, it seems TOS is an answer to some basic problems in social development. A member in a Regional Parliament (*Duma*) mentioned that ‘Russian administration had forgotten how to work with problems on local level’.<sup>34</sup> TOS offers concrete and practical means in this context. It brings some local people with similar problems together, is easy to organize, and aims for concrete results. Is it a social innovation?

According to Dees et al. ‘Social innovations are production and integration of new knowledge in the form of programs, organizational models or definite sets of principles and other means which are utilized at local level to respond and react to positive and negative results of restructuring.’<sup>35</sup>

The Russian TOS is quite similar to the EU’s LEADER. It is an organizational model. Partnership between local people, enterprises and administration is part of the model and what is new is that local people are an active part of this partnership – instead



A new walking bridge, built in a TOS project in Archangelsk oblast.

of the partnership only being between business and administration. TOS is integrating new knowledge to local circumstances in Russia. It is clearly a reaction to negative results of restructuring. TOS has wider consequences, such as recruiting activists to the local administration. TOS is integrating both old and young participants and some of these younger ones have become new staff in local administration, as we could prove in some cases.

Supporting local activity can suffer from management problems and lack of autonomy in financial operations. Some TOSs are steering funding through municipality accounts, and accounts of traditional NGOs have also been used. There are not many NGOs in small places, however, and these solutions were impractical, because TOSs may have an ongoing need for collecting and using money. We were told about proposals to change some TOSs to NGOs, through registration, and opening of the TOS’s own bank accounts. This has already been done several times (Vestnik TOS 2013).

To sum up, TOSs do actively solve local problems, they produce solutions and activate people for local society’s needs: in doing so they empower people, produce trust and social networking. In brief, in the best cases they successfully renew the socio-economic living environment to a much more positive state.

## A capability to act at local level

The SIDA and Ladoga projects, the development of TOS, along with concrete examples of using the Federal and Oblast’ programs for local needs: All these cases provide evidence for a capability to act on behalf of local populations. For analytical reasons we use Sen’s classification of assets into resources, rights and relations to distinguish between the different actions the local population has used.<sup>36</sup> This particular framework helps distinguish different kinds of agency, transforming the assets in question into goods or services. While some of the resources,





New houses for teachers, industrial village, Nizhny Novgorod oblast.

rights and relations are more associated with coping other kinds of agency is connected to local development. For example, while getting social benefits would be related to coping, getting access to land for agricultural production or to establish an enterprise is more connected to strategic behavior. As you have to apply yourself to get social benefits or a grant to start a business or to build a house, both coping and strategic agency requires some form of intentional action. Therefore in the present context we will focus on the type of actions that actually lead to development in a local context, contributing to improving life quality for the ordinary population. Interviewees talk about using land in order to produce food for their family's consumption and also to build their own houses on it. This is about using grants from the federal programs and about having a capacity for manual work. But it is also about using rights to unemployment benefits and other benefits. One of our female respondents has mentioned as the most valuable resource "the hard-working husband who does not drink".<sup>37</sup>

Sen's analytical framework also connects agency to the issue of empowerment. He seeks not only to determine the actual needs for a resource (e.g. money, housing), but also to identify the kind of support needed to transform resources into goods and services.<sup>38</sup> This requires agency on the part of those receiving support based on individual perceptions of what they need. The core of the empowerment concept lies in the ability of the individual to control her own destiny. Agency represents people's ability to act towards goals that matter to them. Sen argues that this includes an aspect of freedom which is a vital ingredient of social change.<sup>39</sup>

## The use of rights

With reforms, ordinary people gained some new rights while losing others. For example, they received the right to start busi-

nesses or private farming, but they lost the right to get a job, along with different rights to services they had been entitled to in the Soviet period.

They also tried to find solutions to structural problems, of which the non-finalized privatization of state property had a big role in small settlements. An important stage was achieved in this process 2010, when the owners of virtual land plots lost their right to realize their ownership if not yet completed. After that e.g. former *sovkhoz* land could be privatized and sold for building activities, agricultural enterprises or other purposes.<sup>40</sup>

It appears that some state or regional programs have provided opportunities. Interviews describe families using the opportunity to gain a grant to build their own house from the "Federal Program for Young Families" from 2010.<sup>41</sup> We also heard about families using the motherhood program "Mother's Capital" to improve living conditions. Communities also use the possibility of taking part in federal programs. There are, however, great differences between communities in this respect, indicating that the agency of local administrations makes a difference. This is also clear when it comes to the creation of TOSs. In one community, it was fairly clear that the Mayor did not consider TOS to be an important ingredient in local development, but he did not prevent one of the employees from working with their development. Consequently, the idea of creating TOSs to realize local ideas spread, increasing grass-root level activities in the community quite rapidly in a couple of years.<sup>42</sup>

## The use of social relations

Social relations are a basic unifying element in the LEADER approach of the European Union's rural policy. Partnership between local actors is institutionalized in Local Actions Groups. Russian local initiatives also contain partnership, even if not in such a systematic form as LEADER. One of the main differences is that while LAG is responsible for making local development plans, in Russia such plans are not made at local level. In our data, local projects were not integrated into any larger local plan and project activists did not work together with municipal leaders and business people in order to find a coherent path for development. In any case, social relations are also developing in Russian local projects. Some authorities seem to get support from citizens' networks, not least in social policy programs. In one case foster families were organized in a club which was finding ways to collaborate and to mediate their needs to donors and to authorities.<sup>43</sup>

Social relations enhance the growth of social capital while opening opportunities for the empowerment of participants in the process. New social relations increase opportunities to find ideas and make initiatives for new steps to go further in personal agency and local development efforts.

Interviews with entrepreneurs reveal that they did not like to start with somebody outside the family.<sup>44</sup> On the other hand, it was important to have good relations with the local administration in order to get a contract. It could matter when it comes to being able to rent a building to run a restaurant or a shop, or being assigned the task of building or renovating a road.<sup>45</sup>

Local administrations often use their relations with entrepreneurs to ask/insist on them becoming sponsors for local events and projects or fulfilling social contracts.<sup>46</sup> One local head succeeded in getting support from local entrepreneurs for building a church.<sup>47</sup>

## The use of resources

In line with earlier research,<sup>48</sup> respondents express the view that it has become more difficult to set up private businesses than before.<sup>49</sup> However, people still start their own businesses in, for instance, trading or taxi-driving. Interviews show how entrepreneurship increases in crisis years, when families' incomes are not enough to live on (these businesses are most likely not formally registered in order to avoid taxes). In particular, it seems difficult to survive after the first year. The three to four successful examples of business development from the SIDA project reveal that it is possible to build up businesses even in the 2000s. These examples show that slow step-by-step development based on investments from the entrepreneur's / business's own resources could be a viable strategy for survival and gradual development. Some interviewees mentioned the option of the *vakhtovyi metod*, which usually means that the husband goes away for specific periods to work in, for example, the oil fields or the forest, although they pointed out that this way of working could be detrimental to the family.<sup>50</sup> Respondents further indicated that plot production is important for most people.<sup>51</sup> We also heard about the use of other natural resources.

The local administration uses resources to increase the local budget available for the co-financing of federal or oblast' projects.<sup>52</sup> Well-educated women working in the budget sector provide a valuable human resource, and we have heard some of them talk about how the smallest projects showed them new possibilities.<sup>53</sup> This, in turn, encouraged them to take new initiatives.

## Conclusions

Our data gives a lot of evidence of strategic agency in the Russian countryside and small towns (Table 1). The Russian local economy is still experiencing major structural changes. Bankruptcies of post-Soviet type large-scale enterprises take place, and newer entrepreneurs increase their activities. It is sometimes said that it is more difficult to start a business now than earlier. However, some young entrepreneurs seem to act even in smaller communities. One aspect is the view that there are more options now, that society/opportunities is (in a regional sense) more democratic. New Governmental programs have clear positive effects, not only within metropolitan areas. Private-public mixtures and project funding are becoming more widespread, which might mean more flexibility and decreasing negative consequences from the traditionally very hierarchic administration in Russia.

Local governance has stabilized after reforms in late 2010s. Privatization of local land has achieved its culmination, which offers opportunities to reorganize land-based activities in housing as well as in business and agriculture. In the authors' experience, local authorities are very willing to support the local

economy and activities, but have very scarce resources. To solve their acute economic and social problems, they try to find ways forward using sponsoring funds and increasingly, with project-type funding.

Concerning the views of how passive people are, the present research provides evidence of the opposite tendency. Studies of foreign experiments, SIDA and Ladoga projects and above all the regional TOS movement reveal a relatively large potential for activity among the local population. Each of the established projects needed enthusiastic project leaders and several active participants. They realized resources, which both produced material things and secured new social capital. To sum up, SIDA and Ladoga projects and TOS activity indicate that it is possible, in Russian conditions, to realize successful projects and to facilitate social capital and empowerment.

To interpret what is taking place on the local level in Russia, one needs to go further to understand the logic of economy in the Russian framework. It is not pure market logic; entrepreneurs have a lot of troubles other than prices and markets of their products, credit rates and salary levels. The Russian state has a strong hold on the economy both through various controlling measures and because of state-owned business. A major proportion of business people work on the basis of public orders and the state's authoritarian character has consequences on local companies' working possibilities.<sup>54</sup> Furthermore, Russian local administration is economically weak and needs the state's redistributed funds.

Another option for local administration is to have strong private enterprises, which contribute to the local economy both through taxes and donations. Taxes are normally not enough and therefore donations are needed. Donations follow Soviet traditions, even if local private enterprises which donate money are often smaller and weaker than Soviet state farms or big industrial companies. The existing local companies contribute a lot in the local social and economic sector. The general picture is not very clear; however, discussions with local authorities and enterprises themselves give evidence of continuous donations to charity and to local development efforts, such as building walkways or sports fields. Charity is often promoted: for children's needs, as when a children's home found a local entrepreneur to support its activities. Later the entrepreneur disappeared but the support from his company continues.<sup>55</sup> Development efforts are often allocated to the entrepreneur's own home village, as when one TOS received a remarkable sum of money from a local female entrepreneur for building a village house for local events.

What makes enterprises donate money? This question is in fact a variant of the basic question of informal institutions for an institutional economy. An answer to this question can be sought from the field of moral economy. According to Andrew Sayer<sup>56</sup> – the developer of new moral economy – the question in moral economy is about norms, dispositions and commitments, which concern interrelations between individuals and institutions, their mutual responsibilities and rights. Our field study results indicate that norms of contributing to local social needs are very strong in Russia.

It is not possible in this paper to go further into the question of the moral economy in Russia. We suggest, however, that the Russian economy is not only characterized by paternalist and authoritarian features but also by a special type of moral economy, demonstrated in the interdependency of economy and moral commitments. ✖

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Ikea in Khimki, Moscow.

PHOTO: ANDREI RUDAKOV/BLOOMBERG



# Business climate in Russia

## Swedish investors' perspective

by Olga Golubeva

The notion of business climate is commonly used by international policy-makers, researchers and business people to address the set of location-specific factors shaping the opportunities and incentives for firms to do business in a particular country. The use of this concept is often more rhetorical than tangible as different parties include diverse factors in the definition. Nevertheless, business climate has been institutionalized as a concept that contributes to a country's economic growth and competitiveness. The poor business climate in Russia is, according to the OECD, "a glaring and persistent handicap for the Russian economy. Doing business in Russia is difficult and risky, due to the heavy administrative burden, widespread corruption and a weak rule of law."<sup>1</sup>

Facing up to the problem, Russia's top leaders express their commitment to making improvements in the business climate. In October 2014, President Vladimir Putin assured the audience of the Russia Calling Investment Forum in Moscow: "We will continue system-wide work on improving the business climate in Russia".<sup>2</sup> Putin also cited the considerable changes to many laws in Russia and the optimization of administrative procedures which has taken place. In appreciation of such steps, the World Bank's Doing Business Ranking, one of the proxies for business climate, moved Russia from 120<sup>th</sup> place in 2012 up to 112<sup>th</sup> in 2013.<sup>3</sup>

Today, over 400 Swedish companies are present in the Russian market.<sup>4</sup> Sweden is currently among the top ten foreign investors in Russia with 15.8 billion USD of accumulated investments.<sup>5</sup> In 2013, Russia was Sweden's 13<sup>th</sup> biggest export market and 7<sup>th</sup> biggest import market.<sup>6</sup> But why are Swedish and other foreign companies interested in Russia?

A large and potentially expanding consumer market, rich natural resources and sizable government investment

projects are cited as being central to Russia's competitiveness. It is, however, broadly recognized that Russia should establish a more balanced economy and diversify areas of growth. In order to improve the business climate in Russia, economic and political advisors often suggest that Russian government intensify its efforts to reduce administrative burdens, minimize bureaucracy and corruption, increase transparency, consolidate the rule of law, foster entrepreneurship and develop innovation capacity.<sup>7</sup>

While the importance of the business climate is emphasized by economists and policy-makers, there is still little guidance about what aspects of business climate in Russia are important and what specific reforms are needed. The influence of different variables in the business climate on Russia's attractiveness for foreign investors is an important issue that needs closer examination.

The purpose of this article is to analyze the business climate in Russia from the Swedish investors' perspective. The case presented is related to general theoretical discussions regarding

the concept of business climate and its definition in social science. The article also aims to present and analyze recent empirical survey data on the subject.

The paper summarizes the main theoretical frameworks that have been applied by previous research in business climate studies. Mainstream frameworks include institutional theory, macro-economic literature, micro-economic perspective (the theory of the firm) and the political process approach. Although a consensus definition of business climate may never be reached, the article attempts to systemize existing definitions and to highlight problems in the current usage of the term.

The article uses data from the Business Climate Survey conducted by Business Sweden<sup>8</sup> during July–August

### abstract

The article addresses the issue of the business climate in Russia from the Swedish investors' perspective and relates it to a general theoretical debate in the field. Statistical test suggests that the majority of variables relating to the business climate has deteriorated between 2012 and 2014. The findings support several mainstream theories regarding the business climate but also demonstrate some contradictions that would require further investigation. These include the reaction of Swedish business to the escalation of political tensions between Russia and the West and the factor of corruption, which is not viewed as serious enough to fully discourage foreign investors from staying in Russia.

**KEY WORDS:** Business climate, firm-level approach, business climate theories, survey analysis, T-test for paired samples, foreign (Swedish) investors, Russian market.

2014 in cooperation with Magnusson Law and Raiffeisen Bank.<sup>9</sup> The survey presents the perception of the business climate in Russia among Swedish companies operating in the market. Experienced top executives, mainly Swedish nationals representing 82 companies, or 20% of all Swedish companies operating in Russia, participated in the survey in 2014. The survey was conducted using approximately 55 closed questions, while several questions allowed respondents to write comments and recommendations. Managers from small, medium-sized and large companies answered the questions; the proportions of service, production and trading companies across different industries is almost equal.

A similar survey was also conducted by Business Sweden in 2012. Since 2012, Russia's relations with EU and US have deteriorated. The annexation of the Crimea by Russia, the armed conflict in the eastern Ukraine, the introduction of sanctions against Russia by the EU and the US and the response by the Russian government with counter-sanctions have created challenges that were not on the agenda in 2012.

Although the current dynamics between Russia and the West do not yet constitute a new Cold War, Business Monitor International (BMI) expects a turbulent period to prevail for the next few years.<sup>10</sup> Such a situation decreases the attractiveness of Russia for foreign investors. There is a serious concern as to whether Russia can continue to improve its business climate if it is in opposition to major parts of the global economy. The possible impact of an escalation of the conflict between Russia and the EU/US on the business climate in Russia, therefore, remains currently unknown.

The research paper compares the answers of top managers on different aspects of the business climate in Russia for 2012 and 2014. Does the managers' perception follow the global investors' current negative views on Russia? One might expect that the recent escalation of the conflict between Russia and the West would be reflected in the answers provided by top managers.

The study analyze whether business climate in Russia has deteriorated due to the recent escalation of turbulence between Russia and the West.

The research design combines qualitative and quantitative methods in order to address the research issue. Qualitative methods are a vital aid in identifying possible trends and developments as well as understanding which variables of the business climate are of major importance for foreign investors.

The methodology includes a quantitative T-test analysis for 20 selected business climate parameters.<sup>11</sup> The analysis starts with an estimation of a sample mean<sup>12</sup> for responses of managers during 2012 and 2014. Managers chose suggested alternatives ranging from 1 (low risk assessment or positive developments) to 5 (high risk assessment or negative developments). If the situation had deteriorated in 2014 compared to 2012, the scores provided by managers would be expected to rise to reflect higher risks associated with business climate in Russia. We assume that the answers have approximately normal distribution. T-test analysis was carried for paired samples of different business climate variables for 2012 and 2014.

The null hypothesis  $H_0$  states that there is either an improvement of the mean for the 20 selected variables of the business climate in 2014 compared to 2012 or they are unchanged. The sample mean for 2012 ( $\mu_{2012}$ ) is assumed, therefore, to be equal or higher than the sample mean for 2014 ( $\mu_{2014}$ ).

The alternative hypothesis  $H_1$  suggests that the sample mean for selected variables deteriorated in 2014 compared to 2012 reflecting higher (respectively, more negative) scores in the managers' replies. We can express the null and alternative hypothesis as follows:

$$H_0: \mu_{2012} \geq \mu_{2014} \quad H_1: \mu_{2012} < \mu_{2014}$$

$H_1$  hypothesizes that there has been deterioration in the assessment of different parameters of the business climate by managers in 2014, therefore a one-tailed T-test is performed. The level of significance of 5% is chosen ( $\alpha = 0.05$ ).<sup>13</sup> If the null hypothesis is rejected, then we have statistical support for the alternative hypothesis. If the evidence shows that the null hypothesis is false, we can conclude that the data supports the alternative hypothesis regarding a deterioration trend in selected variables of the business climate in 2014 compared to 2012.

The empirical data presentation combines qualitative analysis with an output from the T-test statistics.

Finally, topics regarding theoretical frameworks for and empirical investigations into business climate are suggested for future research.

## Business climate, theoretical frameworks and definition

The concept of business climate has no significant body of shared views but is fragmented into different schools of thought. Various theoretical frameworks have been developed to study business climate.

The institutional theory takes as its point of departure that organizations are under pressure to adapt and be consistent with their institutional environment. Companies are assumed to aim for legitimacy and recognition, and they do so by adopting structures and practices defined as appropriate in their business environment. Pande and Udry conclude that long-run growth is faster in countries with a favorable business climate including higher quality contracting institutions, and higher levels of trust in such institutions.<sup>14</sup> According to Yakovlev, the incompetence of public institutions in Russia imposes serious restrictions on the development of the business climate.<sup>15</sup> A lack of institutions forces companies to search for their substitutes. The weak legitimacy of formal institutions in Russia, therefore, pressures firms to rely excessively on informal institutions, including personal networks.<sup>16</sup>

The macro-economic mainstream literature has generally used cross-country samples to explain GDP-based outcome variables with broad, country-level indicators of the business climate such as institutional quality, the policy environment and infrastructure. The majority of such analyses have found that these business climate variables have significant effects on eco-

nomic performance.<sup>17</sup> The macro-analyses obviously generated useful insights, among others about the central role of secure property rights and good governance for the business climate.

The findings of the macro-econometric literature are often questioned due to concern about the robustness of the results. The explanatory variables at country level obscure variations across different regions within a country, across different types of firms (by firm size, age, ownership type, etc.), or both. The precise channels through which business climate variables affect economic growth are still not fully understood, and recent studies have been more cautious in their interpretation of the evidence.<sup>18</sup> Other econometric problems, such as the failure to account for model uncertainty in cross-section studies, persist.<sup>19</sup> Banerjee and Duflo, for example, stressed that macro-economic models can hardly account for the behavior of firms in a world full of different constraints and uncertainties.<sup>20</sup> The impact of constraints such as infrastructure limitations, lack of access to finance, or political issues on individual firms' decisions can be better analyzed at company level with the help of non-aggregative methodology.

In an effort to break through these limitations of macro-economic models, recent research attempts to search for micro-level evidence on the business climate and for ways to trace the climate's impact on company decisions and performance. While policy-makers and researchers often have very specific objectives regarding business climate, the firm is more likely to appreciate the holistic view of the business climate rather than any one specific goal.

One of the new frontiers of economics is, therefore, the analysis of business climate from a micro-economic perspective. Company theory puts the focus on a company as the core element, instead of the broad aggregate numbers in macro-economic analysis.<sup>21</sup> Dethier et al. use enterprise surveys to provide an overview of literature with the focus on the impact of the business climate on productivity and growth in developing countries.<sup>22</sup>

The crucial prerequisite for finding more disaggregated evidence is the availability of raw disaggregated data. Before the 1990s, standardized firm-level business surveys spanning multiple countries were practically nonexistent. The key development of the early 2000s was a push for greater standardization in order to build up a single, centralized database of comparable business climate surveys from around the world. The World Bank's World Development Report (2005) was the first to bring together insights from two World Bank initiatives, namely the Investment Climate Surveys and the Doing Business Project.<sup>23</sup> The EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS)<sup>24</sup> is another initiative aiming to capture indicators of the business environment and track changes in the business environment over time.

There have been considerable discussions about the possible weaknesses of subjective, perception-based surveys compared to objective, quantitative data.<sup>25</sup> Carlin et al.<sup>26</sup> highlight the ease with which a subjective ranking of constraints is used for comparisons. Exploring such concerns, Gelb et al. examine subjective data yielded by the core Enterprise Survey perception questions. They conclude that while perceptions of business climate constraints may not always correspond fully to 'objective' reality, firms do not complain indiscriminately, and response patterns correlate reasonably well with several other country-

level indicators related to the business climate.<sup>27</sup> Examination of data surveys provides evidence that a good business climate favors growth by encouraging investment and higher productivity. Various infrastructure, finance, security, competition, and regulation variables have been shown to have a significant impact on enterprise performance.<sup>28</sup>

Because business climate is obviously affected by political factors, some researchers suggest a political process approach as a theoretical framework for analysis. Curmudgeon analyses the business climate as a cumulative aggrega-

tion of policy decisions across departments, policy areas, and time periods, which are based on the decision-makers' belief.<sup>29</sup> Bittlingmayer et al. stress an explosion in the use of the business climate concept during last ten-fifteen years, among other things as a tool to affect public opinion and policy change.<sup>30</sup>

Several researchers have demonstrated the great relevance of the political process approach to studying the business climate in Russia. Frye, for example, admits that ideally one would like to make investment decisions primarily on economic grounds where political power matters less than economic efficiency, but this is far from the case in Russia.<sup>31</sup> Rochlitz provides some empirical support for the view that political motivation to acquire electoral votes by the federal government in Russia had an impact on the business climate of a particular region.<sup>32</sup>

There is no way to prove which of these (or any other) theoretical approaches is more appropriate to analyze the business climate. Currently, no single approach can fully accommodate the concept of business climate and explain its nature. Neither of these approaches in isolation can give guidance on policy recommendations on how to improve business climate in different countries and regions. There might be room, therefore, for the co-existence of different academic approaches as they address different aspects and issues of business climate. Instead of deciding on which approach is the most suitable for analyzing the business climate, the current challenge might lie in systematizing the contributions of different theoretical schools and understanding their added value for different business environments.

But what is business climate? Business climate is often de-

**“BECAUSE BUSINESS CLIMATE IS OBVIOUSLY AFFECTED BY POLITICAL FACTORS, SOME RESEARCHERS SUGGEST A POLITICAL PROCESS APPROACH AS A THEORETICAL FRAMEWORK FOR ANALYSIS.”**



defined as an environment that surrounds firms within a given geographic area, where conditions and circumstances have a profound effect upon the success or failure of businesses.<sup>33</sup> It is also commonly stressed that differences in business climate are a reason why some countries are economically more successful than others.<sup>34</sup>

Eathington, Todd and Swenson distinguish three major meanings in the concept of business climate: (1) an overall measure of growth or business health in a region; (2) a set of factors believed to contribute to regional economic growth; and (3) an intangible asset in the form of a regional reputation for business friendliness and receptiveness to growth.<sup>35</sup>

The definition of business climate as an intangible asset is supported by the importance of sending a pro-growth, pro-business message to the international and local business community. Countries are, in that case, booking the business climate onto their balance sheets in the hope it will yield future 'earnings' from other businesses attracted to the region. Business climate in that context becomes a message, not a measure. This conceptual definition of business climate is perhaps the most problematical one for sound policy development. In the name of improving the region's reputation for business friendliness, countries and regions may commit significant public resources. In any case, the notion of business climate as a regional asset deserves the additional attention of researchers.

It is also possible that business climates may have their most crucial impact variables outside existing frontier definitions. Bittlingmayer et al. claimed that the business climate indexes with the best outcome explained only 5% of the total variation of performance.<sup>36</sup> A tentative conclusion might be that business climate ratings do not capture the concept of business climate in the right way.

Literature on the importance of different aspects of business climate for foreign investors is characterized by a certain inconsistency in conclusions between the studies.

Dollar et al. reach conclusions about the importance of the investment climate (including physical and financial infrastructure variables) for attracting foreign investors into eight Latin American and Asian countries.<sup>37</sup> Kinda shows that physical infrastructure problems, financing constraints, and institutional problems discourage foreign investors, particularly for Sub-Saharan African countries. The study supports the thesis that introducing additional explanatory variables of the investment climate can enhance understanding of the issue.<sup>38</sup> Mottaleb and Kalirajan argue that socio-economic and political variables such as regulatory frameworks, bureaucratic hurdles and red tape, regulations relating to setting up a new business, judicial transparency and the extent of corruption in the host country may impact foreign investors.<sup>39</sup>

Several researchers question whether a conventional set of business climate variables is really important for foreign investors. The empirical results of the study by Goswami and Haider suggest that the host government policy has little impact on foreign investors.<sup>40</sup> Rather, cultural conflict and the attitude of the foreign investor country towards the host country are found

to be mostly significant variables. Empirical results by Blonigen et al. also reflect little support for the view that government policies are an important indicator.<sup>41</sup> Researchers found no robust evidence in the analysis that business climate policy variables controlled by the host country (such as multilateral trade openness, business costs, infrastructure, and political institutions) have an effect on foreign investors.

It can be concluded that the importance of different business climate variables for foreign investors remains an ambiguous and open-ended issue in the literature. The reason behind such uncertainty might be our limited understanding of the concept of business climate and its theoretical framework. Another explanation might be the complexity of the phenomenon itself. We obviously face a challenge: researchers, policy-makers and the business community should pool their resources in order to reach consensus, even on a partial basis. There are many ways to describe business climate and plenty of variables that might be included in the definition. In the face of such uncertainty, the right approach might be to search for factors identified by the business climate concept that can enhance economic growth and competitiveness and attract foreign investors.

## Business climate from the point of view of Swedish companies

The BCS data was collected for both 2012 and 2014, while for newly introduced questions, the empirical response is available only for 2014. Besides this, several responses are more of a qualitative nature and do not suit T-test methodology. However, they provide a valuable insight into different aspects of business climate from the point of view of Swedish companies operating in Russia. Therefore, statistical conclusions are complemented by a qualitative analysis.

The empirical data presentation and analysis is carried in two steps. First, we address strategic issues related to Swedish companies' establishment in Russia, including the perception of the Swedish brand in Russia, the profitability of business, establishment of local contacts in Russia and future plans of Swedish companies. Secondly, we summarize the empirical data for 20 selected variables regarding business climate in Russia. This data was used to carry a statistical paired samples T-test. Findings from the statistical T-test are complemented by the qualitative empirical data acquired from managers.

### Strategic issues for companies' business establishment

An encouraging starting point for our empirical data presentation is that Sweden is perceived as a brand that is welcome in Russia. In 2012, for example, 79% of respondents emphasized that they were positively treated as Swedish business people in Russia, the figure being raised to 90% for 2014. According to the data, the escalation of conflict between Russia and the West was not directly reflected in the reception of Swedish companies by Russian society. On the contrary, Swedish brands were more appreciated in Russia in 2014 compared to 2012. This topic deserves further analysis, especially from the point of view of policy and government structures aiming to enhance co-operation between





The opening of a new H&M shop in Moscow, 2009.

Sweden and Russia in different areas. Evidently, certain measures promoting the image of Sweden in Russia contributed to offsetting the negative effects caused by political disturbances.

On the negative side, the empirical data suggests that it is hard for foreign companies to find the right business contacts in Russia. Many foreign advisors stress the importance of investing time in building up relationships with local partners: Russians do business with people, not with companies.<sup>42</sup> According to the analysis, only 15% of respondents believe that it is easy to find reliable business partners in Russia; the figure is almost unchanged between 2012 and 2014. The amount of respondents that found very difficult to find a reliable partner in Russia rose from 3% in 2012 to 21% in 2014. The data indicates, therefore, that more efforts and promotion actions are required to assist foreign companies in establishing business contacts with local firms in Russia.

The analysis suggests that Russia offers a high potential return in combination with a high growth rate. Good profitability was reported by 72% of respondents in 2014, down from 82% in 2012. Good growth potential in 2014 was reported by 82% of respondents, compared to 95% in 2012. Although appreciation of return and growth potential by Swedish investors is high, the trend seems to be negative for both indicators. An interesting observation is that 10% of managers in 2014 expressed uncertainty about profitability of Russian business, compared to none in 2012.

The survey demonstrated that in 2014, 55% of goods or services produced by Swedish companies in Russia are sold on the local domestic market against only 8% on the international market. The analysis supports the view that that Russia's large, expanding consumer market continues to be one of its most attractive features for foreign companies. A large population, ris-

ing disposable income and a burgeoning middle class are drawing the attention of foreign investors.

A question about Swedish companies' expansion plans in Russia for the next three years deserves special attention. Surprisingly, in 2014, as many as 65% of managers did have expansion plans in Russia. Business executives remain upbeat about Russia's growth prospects in the medium term. Although in 2012 this figure was 82%, the current level of expansion plans in Russia seems to be at a high level in view of the recent deterioration in the relationship with the US and EU. We do not seem to have a good explanation regarding how the conflict escalation impacts particular firms operating in Russia. Foreign investors that are already established in the Russian economy might be more optimistic about the country's future than those who do not have practical experience and knowledge and form their judgments based, for example, upon mass media articles.

In summary, the consensus view on strategic issues related to Swedish companies' business establishment in Russia remains rather positive. Foreign investors appreciate the good profitability and growth possibilities, including the sizable domestic consumer market. Several potential pitfalls include the difficulty of finding reliable business partners as well as some signs of slow-down in potential growth possibilities. More analysis is, however, needed in order to understand the potential impact of an escalation of conflict between Russia and the US/EU, in particular on foreign investors and their plans for Russia.

#### **Selected variables regarding business climate**

The empirical data for the paired samples T-test for selected variables regarding the business climate is summarized in Table 1.

From statistical tables for T-distributions, we can determine

**Table 1: Summary of the empirical data for paired samples T-test for selected variables regarding business climate in Russia**

		Paired Differences					T-values	Df <sup>43</sup>	Sig. (one-tailed)
		Mean	Std. Deviation	Std. Error Mean	95% Confidence Interval of the Difference				
					Lower	Upper			
1	Political risk 2012–2014	-.97561	.64742	.07150	-1.11786	-.83336	-13.646	81	.000
2	Currency risk 2012–2014	-.84146	.36749	.04058	-.92221	-.76072	-20.735	81	.000
3	Counterparty risk 2012–2014	-.10976	.38510	.04253	-.19437	-.02514	-2.581	81	.006
4	Inflation risk 2012–2014	-.69512	.46319	.05115	-.79690	-.59335	-13.590	81	.000
5	Company registration 2012–2014	.09756	.51183	.05652	-.01490	.21002	1.726	81	.044
6	Getting information 2012–2014	-.26829	.44580	.04923	-.36625	-.17034	-5.450	81	.000
7	Availability of statistics 2012–2014	-.32927	.64893	.07166	-.47185	-.18668	-4.595	81	.000
8	Russian law 2012–2014	.40244	.49341	.05449	.29403	.51085	7.386	81	.000
9	Corporate taxation 2012–2014	.02439	.60809	.06715	-.10922	.15800	.363	81	.358
10	Customs procedures 2012–2014	-.31707	.58538	.06464	-.44569	-.18845	-4.905	81	.000
11	VAT refunds 2012–2014	.04878	.38176	.04216	-.03510	.13266	1.157	81	.125
12	Payment discipline 2012–2014	-.09756	.43347	.04787	-.19280	-.00232	-2.038	81	.022
13	Banking short-term 2012–2014	.26829	.44580	.04923	.17034	.36625	5.450	81	.000
14	Banking long term 2012–2014	.06098	.50547	.05582	-.05009	.17204	1.092	81	.139
15	Postal infrastructure 2012–2014	-.41463	.62758	.06930	-.55253	-.27674	-5.983	81	.000
16	IT infrastructure 2012–2014	-.37805	.71389	.07884	-.53491	-.22119	-4.795	81	.000
17	Managers availability 2012–2014	-.04878	.49447	.05461	-.15743	.05987	-.893	81	.187
18	Employees fraud risk 2012–2014	.08537	.45000	.04969	-.01351	.18424	1.718	81	.045
19	English proficiency 2012–2014	.50000	.61363	.06776	.36517	.63483	7.379	81	.000
20	Corruption 2012–2014	-.76829	.47917	.05291	-.87358	-.66301	-14.519	81	.000

the critical value, which should be used for comparison with a computed T-value. <sup>44</sup>

The null hypothesis states that there is no worsening of the mean for selected variables of the business climate in 2014 compared to 2012. Based upon calculated T-values, the for the following 11 variables of the business climate can be rejected: *political risk, currency risk, counterparty risk, inflation risk, getting information, availability of statistics, customs procedures, payment discipline, postal infrastructure, IT infrastructure, and corruption*. For these variables, we have statistical evidence that situation deteriorated in 2014 compared to 2012.

How confident are we in rejecting the null hypothesis? P-value is the probability (assuming that the null hypothesis is true) of getting a value of the test statistic at least as extreme as the value actually obtained. If the p-value is smaller than the significance level (in our case 0.05),  $H_0$  is rejected. P-values for a one-tailed T-test are presented in the last column of the Table 1.

We rejected  $H_0$  hypothesis for 11 variables of the business climate. For all these variables, the p-value is far beyond 0.05, which gives us additional support to the strength of the decision to reject the null hypothesis.

Furthermore, very low p-values have been observed for 3 other variables: *Russian law, short-term banking, and English proficiency*. A p-value is a way to express the likelihood that  $H_0$  is false. While the p-value for these 3 variables is as low as 0.000..., the conclusion about the rejection of the null hypothesis is statistically supported.

The statistical test, therefore, supports the alternative hypothesis regarding a deterioration trend in 14 (of 20) variables of business climate in 2014 compared to 2012.

In economic literature, the term ‘political risk’ usually applies to a country as whole, being associated with nationalization or expropriation, possible changes in regulation, trade agreements and general instability. The same approach is also valid for currency and inflation risks. However, there have been few attempts to analyze these risks as company-specific factors.<sup>45</sup> In our study, managers emphasized the importance of political, currency, inflation and counterparty risks for their business in Russia.

Our analysis suggests that political risk in Russia increased between 2012 and 2014 from the point of view of foreign investors. Currency, inflation and counterparty risks have also increased between these two years, which is in line with the deterioration

in the current economic and political situation in Russia.

In 2014, a new question was posed inquiring about managers' views regarding the impact of the recent escalation of conflict between Russia and the US / EU. The response is rather mixed and hard to interpret. About 39% of respondents claimed that they were seriously affected by such relationship crises, while 42% found very little impact from the conflict on their business activities in Russia.

While it is hard to generalize from one survey, there is an obvious need to deepen our understanding of how major political and economic risks as well as escalation of international conflicts impact particular companies. It seems rather confusing that more than 40% of managers indicate very little impact from a conflict escalation between Russia and the West on their business in Russia.

Several researchers stressed the importance of acquiring the basic knowledge about the factors that govern the Russian market. Such factors involve economic, political, cultural, and ethical barriers that companies need to manage when working with Russia.<sup>46</sup>

Our analysis indicates that it is rather hard to obtain information from Russian authorities and difficult to find applicable Russian statistics. The situation worsened between 2012 and 2014. One suggestion could be a proposal to improve the distribution of information and relevant statistics from the Russian authorities to foreign investors. Many potential investments might fail at an early stage of the project cycle if the Russian government were unable to provide the necessary information support to foreign companies.

The data suggests that customer procedures do not work satisfactorily, and the trend is negative between 2012 and 2014. The Russian Federation has been a member of World Trade Organization (WTO) since August 22, 2012. There have been several achievements in Russia's incorporation into WTO; the mission is, however, far from being completed. The high level of tension remains with the on-going current disputes between Russia on one hand and the EU on the other.<sup>47</sup> In addition, Russia's customs organization is often accused of being corrupt and bureaucratic.

According to statistical analysis, payment discipline and short-term banking deteriorated between 2012 and 2014. Having been shut out of international financing due to sanctions imposed by the West, Russia's banks started to experience certain troubles with funding. A worsening of payment discipline could also be the result of the general slowdown of the Russian economy.

Different infrastructure variables, including government authorities, transportation, IT infrastructure, registration and start-up of the company, etc., are important for the presentation of the business climate. According to the analysis, investors expressed concerns about the availability of infrastructure. Respondents acknowledged that meaningful improvements on

many positions are not yet happening. *P*-values for postal services infrastructure and IT infrastructure indicated that there is a negative trend between 2012 and 2014. It is of vital importance to stop the negative trend and further develop infrastructure in Russia.

According to Transparency International, Russia occupies 127<sup>th</sup> place out of 177 countries, approximately the level of Togo and Uganda.<sup>48</sup> Our study suggests that corruption is still a problem in Russia that limits business climate potential. Empirical data also indicates that there has been an increase in corruption

in Russia between 2012 and 2014. When deciding to establish their business in Russia, 45% of managers calculated with the risk of facing corruption in 2014, while 53% of managers estimated that the risk of becoming exposed to corruption in Russia is high.

About 82% of respondents confirmed that Swedish companies have developed a code of conduct or similar policy documents dealing with the topic of corruption in Russia. Establishment of a code of conduct by foreign companies operating in Russia plays an important role in shaping the future

of the business climate in the country. However, in 2014, only 6% of managers acknowledged that their companies were considering leaving Russia due to corruption while 64% were not evaluating such an option. A very tentative conclusion might be that although corruption plays a negative role in the business climate in Russia, the impact of corruption is not enough serious to fully discourage foreign investors from staying in Russia. Due to the fact that managers confirmed widespread corruption, the only explanation might be that the profit received by business is enough to accommodate the necessary payments, if required.

**RUSSIA IS KNOWN** to have conflicting, overlapping, and frequently changing laws, decrees and regulations, which complicate the business climate. Poor rule of law is often seen as one of the risks of doing business in Russia for foreign firms, as it was shown by the experience of the UK-based Hermitage Capital Management and Telenor of Norway.<sup>49</sup> A special term, *reiderstvo*, was introduced in the literature to describe the acquisition of business assets in Russia through manipulation and distortion of the law, albeit often with active involvement of law-enforcement officers and courts.

The study indicates a rather negative assessment of Russian law by foreign investors, and the situation deteriorated between 2012 and 2014. The government is trying to create a more balanced and business-oriented set of rules, which could regulate business relationships more flexibly and effectively protect their participants' rights and interests.<sup>50</sup> In line with achievements to improve Russian legislation, some managers acknowledged a few positive developments. These positive changes, however, have not yet resulted in changing the negative trend. It also ex-

**“RUSSIA IS KNOWN TO HAVE CONFLICTING, OVERLAPPING, AND FREQUENTLY CHANGING LAWS, DECREES AND REGULATIONS, WHICH COMPLICATE THE BUSINESS CLIMATE.”**



plains why Russian businesses continue to structure themselves under offshore holding companies in order not to fall under Russian law.

In 2014, a new question was introduced into the survey regarding arbitration court proceedings in Russia. Surprisingly, 53% of managers had no knowledge regarding arbitration courts while the remaining answers were almost equally split between different alternatives. The efficiency and reliability of Russian courts, especially arbitration courts, have been studied by several researchers. Timothy Frye demonstrated that in 2000, 76% of managers from the survey believed that the courts could protect their legal interests in a dispute with another firm, while this figure increased to 89% in 2008.<sup>51</sup> In both surveys, however, managers were significantly less confident in their ability to use the courts against regional governments in Russia. Gans-Morse suggested that during the 2000s new threats emerged in Russia in the form of attacks on business by lower and higher-level state officials such as regulators and law enforcement agents themselves.<sup>52</sup>

UNFORTUNATELY, IN THE empirical survey BCS, no distinction was made between protection by the courts against private firms and against the Russian government bodies. It can be strongly recommended, however, that future surveys should include this distinction. The issue of strengthening of property rights in Russia might have less to do with the capacity of the state to decide disputes between private firms in the arbitrage court than with the necessity of legal constraints on the power of corrupt state officials. Lucy Chernykh, for example, demonstrates that lack of trust between the authorities and private business is an important feature of the business environment in Russia.<sup>53</sup>

It is not clear why such a large proportion of managers are not aware of the situation regarding arbitration in Russia. One possible explanation might be that they did not need to turn to the courts for commercial disputes. Another explanation is that there is a common practice of holding potential arbitration proceedings outside the Russian jurisdiction. Therefore, foreign managers do not possess information on the subject.

Managers also stressed that there are still few English speakers in Russia. According to Education First English Proficiency Index 2012, Russia displays a low proficiency for the English language: it ranks 36<sup>th</sup> (and the lowest) in Europe<sup>54</sup>. In our analysis, English proficiency by Russian people deteriorated between 2012 and 2014. There is no good explanation of the reasons behind this deterioration. In any case, an increased availability of English proficiency is needed to match requirements of foreign investors.

According to Table 1, several variables have relatively high  $p$ -values. If the  $p$ -value is large, then it is likely that  $H_0$  is true. Therefore, there is an indication that  $H_0$  might be true for the following 4 variables of the business climate: *corporate taxation*, *VAT refunds*, *manager's availability*, and *long-term banking*.

There is some statistical evidence that these 4 variables of the business climate have improved in 2014 compared to 2012.

The analysis indicates that there is progress regarding developments in taxation issues in Russia from the point of view of foreign companies. Managers also provide rather a favorable assessment of the development of the VAT refund process.<sup>55</sup>

According to the analysis, the availability of qualified staff in Russia has improved between 2012 and 2014. Availability of managers affects the economy, and lack of human capital can adversely affect the business climate. Respondents pointed that in

the Moscow region, for example, there is still competition for highly qualified personnel. Besides, although Russia's education system is well respected, it still needs to cover more material relevant to businesses. As a result, Western companies need to spend a considerable amount of time on attracting, training and retaining Russian talent. The trend for the availability

## “AN INCREASED AVAILABILITY OF ENGLISH PROFICIENCY IS NEEDED TO MATCH REQUIREMENTS OF FOREIGN INVESTORS.”

of qualified managers, however, seems to be positive between 2012 and 2014. It seems that it has become easier to find qualified managers, which could perhaps be explained by the economic slowdown in Russia.

Surprisingly, the analysis suggests that long-term banking has improved between 2012 and 2014. This is in contradiction with previously received indication on the worsening of payment discipline and short-term banking. On the other hand, several managers explained that they observed certain improvements on how the banking system in Russia works in general and reflected these positive changes in their assessment of long-term banking. Current turbulences, on the other hand, were reflected under the assessment of short-term banking. Besides, many Swedish companies get long-term financing from their headquarters in Sweden, while they use short-term banking products locally. Therefore, possible disturbances of the Russian banking system might be more obvious in short-term banking.

A new question was introduced into the 2014 questionnaire regarding the impact on Swedish companies of the withdrawal of Nordic banks from Russia. Surprisingly, 70% of respondents were not affected by such a withdrawal and only 16% experienced some troubles. This can be explained by the fact that Russian banks and other foreign banks quickly took over the market share of Nordic banks. Possibly the quality of banking services offered by Russian banks to the foreign companies was high enough to off-set the withdrawal of Nordic banks from Russia.

For two variables of the business climate (*company registration* and *employees' fraud risk*), the  $p$ -value is slightly lower than the significance level of 0.05. Statistically, we can reject the null hypothesis, although with a small margin. These two variables, therefore, probably deteriorated between 2012 and 2014, i.e. it became harder to register a company and the level of employees' fraud increased.

It is interesting to note that several Swedish managers expressed concerns regarding the high risk of fraud from their own



employees. There is a severe problem with human resources as almost half of western managers do not trust their employees in Russia. Serious discussion is needed including topics of education as well as ethical norms of business behavior.

## Conclusions

One of the central assertions of the 2005 World Development Report on the business climate is that a good business climate drives growth by encouraging investment and higher productivity. Despite the established importance of a positive local business climate, we have shown in the article that current knowledge regarding elements that constitute business climate remains broad, elusive and hard to define. The reader should not draw the conclusion that business climate as a strategy or concept is worthless and does not deserve our attention. On contrary, we believe that business climate plays an important role in economic development.

For this reason, it is important to study this concept, including uncertainties about the very scope of the term business climate. Instead of a one-dimensional concept, we might need to pay more attention to different aspects of business climate. This approach highlights not only the complex nature of how the business climate affects firms, but also emphasizes that a region can excel in some areas while lagging in others. It is necessary to further explore the definition of business climate to include: the role of government, demographic configuration, political culture, natural resources, settlement and immigration patterns, geographic location and population distribution among city, suburb, small town and rural environments. Characteristics such as history, geography, community values and attitudes can be also considered for the future research agenda.

Our study suggests that the following variables of business climate deteriorated between 2012 and 2014: Political risk, currency risk, counterparty risk, inflation risk, getting information, availability of statistics, customs procedures, payment discipline, postal infrastructure, IT infrastructure, corruption, Russian law, short-term banking, and English proficiency. Our observation is in line with the worsening current political and economic situation in Russia. When someone does business in Russia, they need to have a long-term commitment. This would be impossible if the investors' picture on different risks continues to deteriorate. In order to break the trend and make Russia more attractive for foreign investors, the Russian government needs to build a business climate based on transparent and predictable rules, reducing risks and uncertainty.

While corporate taxation, VAT refunds, manager's availability, and long-term banking continue to evolve and foreign investors still face various challenges in navigating the system, our analysis indicated that they have enjoyed positive developments between 2012 and 2014.

To improve its business climate, Russia needs to change the way that foreign investors, particularly potential ones, see the country. This concept – viewing business climate as an asset – could be relevant for Russian politicians and government officials. Russia needs to send a welcoming message to encourage new investors to enter the market and current investors to stay.

This is, however, impossible without radical reforms aiming to enhance the quality of the “business climate” itself. An intangible asset “business climate,” being booked on Russia's balance sheet, should provide the high quality features insuring long-term prospects for investors.

The findings provide support to several mainstream theoretical arguments regarding the business climate but also demonstrate some contradictions that require further investigation. These include the reaction of the Swedish business to the escalation of political tensions between Russia and the West and the corruption factor, which is not viewed as sufficiently serious to fully discourage foreign investors from staying in Russia.

The article does not identify any strong reasons for preferring one school of thought for analysis of business climate at the expense of another. This paper applied a micro-level analysis, and some results on company-based business climate work are encouraging. Company-level enterprise has proved a rich resource for research to explain firms' performance as a function of different aspects of the business climate.

For future research, a more disaggregated approach (company or industry level) is suggested as the relative importance of each component is likely to differ from business to business. The international research community is also well placed to develop more standardized measures of the business climate in order to make cross-country comparisons. When more survey analyses become available, proper data macro-economic regressions could test for the impact of changes in the business climate on productivity, investment returns, and growth. ✖

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# The decline of the Russian economy

## Effects of the non-reform agenda

by **Susanne Oxenstierna**

In 2014 the Russian economy showed almost zero growth and the forecasts for 2015 indicate a contraction of 3–4%. This stands in sharp contrast to the high growth rates of the 2000s but also compares poorly with the more moderate expectations of 3–4% GDP growth after the economic crisis in 2009. Nevertheless, instead of choosing the path of modernization after the crisis, the Russian leadership opted for more state intervention and more state control of the economy and it continued to support non-viable production by old state enterprises despite the decline in growth rates. The non-competitive environment where political ties and subsidies have been more important for survival than market performance has slowed the development of new private small- and medium-sized enterprises that represent the future of the economy. Weak institutions have been the trade mark of the economic order under Vladimir Putin and rule of law, effective governance, control of corruption and other governance indicators have deteriorated during his time in office. Why has the Russian leadership become so uninterested in promoting growth and further prosperity for the country?

The downgrading of economic goals is linked to the increased prioritizing of geopolitical objectives in Russian foreign policies. As early as in his speech to the Federation Council on April 25, 2005, President Vladimir Putin claimed that “the collapse of the Soviet Union was a major geopolitical disaster of the century”.<sup>1</sup> In his speech to the Munich Conference on Security Policy two years later Putin described the

unipolar world that developed after the Cold War, with the US as the only superpower, as “unacceptable” and that “[t]he United States has overstepped its borders in all spheres – economic, political, and humanitarian and has imposed itself on other states.”<sup>2</sup> Thereafter, preserving its influence over the post-Soviet states became an overriding goal in Russian politics, taking precedence over other things such as economic growth. Likewise, the imperative of domestic stability and the anxiety over color-themed revolutions and a potential Russian Maidan<sup>3</sup> have decisively influenced the way Russia’s domestic politics have evolved with significantly limited citizen rights, persecution of NGOs with foreign funding as “foreign agents,” and repression of all political opposition. Thus it appears reasonable to state that geopolitical aspirations and the preeminence of maintaining the political status quo at home have become more important than economic growth in Russian politics. This article explores the effects of not reforming the economy and strengthening the market economy but instead letting political objectives overshadow concerns for economic development.

### abstract

The objective of the article is to analyze the economic effects for Russia of pursuing political goals instead of reviving the economy and carrying out necessary reforms. The “non-reform agenda” since the mid-2000s means that for many years, the economy has been sliding due to structural problems and weak institutions. These tendencies were reinforced with the re-election of President Vladimir Putin for a third term in 2012 and his economic agenda. Since 2014 the additional problems of geopolitical tension, low oil prices and economic sanctions have resulted in the economy contracting. Despite the depressed economy the leadership keeps military expenditure at a high level. Import substitution as a means to mitigate the economic crisis is not convincing.

**KEY WORDS:** Russia, economic decline, political versus economic goals, institutions, rent addiction, rent management, sanctions, import substitution.

**THE OBJECTIVE OF** the article is to analyze the economic effects for Russia of pursuing political goals instead of reviving the economy and carrying out necessary reforms. The “non-reform agenda” since the mid-2000s that was reinforced with the reelection of President Vladimir Putin for a third term in 2012 has led to the economy sliding due to structural problems and weak institutions over many years.

Since 2014 with the additional problems of geopolitical tension, low oil prices and economic sanctions these weaknesses have been revealed and the economy is contracting.

The article is organized as follows. In the second section the foreign political background to the present crisis is described. In the third section the structural reasons for the economic decline are analyzed. In the fourth section Putin's economic policy since 2012 is investigated and in the fifth section the economic situation 2013–2015 is explored and effects of sanctions are discussed. The final section draws the conclusions of the article.

## Political background of the crisis with the West<sup>4</sup>

The deterioration of the relationship between Russia and the West after Russia's annexation of Crimea reflects a deep disagreement over the post-Cold War security order in Europe that has existed over some time. In brief, Russia has become dissatisfied with the arrangements that developed after the collapse of the Soviet Union in 1991 and wants to preserve at least what is left of the former Soviet "sphere of influence," which includes the remaining former Soviet republics in Europe, Ukraine, Belarus, Georgia and Moldova, Armenia and Azerbaijan and Central Asia. Meanwhile the West regards these countries as sovereign states that are free to engage in any international cooperation and form the alliances they choose. Russia's former satellites in Europe and the three Baltic republics joined NATO in 1999 and 2004<sup>5</sup> and they acquired full membership in the EU in 2004 and 2007.<sup>6</sup> When Georgia and Ukraine pursued attempts to join NATO in 2008 and the alliance spoke positively of these countries eventually joining the alliance, this was too provocative for Moscow and resulted in the military conflict in 2008 with Georgia over South Ossetia and Abkhazia in which Western countries were not inclined to intervene.

After the Georgian war the EU launched the Eastern Partnership which was to include Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine. This was mainly an economic initiative, offering the opportunity for economic reforms through increasing interaction and exchange with the EU; however, it also included goals of building a "common area" of democracy, prosperity and stability. The idea was thus to create stronger economic cooperation with the EU and strengthen the market economy in the Eastern Partnership countries and also to transfer Western values of democracy, rule of law and fighting corruption. Russia disliked this initiative and found the EU trespassing in its "sphere of influence".

In response, Russia announced that it intended to form the Eurasian Customs Union (ECU) by 2015. Belarus and Kazakhstan signed the agreement to establish ECU in 2011, but the union would be insufficient with only these two countries. In addition Russia opted to include Armenia, Moldova and Ukraine, and of these countries Ukraine mattered most to Russia because of its size and strong economic, historical and cultural ties with Russia. If Ukraine signed the Association Agreement with the EU, which was planned for November 2013, it could not join the ECU. For Russia it was vital to prevent any further expansion of "EU's

sphere of influence" and especially to block Ukraine's accession to the Eastern Partnership. As is now known, the then President Yanukovich did not sign the agreement with the EU in November; instead he signed an agreement with Russia for a bail-out loan of USD 15 billion in December 2013. This was the last straw that triggered the still ongoing crisis in Ukraine.

Pro-European protests on Maidan, Independence Square, in Kiev started in November 2013. After the failure to sign an agreement with the EU, tension increased and the government tried to fight the uprising by force, resulting in many casualties. On February 22, 2014, the protesters ousted President Yanukovich who fled to Russia. On February, 27 Russia's "little green men"<sup>7</sup> took the airport in Simferopol' and occupied the Supreme Council of Crimea, enabling a pro-Russian government to be installed. By 18 March Russia's annexation of Crimea was a fact.

## Factors behind the economic decline

Russia's current economic situation stems from multiple accumulating problems; it does not simply reflect the consequences of the international reactions on policies towards Ukraine or to President Putin's authoritarian domestic policies in his third presidency. First, despite a lot of discussions over the years and a serious modernization proposal by then President Dmitry Medvedev in 2009, Russia has not managed to escape its dependency on exporting hydrocarbons and there seem to be very few new up-coming innovative products "made in Russia" in view. Second, the inability to leave the extensive energy-export-driven path of development is explained by the power vertical's dependence on rents from the commodity trade and the distribution of rents that has evolved under Vladimir Putin.<sup>8</sup> Oil rents are used to subsidize economic actors that are not economically viable, so called "rent addicts", who support the regime in exchange for subsidies and further survival. Third, new private small and medium-sized enterprises that as a rule are outside Putin's rent distribution system find it difficult to attract investment and manpower in order to grow. Institutions are weak and the business climate is unfriendly for these market actors.<sup>9</sup>

These factors have been on the scene since the mid-2000s, long before more acute depressing factors were added in 2014. The new tendencies have seriously damaged the economic prospects and the economy has gone from a stagnating muddling-through to a meltdown. The confidence in the Russian economy declined as the Ukrainian crisis developed with a fall of investments and FDIs as a result. Economic sanctions have made it difficult for the Russian state banks and companies to access Western capital markets which has negative multiplier effects throughout the economy, and some specific exports to Russia were banned which has suppressed technology transfer from the West on which the Russian industry depends. In particular, this has caused problems for oil exploration on the Arctic shelf and the defense industry. The final blow was the dramatic fall in the oil price which appears likely to stay low at around USD 50 per barrel during at least 2015, which has decreased income to the federal budget. The value of the Russian ruble (RUB) was halved against the dollar, which has made imported goods



expensive and has contributed to inflation. In response to the Western sanctions the Russian government imposed counter sanctions on certain food products that have further spurred inflation.<sup>10</sup>

The Russian economy has suffered from structural problems since the early 2000s and unfortunately the modernization program launched in 2009 by then President Dmitry Medvedev – which addressed the need for diversification from the heavy reliance on the export of hydrocarbons, too much state involvement in the economy, the weak business climate for small and medium-sized businesses problems and corruption – was too much of a challenge for the various political elites and never materialized.<sup>11</sup> Yet the popular protests in the fall of 2011 and early 2012 against electoral fraud and Putin's standing for president again showed that a considerable part of society wanted a change in the political sphere as well.

A major obstacle to any modernization program in Russia is that the economic system that has developed since the reforms in the 1990s still bears features of the Soviet command system. Despite the change of system from a command economy to a market economy, the institutions that normally support market allocation are weak and are overruled in many ways by informal institutions surviving from the Soviet era and new variants of manual management that have evolved during Putin's reign. That Russia's market institutions are deficient is reflected in the Worldwide Governance Indicators.<sup>12</sup> The WGI project constructs aggregate indicators of six broad dimensions of governance: political stability and absence of violence/terrorism; voice and accountability; government effectiveness; regulatory quality; rule of law; and control of corruption. When these indicators are studied over time it is found that in Russia they have generally been low, that they improved up to the early 2000s, but that since 2004 there has been a marked deterioration in vital institutions like "rule of law" and "control over corruption".<sup>13</sup> "Voice and accountability" shows a downward trend over the whole period of Putin's leadership since 2000. Weak institutions create scope for manual management of economic matters, which is also a reason why institutions need to be kept weak – so that political goals rather than economic goals can be pursued.

**THE PRESENT RUSSIAN** economic system may be characterized as a hybrid of the old Soviet heritage with inefficient state-owned or state-controlled subsidized enterprises and state intervention, on the one hand, and a market economy consisting mainly of the small and medium-sized business sector that evolved after the change of system, on the other hand. In Putin's power balancing system, the loss-making "Soviet-type enterprises"<sup>14</sup> are subsidized to ensure continuing support for the regime. Rents from high oil prices have been distributed in what Clifford Gaddy and Barry Ickes call a "rent management system" and economic behavior has been labelled "rent addiction," alluding to the fact that when rents from natural resources are invested in inefficient production by loss-making firms – "addicts" – they will continue to demand resources in order to save jobs and capital already installed.<sup>15</sup> This preservation of the old industrial structure and

the resulting rent management system inhibits the growth of the private market-oriented sector. It provides an explanation for the weak institutional framework and poor business climate in Russia. The old industrial sector is not interested in institutional reform and more competition; more market and competition would upset the power balance. Thus, growth cannot be restored within this economic system.<sup>16</sup>

Nevertheless, liberal economists in Russia have argued for a renewed market reform in order for Russia to be able to compete in the global environment, overcome capacity constraints and support innovation. They have also emphasized the need for real democracy to enable modernization.<sup>17</sup> In fact, political reform would be necessary to reinstate the market as the main instrument in resource allocation. However, the regime under Putin has become more authoritarian and since he came back to presidential power in 2012, civil society has been repressed and civil liberties have been severely restricted. Tax policies and anti-corruption campaigns have had an adverse effect on the establishment and growth of new businesses and small businesses have shut down or become part of the informal economy instead of expanding and increasing their share in the formal economy.

## Putin's economic policy

On the macro level the Russian economy performed well in the 2000s and its fiscal management won praise. Economic policy under former Minister of Finance Alexei Kudrin was commended for its restraint and low government debt. The crisis management during the 2009 economic contraction resulted in Russia recovering from the crisis, and growth in 2010 was 4.5%.<sup>18</sup> In connection with Kudrin's resignation in September 2011 the direction of economic policy became less consistent and the idea of Russia taking its own route with a "Russian economic model" seriously challenged the liberal paradigm. This idea matches the general nationalistic trend in Russian policy which is based on the notion that Russia is a special country with a special mission that should pursue its own path and not follow the "decadent West," ideas that have been developed after Putin's return as president in May 2012.

President Putin presented the main directions of his economic program immediately after his inauguration in May 2012. In his first decree on economic policy, he spelt out the economic improvements that should be achieved by 2018–2020.<sup>19</sup> These included: the creation of 25 million highly productive work-places by 2020; an increase in the share of investment in GDP to 27% in 2018; an increase of investment in state priority industries; an increase in labor productivity by a factor of 1.5; preparations for the privatization of state assets outside the commodity-energy sector; and an improvement of the rating of Russia in the World Bank Ease of Doing Business Index from 120<sup>th</sup> place in 2011 to 50<sup>th</sup> in 2015 and 20<sup>th</sup> in 2018.

Moreover, despite the negative Soviet experience and evidence from other countries that high military spending does not guarantee high growth, the increased role of the defense industry was stressed in Decree No. 603 and in the budget address 2012.<sup>20</sup> There the defense industry was named "a driver" in

economic development. The government's economic program up to 2018 also stressed the importance of the defense sector in technological modernization and for generating economic growth.<sup>21</sup>

Several of Putin's goals appeared difficult to achieve even before the sharp decline in growth in 2013. Raising the investment ratio to 27% would have been a difficult task even before the surge in capital flight in 2013–2014. Creating 25 million highly productive workplaces would also have been difficult before the present economic stagnation since the rent-dependent companies hoard labor in order to motivate continuous subsidies and Russia is experiencing labor shortages due to the decline in the working-age population and the low geographical mobility of the workforce.<sup>22</sup> The labor market is tight and for new jobs to be manned old, inefficient "Soviet-type" jobs need to be scrapped and labor motivated and helped to move. As the reform economist Vladimir Mau remarked, there is no labor surplus to employ in these new jobs. Mau also notes that a large part of the educated middle class living in the big cities is ready to leave the country.<sup>23</sup> The trend in emigration supports this notion. According to Rosstat data, annual emigration has quintupled since 2010.<sup>24</sup>

The weak business climate has been a characteristic of the Russian economy despite years of reform aimed at improving it. Nevertheless, Russia's ranking in the World Bank Ease of Doing Business Index has improved since Putin's Decree No. 596. In 2013 it had improved to 92nd among 189 countries (from 120<sup>th</sup> place 2012). In 2014, Russia had reached place 64 in the ranking and in 2015, place 62.<sup>25</sup> The aspects in which Russia still has substantial disadvantages are "getting electricity", "obtaining construction permits" and "trading across borders". Moreover, between 2014 and 2015 the rank of the indicator "getting credits" has deteriorated. However, this index reflects performance with respect to six different indicators and it does not capture the balance between old, large enterprises with political influence existing outside market competition and small and medium-sized firms struggling to stay in business and expand. Nevertheless, it is worth noting that with respect to the business climate Russia has taken some steps in the right direction, although the credit crunch will probably continue for the foreseeable future.

## Economic growth and policy 2014–2015

In 2013, Russian growth plummeted to 1.3% a year instead of the 2–3% forecasted. The confidence crisis following Russia's annexation of Crimea in March 2014 and its continuing aggression against Ukraine lowered growth expectations, and in October the IMF revised its forecast to 0.2% growth for 2014, 0.5% for 2015 and a recovery to 1.5% only in 2016.<sup>26</sup> In January 2015, however, the preliminary result for 2014 was 0.6% growth and the IMF now projected a contraction of -3% for 2015 and -1% for 2016.<sup>27</sup> Western sanctions, Russian counter-sanctions and the dramatic fall in the oil price added to the negative trend. In April 2015, the World Bank presented three scenarios with growth rates

**Table 1: Macroeconomic development 2012–2015** (World Bank baseline scenario 2015)

	2012	2013	2014	2015	2016
Oil price, USD/bbl	105	104	97.6	53.2	56.9
GDP growth, %	3.4	1.3	0.6	-3.8	-0.3
Consumption growth, %	6.4	3.9	1.5	-5.3	-1.9
Gross capital formation growth, %	3.0	-6.6	-5.7	-15.3	1.1
General government balance, % GDP	0.4	-1.3	-1.2	-3.6	-3.1
Current account, USD billion	71.3	34.1	56.7	73.7	62.9
Current account, % GDP	3.6	1.6	3.0	6.0	4.4
Capital and financial account, USD billion	-32.3	-56.2	-143.2	-122.1	-60
Capital and financial account, % GDP	-1.6	-3	-7.7	-10	-4.2
CPI, average, %	5.1	6.8	7.7	16.5	8.0

Source: "The Dawn of a New Economic Era?", *Russia Economic Report*, 33 (World Bank, April 2015): 24. Accessed April 20, 2015, [http://www-wds.worldbank.org/external/default/WDSCContentServer/WDSP/IB/2015/04/12/000333037\\_20150413141814/Rendered/PDF/956970NWP00PUB0B0WB0RER0No0330FINAL.pdf](http://www-wds.worldbank.org/external/default/WDSCContentServer/WDSP/IB/2015/04/12/000333037_20150413141814/Rendered/PDF/956970NWP00PUB0B0WB0RER0No0330FINAL.pdf).

between -2.9 and -4.6 for 2015 and 0.1 to -1.0 for 2016; the baseline scenario is described in Table 1 and predicts -3.8% for 2015 and -0.3 for 2016.<sup>28</sup>

## Impact of the economic sanctions imposed by the US and the EU

In July 2014 the US and the EU imposed economic sanctions on Russia affecting its financial sectors, energy sector and defense industry.<sup>29</sup> As a result, in 2015 six major state banks and major energy and defense companies in the listing can only apply for loans and issue debt not exceeding 30 days of maturity on EU and US capital markets. The defense and energy sectors have also been hit by the prohibition to export arms and dual-use goods and advanced technology for oil exploration to Russia.

There is still no comprehensive analysis on how the sanctions hit the Russian economy and even less on the magnitude of the effects because this cannot be separated from the impact of other factors. More time need to elapse before these matters can be fully investigated. Nevertheless, the World Bank argues that Western sanctions have hit the Russian economy through three channels: first they have caused volatility on the foreign exchange market and a significant depreciation of the ruble.<sup>30</sup> This has also led to capital flight and deterioration of international reserves. The second channel through which sanctions have hit the economy is the restriction on access to international financial markets. The tighter domestic and external credit conditions have negatively affected investment and consumption.<sup>31</sup> This is the sanction that has impacted the economy most in the short-run since it inhibits investments and refinancing of major state banks and other financial institutes. The third channel cited by the World Bank is the confidence crisis that has developed as a consequence of the geopolitical tension and sanctions that have

**Table 2: Federal budget items as shares of GDP in 2012–2015** (percentage of GDP)

	2012 Actual	2013 Actual	2014 Actual	2015 FZ- 384	2015 New budget
Federal budget as % of GDP	20.6	19.8	20.9	20.0	20.8
General state issues	1.3	1.4	1.3	1.4	1.5
National defense	2.9	3.1	3.5	4.2	4.3
National security and legal system	2.9	3.0	2.9	2.8	2.8
Support to the economy	3.1	2.7	4.3	3.0	2.9
Housing and utilities	0.4	0.2	0.2	0.2	0.2
Environment protection	0.0	0.0	0.1	0.1	0.1
Education	1.0	1.0	0.9	0.8	0.8
Culture	0.1	0.1	0.1	0.1	0.1
Health	1.0	0.8	0.8	0.5	0.5
Social policy	6.2	5.7	4.9	5.2	5.8
Physical culture and sport	0.1	0.1	0.1	0.1	0.1
Media	0.1	0.1	0.1	0.1	0.1
Debt service (state and municipal)	0.5	0.1	0.6	0.6	0.8
Inter-budgetary transfers	1.0	0.6	1.1	0.9	0.8
Deficit/surplus	–0.1	–0.8	0.5	–0.6	–3.7
GDP bn RUB	62,599	67,519	70,976	77,499	73,119

Sources: Data for 2012 and 2013: The information on the execution of budgets, Federal Treasury of the Russian Federation, July 2013, accessed 5 July 2014. [http://www.roskazna.ru/en/the-information-on-execution-of-budgets/](http://www roskazna.ru/en/the-information-on-execution-of-budgets/)  
Data for 2014 and 2015: Poyasnitel'naya zapiska k projektu Federal'nogo Zakona "O vnesenii izmenenii v Federal'nyi zakon "O Federal'nom byudzhete na 2015 god i na planovyi period 2016 godov" [Explaining note to the project "Revisions to the federal budget law for the budget 2015 and the preliminary budget for 2016"], Ministry of Finance RF (2015) 8, accessed March 25, 2015. [http://asozd2.duma.gov.ru/main.nsf/\(ViewDoc\)?OpenAgent&work/dz.nsf/ByID&04D187289DAC194943257D63004E6253](http://asozd2.duma.gov.ru/main.nsf/(ViewDoc)?OpenAgent&work/dz.nsf/ByID&04D187289DAC194943257D63004E6253). Prilozhenie No 5 k poyasnitel'noi zapiske k projektu FZ "O vnesenii izmenenii v Federal'nyi zakon "O Federal'nom byudzhete na 2015 god i na planovyi period 2016–2017 godov" [Annex No 5 to the Explaining note to the project "Revisions to the federal budget law for the budget 2015 and the preliminary budget for 2016"], Ministry of Finance RF (2015), accessed March 25, 2015. [http://asozd2.duma.gov.ru/work/dz.nsf/ByID/1F4B4A870CEEDFB43257D6300510063/\\$File/%D0%9F%D1%80%D0%B8%D0%BB%D0%BE%D0%B6%D0%B5%D0%BD%D0%B8%D0%B5%20%E2%84%96%208%20%28%D0%BD%D0%BE%D0%B2%D0%BE%D0%B5%29.pdf?OpenElement](http://asozd2.duma.gov.ru/work/dz.nsf/ByID/1F4B4A870CEEDFB43257D6300510063/$File/%D0%9F%D1%80%D0%B8%D0%BB%D0%BE%D0%B6%D0%B5%D0%BD%D0%B8%D0%B5%20%E2%84%96%208%20%28%D0%BD%D0%BE%D0%B2%D0%BE%D0%B5%29.pdf?OpenElement)

resulted in great uncertainty regarding policy and economic development. Consumption growth slackened in 2014 and fixed investment contracted by 2.5%. Foreign direct investment (FDI) was halved in the first three quarters of 2014 compared with the same annual periods 2011–2013.

In addition trade flows have been impacted and imports have decreased mainly due to the weakened ruble and the Russian counter sanction banning certain food imports. Effects on Russia's oil and gas export volumes have not been too evident yet. This is due to the fact that oil and gas contracts are usually set for a longer

period. Effects of the sanctions on targeted sectors such as the prohibiting the export of arms, dual-use technology and advanced technology for oil and gas exploration and the defense industry are still to come according to the World Bank assessment.<sup>32</sup>

## The federal budget

In the initial three-year budget for 2014–16 there was an aim to reduce the federal budget as a share of GDP from 20 to 18% by 2016.<sup>33</sup> Social policy expenditure, which has had high priority since 2009, was to fall from 6 to below 5% of GDP. The shares of education and health were also to decline. Defense spending remained at a high level and was planned to rise from 3.1% of GDP in 2013 to 3.8% by 2016. Fiscal policy during 2013 remained restrained and actual budget expenditures were slightly lower than approved.<sup>34</sup> Table 2 shows the actual federal budget shares for 2012–2014 and here the austerity in 2013 is reflected: the federal budget's share in GDP dropped to 19.8%. However, in 2014 the share increased again to 20.9%. The increased priority given to defense and Russia's increasing security policy ambitions with Putin's return to power is reflected in that the share of national defense rose from 2.9% in 2012 to 3.1 in 2013 and to 3.5% in 2014 (Table 2).

THE BUDGET FOR 2015–2017 (FZ-384) was adopted by the Duma in November 2014. The Ministry of Finance had opted for a minimal budget deficit of less than 1% and fierce discussions had accompanied the budget process in the government on where the cuts should be made, not least on how far defense spending could be preserved at high levels when other public spending had to be reduced. The budget law implied a defense budget of 4.2% of GDP in 2015. However the Minister of Finance Anton Siluanov had already signaled that a new defense program needed to be developed that took into account the changed economic situation, even though the deputy Prime Minister Dmitry Rogozin in charge of the sector had ruled out any cuts in military spending.<sup>35</sup> "A new defense program will be prepared now, and in its framework we want to reconsider the amount of resources that will be spent from the budget in order to make it more realistic," said Siluanov. This was an echo of his veteran predecessor, Alexei Kudrin, who quit in protest when the rise in military spending was initially proposed under President Medvedev in September 2011. At that time, however, the funding of the military reform and the rearmament program were based on the assumption that Russia would maintain its unprecedentedly high growth rate of 6% per year throughout the decade. Now times had changed and Siluanov stated quite bluntly "Right now, we just cannot afford it".<sup>36</sup> The lower growth due to the dip in oil prices, the halving of the value of the ruble against the US dollar, and the Western sanctions impeding Russian banks' free access to Western capital markets and restricting exports of advanced technology to Russia, had clearly shattered the Minister of Finance's hopes of a quick recovery. It was time to tell the truth about the economic situation.

Since it became increasingly obvious that the oil price would drop from its high level of around USD100/bbl and that GDP



would contract, the Ministry of Finance prepared amendments to the budget that were discussed during the first months of 2015. The new amended budget for 2015 was adopted by the Duma April 7, 2015 and has a much lower GDP estimate for 2015. As seen in Tables 2 and 3, forecast GDP is almost 6% below that in the original budget law (Table 3). The new law applies to 2015 only and the Ministry of Finance will introduce changes related to 2016 and 2017 in September 2015. The new law is based on the assumption of an oil price of USD 50/bbl and GDP contraction by 3%. Budget revenues are projected to decrease by 3.3% of GDP while expenditure decreases only marginally from 20.9 in 2014 to 20.8% of GDP in 2015. The deficit rises to 3.7% of GDP and the Reserve Fund will be the main source of deficit financing.<sup>37</sup> This means that in total RUB 3.2 trillion (about USD 50 billion) will be drawn from the Reserve Fund, which corresponds to about 60% of the whole fund (USD 85 billion).<sup>38</sup> This reduces Russia's fiscal maneuvering room for future years if the economy does not recover or Western financial markets do not open up for Russian state banks.

AS SHOWN IN TABLE 3, the defense budget has been cut by almost 5% in nominal terms compared to the original FZ-384. National security – much less discussed but also an item that has had high priority and grown during the Putin era – also sees reductions. Support for the national economy is cut by 8.8%, which is quite courageous of the government considering the difficulties Russian companies are experiencing under present circumstances. Furthermore, spending on many of the items that affect the population most, such as the health sector, protection of the environment, education and culture, has been reduced and it may be interesting to see if this has any effect on public opinion. Nevertheless, social policy has been allocated increased funding, which will be devoted to pensions and social provisions for households.<sup>39</sup>

## The anti-crisis program and import substitution

So what is the government doing to mitigate the poor economic prospects? The government has initiated an anti-crisis program worth USD 35 billion (about 1.5% of GDP).<sup>40</sup> The plan was rather vague as to what was to be cut in other public spending in order to afford this program since it was presented before the new budget that was adopted only in April. Some investments are to be financed through the National Wealth Fund and redistributions have been made from other unnamed projects. Most of the spending goes to the banking sector since Western sanctions impede Russian state banks' and big state companies' access to

**Table 3: Federal budgets 2014 and 2015 and proposed changes in 2015** (million RUB [current prices] and percent)

	2014	2015	2015	2015	Change %
	Actual	Budget law FZ-384	Proposed change	New budget April 2015	from FZ-384 to new budget
Total spending	14 830 601	15 513 079	–298 035	15 215 045	–1.9
State administration	934 741	1 113 735	–33 669	1 080 066	–3.0
National defense	2 479 074	3 273 991	–157 218	3 116 774	–4.8
National security and legal system	2 086 165	2 148 072	–80 423	2 067 649	–3.7
National economy	3 062 915	2 338 749	–205 897	2 132 852	–8.8
Housing and municipal services	119 609	144 606	–15 603	129 003	–10.8
Environmental protection	46 366	54 947	–8 868	46 079	–16.1
Education	638 265	632 976	–30 867	602 108	–4.9
Culture	97 832	99 008	–7 115	91 893	–7.2
Health	535 564	420 940	–34 730	386 210	–8.3
Social policy	3 452 374	4 010 082	203 639	4 213 721	5.1
Physical culture and sports	71 164	73 662	–1 818	71 844	–2.5
Media	74 832	69 971	2 152	72 124	3.1
Debt service	415 612	449 304	135 996	585 299	30.3
Transfers between budgets	816 090	683 037	–63 614	619 423	–9.3
Deficit		–431	–2 245	–2 673	
GDP billion RUB	70 976	77 499	–4 380	73 119	–5.7

Source: : See Table 2. Sources for data for 2014 and 2015.

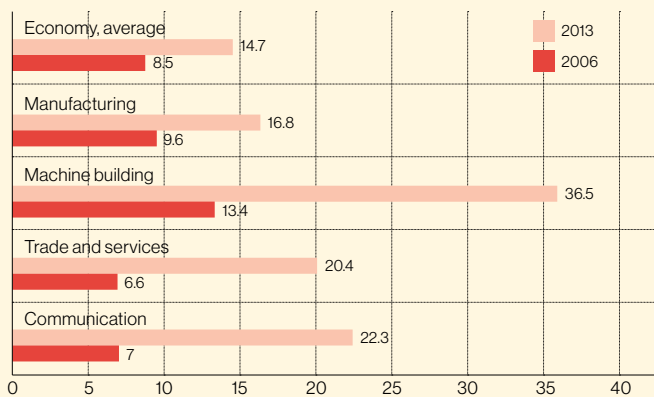
Western capital markets, thus hindering production.<sup>41</sup>

“Import substitution” is the new paradigm of Russian economic policy. The idea that the Russian economy should use the current situation to advance domestic industry and production also permeates the Russian counter-sanctions imposed August 7, 2014.<sup>42</sup> In April 2015 the Ministry of Industry and Trade presented a plan on how Russia should become more self-sufficient by implementing 2,059 projects in 19 branches of the economy up to 2020.<sup>43</sup> The cost is estimated at RUB 1.5 trillion, of which only RUB 235 billion will come from the federal budget (ibid.). Many observers point to the difficulty of this scheme given the relatively high import dependence of the Russian economy after almost 25 years as an open economy and that the funds available for necessary investments are too small. Olga Berizinskaia and Alexei Vedev highlight the fact that the general dependence on imports in production has almost doubled between 2006 to 2013 from 8.5 to 14.7% (Figure 1).<sup>44</sup> In machine construction the figure has risen from 13.4 to 36.5%. High shares may also be noted in communication and transport (Figure 1).<sup>45</sup>

The Russian counter-sanctions have to a large extent been geared towards banning food imports, which demands that domestic production of these goods is increased. However, here

## Figure 1: Import dependence in the Russian economy 2006 and 2013

(import as percentage of producers' total costs)



Source: Olga Berezinskaya and Alexei Vedev "Proizvodstvennaya zavisimost' Rossijskoj promyshlennosti ot importa i mekhanizm strategicheskogo importozameshcheniya" [Production dependence of import in the industry and the mechanism of strategic import substitution], *Voprosy ekonomiki*, 1 (2015: 103-124) 104.

too it is evident that there is a significant dependence on imports in Russian production. Apparently, in meat production there is a dependence of 20%. In fish and seafood production the corresponding figure is 28% and in the production of vegetables and fruits, 33%. In order to cope with the increasing demand, these sectors need to be modernized and to make that possible significant investment is required. In more advanced production there is a need for more advanced technology if Russia is to become more self-sufficient, e.g. in the production of food enzymes the import dependence is presently 68%.<sup>46</sup> At the moment the opportunity for getting necessary investments and acquiring the technology needed for this kind of production is small due to the weak ruble and the lack of equipment on the Russian market.

## Can Russia change its economic orientation from the EU?

The EU has been Russia's most important trade partner since Russia introduced the market economy in the 1990s. In 2013, 53% of Russian exports of goods went to the EU and 46% of imported goods came from the EU. European banks hold 75% of foreign bank loans to Russia and substantial stocks of FDIs.<sup>47</sup> It follows that it will take time for Russia to change its trade orientation if it wants to replace part of the previous export and import activity to and from Europe with trade with Asia, BRICS or the post-Soviet space. In the 2010s, about 80% of its energy exports went to the West and 10% to Asia.<sup>48</sup> Cooperation with BRICS cannot solve Russia's major challenges of attracting investments and technology.<sup>49</sup> To expand the cooperation with the countries in the Eurasian Customs Union (ECU) is plausible but it would imply stressing Russia's "special route" away from the West, market economy and democracy; that is, going backwards rather than forwards.

Could Russia turn to China and increase economic coopera-

tion? China is one of Russia's main trading partners – 6.8% of Russia's exports go to China and 16.4% of its imports come from China.<sup>50</sup> China has bought Russian oil since 2009, and in 2013, Rosneft agreed to double oil supplies to China in a deal valued at USD 270 billion. This means that 20% of Russia's oil exports will eventually go to Asia.<sup>51</sup> In May 2014, after relations with the West were upset, a gas agreement worth USD 400 billion was signed between Moscow and Beijing, under which Russia will supply 38 billion cubic meters (bcm) of gas to China over 30 years starting in 2018. If a second pipeline is built to China's western provinces this would expand Russia's annual gas sales to China to 61 bcm.<sup>52</sup> This is a large amount but still just a fraction of what Russia exports to Europe: in 2013 pipeline gas exports to Europe amounted to 162.4 bcm.<sup>53</sup> In addition to the oil and gas cooperation, China and Russia are partners in the nuclear energy field.<sup>54</sup>

The defense industry is a priority and the Western sanctions have closed Russia's access to Western defense technologies and technologies of dual use, which may become a problem for the defense industry that is not as self-sufficient as is sometimes claimed.<sup>55</sup> More importantly, however, Russia has lost its quite extensive arms cooperation with Ukraine and with it supplies of important arms components (in particular gas turbines and helicopter engines) which were essentially produced in eastern Ukraine. Also, Russia lacks production of electronics, but China has developed its indigenous production, and Russia could use Chinese electronics in its arms development.<sup>56</sup>

## Conclusions

The third term of Vladimir Putin as president of the Russian Federation has implied that geopolitical aspirations and the precedence of maintaining the political status quo at home have become the overriding goals in Russian policies. Economics and economists have very little influence over the present political development, which stands in sharp contrast to Putin's first period and to Dimitry Medvedev's term as president. Presently, becoming a great power of the world is far more important than attracting investors, achieving high economic growth and increasing the living standard of the Russian population. During his third term Putin has given priority to the military sector, military spending has risen substantially as share of GDP, and the defense industry has been launched as a "driver" in the economy. As a result of these choices and a rent management system giving advantages to non-viable producers in exchange for loyalty to the regime, economic performance has been weak for several years and growth dropped to 1.3% and 0.6% growth in 2013 and 2014. Russia's annexation of Crimea and the subsequent war with Ukraine have added to the declining economic trend and created an economic meltdown. The currency was depreciated by half and on top of this Western sanctions have been imposed and the oil price has dropped from a level of USD 100/bbl to USD 50/bbl. Together these factors have led to that the economy will contract at least by 3% in 2015 and the prospects for the coming years are very bleak.

In response to the economic decline the government has launched an anti-crisis program that is small in comparison

to the measures imposed during the crisis 2009 and which is mainly geared at supporting the banks and increasing social programs. The innovative policy initiative that has been launched to curb the negative development is “import substitution” meaning that Russia, like the USSR, should produce more domestically and become less dependent on the outside world. Unlike the USSR though, Russia is quite import dependent after having been integrated in the global economy for twenty-five years; to cope even with the restricted nomenclature of products presented by the Ministry of Industry and Trade does not seem realistic even in the medium-term. Of course, domestic production sheltered by the weak currency and import bans will imply low quality goods at high prices for the consumers.

Productivity growth occurred during the high growth years but Russia did not use the opportunity to invest and create an innovative economy. Instead of modernization and institutional reform the political leadership opted for a political resource allocation preserving rent addiction and non-viable economic actors that need constant state support and subsidies to survive.

**THE WESTERN FINANCIAL** sanctions have impacted the Russian economy severely and contributed to difficulties in refinancing debt and raising funds for investments. In addition, trade flows have been impacted and imports have decreased mainly due to the weakened ruble and the Russian counter-sanctions banning certain food imports. Effects on Russia’s energy export volumes have not been too evident yet because oil and gas contracts are usually set for a longer time. The effects of the sanctions on targeted sectors such as prohibiting the export of arms, dual-use technology and advanced technology for oil and gas exploration and the defense industry are yet to be felt. Since the innovation capacity of the Russian industry is weak the lack of international cooperation in these fields will have long-term effects if Russia is excluded for a longer period. Russia may modify its trade patterns over time and seek more cooperation with other countries such as China, other BRICS countries or Latin America. However, this will take time and the EU remains Russia’s major trade partner.

The present Russian leadership’s political ambitions abroad and at home clearly have a price. Low and near-to-stagnation growth have been exchanged for a major economic contraction. Despite the depressed economy the leadership keeps military expenditure at a high level. The ideas on how to mitigate the economic crisis are not convincing. All these factors imply lower living standard for the population. ✖

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- 3 The protests on Independence square (*Maidan Nezalezhnosti*) in Kiev started in November 2013 and are often referred to as *Maidan* or *Euromaidan*.
- 4 This section draws on Laurence Freedman, “Ukraine and the Art of Crisis Management”, *Survival: Global Politics and Strategy*, June–July, (2014): 7–42.
- 5 Poland, Hungary, and the Czech Republic joined in 1999, and Estonia, Latvia, Lithuania, Slovenia, Slovakia, Bulgaria, and Romania joined in March 2004. Additional new members are Albania and Croatia who joined in April 2009.
- 6 The Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, and Slovakia entered the EU in 2004 and Bulgaria and Rumania in 2007.
- 7 Referring to the masked unmarked soldiers in green army uniforms wielding Russian military weapons and equipment within Ukraine. A retired Russian admiral revealed that the little green men belonged to the army Spetsnaz and said that according to his information the Russian troop deployment in Crimea included six helicopter landings and three landings of IL-76 with 500 people. “NATO Recon Missed Everything: Admiral Reveals Details of Crimea Operation,” *Sputnik*, March 13, 2015.
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# Blaming the state or sharing responsibility

**The Ukrainian Maidan movement  
and changing opinions on Ukrainian  
and Russian corruption**

text & photos by **Mi Lennhag**





Corruption is often said to be a phenomenon hard to combat; it is even harder to fight if, over time, it becomes increasingly widespread, well known, persistent and sometimes almost institutionalized. Ordinary citizens whom I have interviewed<sup>1</sup> in Eastern Europe often express their hatred of systems of extensive corruption, typically blaming state authorities and politicians. However, they simultaneously feel trapped by the informal economic “rules,” without real – or for them obvious – possibilities for either leaving or changing this ongoing “game”.

On a day-to-day basis, citizens feel caught in a post-Soviet system of everyday informal connections, which has a great deal of similarity with the informal distribution networks of Soviet times, but also has new and emerging “market-based” characteristics. From a wider perspective, citizens also express wide-ranging disappointment with high-level corruption among politicians, political parties, leading civil servants, and businessmen.

During recent years, Russia and Ukraine have undergone dramatic and rapid political, economic, and military changes. The media climate in both countries changed simultaneously and fundamentally, including Russian media restrictions and increased state media propaganda, as well as the rise of extensive impact of social media in Ukraine. It has however become more dangerous to be a Russian or Ukrainian journalist.<sup>2</sup> Nevertheless, a free press, freedom of speech and adequate protection of whistleblowers are thought to be key components in the fight against corruption.

Over the past few years, corruption has been highlighted on the Russian and Ukrainian agendas, both as a widespread problem in society and as basis for new public demands and political initiatives. The Russian opposition politician Alexei Navalny has acted as a spokesperson for anti-corruption work. During 2014 the Maidan movement became an important factor for concrete Ukrainian post-Soviet attempts to curb corruption through legislation and new bodies, and it was also the beginning of a process where corruption is described and discussed in new ways.

The World Bank has identified corruption as “the single greatest obstacle to economic and social development.”<sup>3</sup> Corruption is a prioritized crime area for Interpol<sup>4</sup>, and the United Nations states that corruption “contributes to governmental instability” and “attacks the foundation of democratic institutions”.<sup>5</sup> Transparency International defines corruption as “the abuse of entrusted power for private gain”.<sup>6</sup> Michael Johnston, professor of political science, defines corruption as “the abuse of public roles or resources for private benefit,”

while also emphasizing “that ‘abuse,’ ‘public,’ ‘private,’ and even ‘benefit’ are matters of contention in many societies and of varying degrees of ambiguity in most.”<sup>7</sup>

Transparency International’s *Corruption Perceptions Index* (CPI) ranked 175 countries in the latest index, with number one being least corrupt. Ukraine ranked 142<sup>nd</sup> – with the highest levels of corruption in Europe – and Russia was classed as number 136.<sup>8</sup>

According to opinion polls conducted by the independent Russian research organization Levada Center, Russian public opinion and perception of corruption have changed to some extent. Corruption has long irritated Russians, but the topic has since become more commonly raised as a major problem in society, with the same importance as unemployment, education and medical care. According to a 2013 survey by Levada Center, 39% of respondents stated that corruption and bribery was a key issue of concern, compared with 23% in 2006.<sup>9</sup> In the Levada polls after Vladimir Putin’s press conferences in December 2013 and December 2014, citizens were asked which of the issues raised by Putin was the single most urgent one. In both years, the most common answer was “the fight against corruption”.<sup>10</sup>

**IN LEVADA’S LARGE-SCALE** survey “Russian Public Opinion 2012–2013,” a majority in 2012 replied that “adherence to constitution” should be the “foundation for authority in the country”. Simultaneously, the most common answer was that “the current primary foundation” was “cover-up and corruption among the country’s bureaucracy”.<sup>11</sup> In 2013, a majority replied that there, among top officials, is more “corruption and embezzlement [now] than 10–12 years earlier”.<sup>12</sup> In 2013, 42% of respondents stated “bureaucratic abuse of power, corruption and bribery in the top echelons of power” as one reason why “Russia does not demonstrate any considerable economic growth”. This is a higher percentage than answers relating to taxes, investments, the government’s economic policies, outflow of capital, or even oligarchs.<sup>13</sup>

In the latest Global Corruption Barometer (2013), 59% of

Ukrainians answered that “the levels of corruption” had increased over the past two years. As many as 43% declared that corruption had “increased a lot”. Only 5% answered that levels of corruption had decreased. 74% stated that corruption is “a serious problem” within the public sector in Ukraine. The most common replies to a question about governmental actions in the fight against corruption are that they are “ineffective” (43%) or “very ineffective” (37%). Institutions described by respondents as “corrupt/extremely corrupt” are the ju-

## abstract

This article examines how ordinary Russian and Ukrainian citizens experience and relate to extensive and pervasive corruption (high-level, everyday, political) in everyday discussions and demands – in relation to authorities, politicians, civil servants, and fellow citizens. Anonymous interviews conducted in Ukraine and Kaliningrad oblast from 2009 to 2014 show differences in anti-corruption demands and citizens’ attitudes to the states’ versus individuals’ roles and whom to blame for corruption. National corruption debates and quantitative surveys enhance our understanding. In Kaliningrad, citizens continued seeing the state as the main enemy blamed for corruption. Along with the Maidan events, corruption became more significant in Ukrainian everyday discussions, civil society, and media debate. Individuals in Ukraine, unlike in Russia, started to elaborate “personal” or “shared” responsibility regarding corruption. The interview material indicates that abrupt changes in attitudes to corruption are possible.

**KEYWORDS:** Corruption, Ukraine, Russia, Kaliningrad, Maidan.



diary (87%), police (84), public officials and civil servants (82), medical and health services (77), parliament/legislature (77), political parties (74), educational systems (69), and business (65).<sup>14</sup> According to large-scale surveys on perceptions of corruption in Ukraine conducted by Kyiv International Institute of Sociology (KIIS) during 2007, 2008, 2009, and 2011, Ukrainian citizens stressed that the main reasons for corruption are the abuse of power by officials, the absence of adequate government control, the lack of political will to curb corruption, and confusing legislation.<sup>15</sup> We can clearly see how Ukrainians experience corruption in most arenas in society.

## Citizens' perspectives on corruption

A great deal of contemporary corruption research places the focus on high-level corruption among politicians and high ranking state officials, or on economic crime in the spheres of business, trade or foreign aid. Moreover, corruption research in political science is regularly based on quantitative methods for inference, and economists might try to measure the "size" of the black or grey economy. Everyday corruption is not excluded from corruption research, but citizens' opinions in the post-Soviet region might not have had a sufficient hearing, through qualitative interviews for instance, as an important basis for research within social sciences.

Despite this, our everyday informal behavior and interactions, along with traditions, attitudes and norms among ordinary citizens, have great impact. They affect the creation of formal institutions and might limit state authorities in creating functional formal rules.<sup>16</sup> Widespread informality and the persistence of parallel economies can be regarded as threats to (weak) states. It can also be an illustration of a government's failure to incorporate or even consider existing norms and social systems of behavior – or a sign of a state being too weak to be able to adopt new practices or to exert control over its citizens.

Studying corruption – a phenomenon said to undermine democracy, equality and possibilities for social trust and functioning formal institutions – is sometimes quite a discouraging activity for a researcher. It is not made easier if the countries studied are facing a downward spiral – in terms of economy, security and aspects of democracy and freedom of expression – with no predictable end. However, it does become easier when, during interviews, individuals encourage you, trust you, express the wish for changes, and point out that they – ordinary citizens with ordinary jobs – feel excluded when it comes to matters regarding corruption and anti-corruption work. In this study, citizens and their observations, explanations and arguments are included and considered important.

**MORE THAN 20 YEARS** have now passed since the breakdown<sup>17</sup> of the Soviet Union. After 1991, a new market-based order has, to varying degrees, been introduced within the "new" post-Soviet states that followed (or were re-established). Alena Ledeneva's book *Russia's Economy of Favours – Blat, Networking and Informal Exchange* (1998) described the Soviet phenomenon of blat

as an informal economic (but mostly non-monetary), non-hierarchical, network-based channel for transactions, parallel to the Soviet state, that had been in existence since the 1930s. Several researchers<sup>18</sup> have described Soviet blat. Blat<sup>19</sup> was primarily a reaction to shortages in goods, and to "political" hierarchies and bureaucratic routines, but eventually became a more integrated and time-consuming part of ordinary everyday Soviet life. People spent considerable time "collecting" and taking good care of useful contacts and arranging non-monetary exchange chains. Citizens simultaneously associated Soviet blat transactions with precarious circumstances and reduced possibilities, *forcing* them to engage in informal exchange. The unofficial economy did in fact help the official economy, as well as individuals, to survive. Presumably, this double mechanism made this informal economic institution even more stable.

Despite new economic routines and the considerable time that has passed since the Soviet period, it is important to study and incorporate the legacy of up to almost 70 years of informal, time-consuming economic strategies – which both ruled and were necessary for Soviet everyday life – into contemporary corruption research regarding this geographical area. Post-Soviet corrupt practices do differ in many ways from the Soviet ones, as for instance Alena Ledeneva has shown in later work on "post-Soviet blat" and other forms of corruption, embezzlement and informal business practices. Nevertheless, by taking its history and probable legacy into account, we will better understand the present context. I also claim that we need to recognize and comprehend the stories of ordinary citizens in order to improve our understanding of persistent and widespread corruption – both high-level and everyday based – in the post-Soviet region.

## Research focus and material

This study examines and contributes to the understanding of how ordinary citizens (i.e. not politicians, company executives or experts) in parts of contemporary Russia and Ukraine experience, describe and relate to corruption. This article focuses on the role of corruption (high-level, everyday, political, etc.) *as a subject in everyday discussions, as a political topic, and as a component in public demands among ordinary citizens* – toward state authorities, politicians, political parties, civil servants, but also toward fellow citizens.

In essence, I show how citizens in the Russian Kaliningrad oblast and in central and western Ukraine *frame* corruption, and whom they *blame* for its existence and appearance. I focus on citizens' attitudes to the state's role versus their own in contemporary corruption, and on anti-corruption demands.

My new empirical interview material explores the contemporary informal economy in two *former Soviet style economies*<sup>20</sup> as a stable informal institution. According to my respondents, however, corruption has become a more frequently discussed issue.

During several fieldwork visits to post-Soviet states, I arranged interview situations in which ordinary citizens trusted me with extensive information, stories, and personal reflections. During interviews I tried to comprehend 1) *how today's everyday informal economic behavior is described in terms of goods and*



Central Kyiv, nearby the Maidan press center, summer of 2014.

*services involved, and 2) how the extensive corruption is described, explained, motivated and justified by citizens. I also asked questions about corruption, the economy and politics in general, letting respondents discuss those topics more freely.*

This article is based on 44<sup>21</sup> anonymous, in-depth, semi-structured interviews, which I conducted and recorded in Ukraine in 2009 and 2014, and in the Kaliningrad oblast in 2011. Additionally, several relevant discussions with citizens under other circumstances than recorded interviews contributed to my understanding.

The inhabitants of Kaliningrad can present opinions and perceptions like Russians in general, but Kaliningrad cannot automatically be treated as representative of Russia as a whole. Kaliningrad, like Ukraine, has a history of frequent contact with surrounding countries in terms of movement of people and goods, and has important EU and Schengen borders. Ukraine and Kaliningrad share a contemporary history: many citizens moved there from other countries or territories, and the regions incorporate, within today's borders, territories that used to "belong" to other states.

**THE OUTLINE OF THIS ARTICLE** is basically chronological; first the Kaliningrad context in 2011 is presented through interview material, followed by the Russian debate on corruption from 2011 to 2014. Next, the Ukrainian context in 2014 is discussed, based on interviews and media debate, and contrasted to both the Kaliningrad case of 2011, and that of Ukraine in 2009.

The Russian and Ukrainian national debates on corruption are emphasized to enhance the understanding of national differences in citizens' descriptions. Excising survey data on public opinion improves our understanding of the interview contexts, but is of course methodologically treated as something different

from qualitative personal stories. Personal stories, however, capture unique, important knowledge.

Based on respondents' descriptions and explanations, this study highlights differences in Ukraine and Kaliningrad regarding anti-corruption demands and in citizens' attitudes to the states' role in corruption versus their own. Furthermore, the article shows how corruption – both everyday and high-level – quite abruptly became a more significant and important component of Ukrainian everyday discussions, media debate, and within civil society, through the Maidan movement and the new political climate that followed Kyiv's deadly riots in 2014. Corruption in Ukraine in 2014 was not only mentioned when describing society, but also as part of newly expressed demands for change.<sup>22</sup>

Both the Maidan movement's and the citizens' strong focus on new, efficient anti-corruption projects marks a significant change compared to my previous interviews. When the rather exceptional case of Ukraine in 2014 is compared to previous interviews from Ukraine and Kaliningrad, different narratives emerge regarding everyday discussions on corruption. Most interesting is how personal/individual responsibility related to corruption – based on descriptions by my respondents – became a highly debated topic in Ukraine during 2014. Individuals in Ukraine, unlike in Kaliningrad, are starting to accept a share of the blame for the widespread corruption. In Kaliningrad, in citizens' minds, the state is still the main enemy blamed for extensive and pervasive corruption.

The rather dissimilar social movements in Kaliningrad versus Ukraine will not be compared, but describing them is important for seeing the context for the personal stories, and the movements themselves stress the importance of studying individuals' perceptions of corruption. This article aims to demonstrate





Old couple and their dog, Rynok Square, Lviv, 2014.



Sunday activity at Maidan Nezalezhnosti, Kyiv, July 2014.

differences described by respondents, in public debate and in surveys assessing public opinion. The qualitative material in this article indicates a possibility for abrupt changes in attitudes toward corruption, in contrast to what is sometimes seen as a normally slow process.

## Interviews, selection, and ethics

When I study corruption and conduct a narrative analysis by looking for recurring *descriptions*, *explanations* and *motivations* presented by ordinary people, I gather *subjective*, *personal stories*. I do not present *objective reasons* explaining the informal economy (or its change or persistence) with the help of those stories. My standpoint is, however, that those explanations and perceptions themselves are noteworthy and important. Personal stories can through thoughtful selection of respondents, combined with enough material to comprehend the recurring stories, increase the understanding of post-Soviet corruption.

My interview sampling is strategically determined and varies along demographic and social status criteria, portraying the Russian and Ukrainian population. To gather information both from generations who lived and worked during the Soviet era, and from those without memories from Soviet times, the respondents are aged between 18 and 85. Respondents are not “experts,” nor “exceptionally corrupt individuals,” but ordinary citizens. They furthermore embody sectors which during both Soviet and post-Soviet times have been associated with extensive corruption, i.e. universities; kindergarten/schools; medical care; public administration; state employment; police/military; customs; private business/trade; public transportation; journalism/cultural events; politics/opposition.

Interviews were conducted throughout the Kaliningrad oblast. Ukraine is represented by central and western regions, even if several respondents had moved there from other regions,

including eastern oblasts. Ukraine of 2014 was not represented by more “activists” than in 2009. The number of interviews performed was determined by the amount of relevant information gathered; I continued until the later interviews stopped providing substantially new “stories”.

My respondents were offered anonymity and felt surprisingly comfortable when talking with me about the informal economy. Reliability in an interview study is mostly affected by confidentiality, trust and respect. Several ethical dilemmas are associated with interviews on questionable economic transactions, or researchers dealing with potentially harmful information about respondents’ possibly illegal acts.<sup>23</sup>

I tackled the ethical problem of getting information about illegal transactions by not asking about respondents’ *personal* acts, but *indirect questions* about what they regard as “normal behavior” or the common ways (for others) to behave in their work places/generations/surroundings. If someone shared own experiences of giving or accepting bribes anyway, it always occurred at her own initiative.<sup>24</sup>

## Studying and analyzing corruption

Studying corruption is important in many ways: to help understand a lack of efficiency, economic growth, and investments – but also to analyze why foreign aid is not helping as intended, to investigate political corruption and manipulations of elections, or to grasp the possibilities for implementing new laws, to correctly address economic inequities, or to understand low levels of trust and identification with (often recently established) states.

My respondents present stories comprising different informal economic practices. In addition to everyday corrupt acts which they might see or encounter in their daily life, citizens can naturally have thoughts about other corrupt practices, such as



political corruption or high-level corruption within public procurement, for instance.

All types of corruption, according to the most commonly used definitions, capture a tension between self-seeking acts (with both monetary and non-monetary ambitions) and public good. This makes it increasingly interesting to examine citizens' subjective feelings regarding corruption in relation to the state, state representatives, politicians, and civil servants. However – a most important point – citizens might not present or see a clear distinction between bribing a state official, and “bribing” an employee in a private company. This was obvious throughout my fieldwork.

The informal economy, which ordinary citizens observe, take part in, or have opportunities to take part in during daily life, includes transactions and acts that I have chosen to label *everyday corruption*. Other terms for the more or less the same phenomena are: street-level corruption, petty corruption, low-level corruption, small-scale corruption, household corruption, social bribery, grey economy, administrative corruption, bureaucratic corruption, corruption of need, survival corruption, or the Russian/Slavonic word *blat*.

**TALKING EXCLUSIVELY ABOUT** everyday corruption would consequently exclude *political corruption* (when politicians (mis)use legislated power for illegitimate private gain); *electoral corruption/fraud* (illegal/criminal interference with the process of elections or the counting of votes); *business corruption* (additional payments to win a procurement, which occasionally does not qualify as corruption, but as e.g. corporate crime) and *cartels*.

To put it simply, everyday corruption *excludes* corrupt acts performed by companies and politicians and places the focus on ordinary citizens and civil servants. This *includes* everyday corrupt acts such as offering, giving, accepting or demanding bribes. A typical example would be “paying” a small “fee” or giving a bottle of cognac to a civil servant in order to either simply get what one is actually entitled to by law, or for any preferential or additional treatment. Everyday corruption can also include *nepotism/favoritism/cronyism* (“helping” relatives or friends to access goods or services, or to get an appointment regardless of qualifications), and *extortion* (e.g. when police officers demand payment in order to “help” citizens to avoid fines, imprisonment or violence).

It is however problematic to reduce the question of what qualifies as corruption simply to a matter of what is legal or not. In many new states (with the post-Soviet ones as good examples), the legal frameworks might show many weaknesses. In the book *Rotten states?*, political scientist Leslie Holmes, who has presented extensive research on post-Soviet corruption, highlights situations where “many actions or nonactions are not clearly forbidden by law”.<sup>25</sup> Considering corruption solely in terms of illegal acts might not fully capture the informal economy and the public opinions and norms surrounding it.

Political scientist Keith Darden emphasizes environments where “bribery takes the form of a convention” in contact with officials.<sup>26</sup> Darden elaborates informal acts as an obvious

and permitted part of an informal agreement or contract in some societies, and describes situations where “the state is not grounded in the rule of law and functions largely through informal institutions.”<sup>27</sup> He thereby traces and sees deeply embedded rules – enforced by the state itself or widely rooted in expectations among citizens and officials – as an institution, rather than a behavioral pattern. A somewhat similar reflection is made by Rasma Karklins in *The System Made Me Do It*, when describing the “self-sustaining system of corruption”, in which citizens become used to civil servants wanting (and later on expecting) bribes.<sup>28</sup> When, over time, state officials seek bribes, citizens can become willing to pay and, eventually, also offer bribes of their own “free” will.

## Corruption in Kaliningrad oblast

During 2009 and 2010, Kaliningrad faced growing protests related to socio-economic problems such as the rapid decline of the economy, the healthcare system and social institutions, along with rising taxes and prices, isolation from the EU, high unemployment rates, and corruption. These protests eventually also incorporated criticism of the government and Putin, and successful demands for replacement of Kaliningrad's governor Georgy Boos. The now murdered Russian opposition politician Boris Nemtsov was part of the movement, which eventually engaged both common people and local elites. The demonstrations influenced national Russian media. It surprised the Kremlin, where the events' impact was not predicted.<sup>29</sup> These local protests make it even more interesting to conduct interviews in Kaliningrad and see how citizens frame corruption – even if the local protests did not generate changes in citizens' opinions on corruption.

During my fieldwork in the Kaliningrad oblast in the summer of 2011, I was told that the inequalities in society are infinitely bigger than what is required for a revolution. Yet the main political and economic problems articulated by citizens seem to remain unsolved and mostly untouched. Ordinary Kaliningrad citizens described wide political resignation in 2011. They could not image how and when things could change for the better; few could even visualize things getting better during their lifetime. Politics was something happening on a level very far from their sphere of influence. For many respondents it did not matter whether Putin or Medvedev would win the then up-coming presidential election. People spoke of the two leaders with a somewhat surprising contempt. A retired nurse described Putin and Medvedev as a funny pair of parrots that just repeat each other. Respondents overwhelmingly agree that if Russia should establish itself for real, it would require a new leader who really sees the people, who is not corrupt, and who does not derive from the old political class. But according to ordinary people I talked to, no such leader was there to vote for. Without huge amounts of money and questionable contacts, the honest presidential candidates would never make it to the corridors of power.

**THE IDEA THAT SOVIET** citizens “enjoyed beating the system” is often mentioned as a feature and consequence of the Soviet peri-

od, rooted in a perception of citizens as being outside of, and not represented by, or part of, the state.<sup>30</sup> Leslie Holmes argues that most Soviet citizens had a clearly defined conception of “them” – the party and state authorities – and “us,” the fellow citizens.<sup>31</sup> The Soviet so-called planned economy is said to have encouraged a lack of respect for formal institutions, as well as having generated cryptic laws and rules and extraordinary public feelings. Rasma Karklins describes this as a perception that institutions cannot be designed to serve the public good<sup>32</sup>, which also seems to be applicable to the lack of political representation and possibilities of exercising influence, experienced and described by my Kaliningrad respondents. Trust, identity, and feelings of legitimacy are mind-sets that are difficult to implement.

My respondents described widespread Russian corruption. It might nevertheless be possible to “arrange” most things – but for this you need useful connections, know-how, time, and money. Citizens struggle to keep up with the growing sums of informal money demanded in exchange in Kaliningrad. A female doctor at a Kaliningrad state hospital described how one third of life is spent on finding “alternative solutions”. She said that everything today is about money, and that the levels of the bribes have doubled several times since year 2000. The Soviet non-monetary informal economy has developed into, or is replaced by, an informal system involving increasing amounts of money. The time-consuming aspects of the informal economy are however similar.

As an employee at a state hospital, the doctor described her salary as too low for survival without also accepting bribes or taking on a night job. The healthcare sector in many post-Soviet states is associated with extensive corruption, along with schools and universities, the police force, various authorities that either issue documents and licenses or conduct controls, as well as recruitment processes for state employment. In Kaliningrad, respondents described how one can bribe to access most goods and services: academic degrees, heart surgery, buying land for building, “correcting” failed school tests, passing driving tests, obtaining daycare places for children or permanent Schengen visas, or avoiding the long wait to get married.

In many situations, bribery is definitely what Keith Darden describes as “a convention” in contact with state officials. Karklins’ notion of the “self-sustaining system of corruption” also appears to flourish, since citizens are used to civil servants wanting (or needing) unofficial payment or small gifts, and so a common practice emerges of regularly offering them – since they will be required anyway. A Kaliningrad translator working for foreign companies told me that she had bribed a traffic police officer that very morning to avoid a trial, since that would have required her taking several days off work. It appears to be common for the traffic police to stop drivers, even when no law has been violated. It is in essence a convention, and citizens know that traffic police officers hardly can survive on their low salaries; the police job includes the possibility, and almost obligation, to “collect” informal money, and citizens simply cannot avoid that game and the informal rules.

The widespread everyday corruption in Kaliningrad is described by respondents as involving increasing amounts of

money in a rising number of situations, with a growing number of autonomous bribe collectors. In 1993, Andrei Shleifer and Robert Vishny described how post-Soviet Russia (compared to the Soviet state) had a system of “independent monopolists” who collected bribes based on a free and easy entry to the bribe collecting market. Shleifer and Vishny argued that this model had “devastating economic consequences”, and that eventually “the total bribe rises to infinity and production output falls”.<sup>33</sup> Based on my interviews, this statement seems to be valid in the Kaliningrad oblast in 2011. Furthermore, it is in line with estimations by Russian Interior Ministry’s Department for Combating Economic Crimes, indicating that the average bribe in rubles in 2011 was 26 times greater than in 2008.<sup>34</sup>

**THE “FACT” THAT A BRIBE** amounts to one third of an “official fine” – for instance if you pay a bribe to avoid a formal traffic fine – seems to be fairly common knowledge in Kaliningrad, based on my interviews (the amounts of money involved in other types of bribery – regarding preferential access to schools, hospitals etc. – follow a different logic, and seem, as said, to be rising). Hence I find evidence for an unofficial – but rather widely known – “price” or “informal fee” in contact with state employees. The unofficial is almost official, or: the informal price is a stable informal institution, appearing as general public knowledge. I therefore stress that today’s everyday corrupt practices actually show similarities with the “mafia-style” corruption, described by Shleifer and Vishny as the ruling type during Soviet times.<sup>35</sup> Then, you knew whom you needed to bribe and what you informally had to “pay”. I noticed the same phenomenon of widely known informal “prices” in post-Soviet Ukraine in 2009, where young university students, independent of each other, referred to comparable “prices” for being accepted to popular universities, and “fees” for receiving better school grades. There also appeared to be commonly known prices useful in order to speed up the process of obtaining a new passport, for instance.<sup>36</sup>

The system of corruption is not just rooted within state authorities and formal institutions, but also in the ways citizens interact, show distrust, and continue to feel that they need to collect useful “friends” in strategic places. In Kaliningrad I saw more resignation and anger than actual demands for curbing the widespread corruption. The main enemy in the everyday discussions about corruption is the state and, to some extent, politicians and rich businessmen. Respondents articulated a distinct and present division between the state and the citizens today, similar to how Holmes and others have described Soviet society.

A young Russian journalist I interviewed was very critical of how Kaliningrad has managed foreign, including Swedish, aid. He had himself assisted foreign journalists who tried to unravel corrupt foreign aid scandals. This journalist is a good illustration of a person criticizing corruption on different levels of society by including high-level corruption and state businesses involving huge amounts of informal money. In the years represented in Levada Center’s 2013 Russian public opinion poll (2000, 2004, 2007, 2010, 2011 and 2012) the most common reply to a question



Citizens selling vegetables, Kaliningrad oblast, 2011.



Man and grandson at Lavra Monastery, Ukraine, 2009.

about the “main obstacle to democratic market reforms in Russia” was the “corrupt ruling elite”.<sup>37</sup> In 2006, 2010, 2011 and 2012, about 60% of the respondents replied “definitely yes” or “most likely, yes” that Russia would face “high profile corruption scandals and resignation of ministers” within the next year.<sup>38</sup>

An older historian whom I interviewed at his library office presented an unusual attitude toward Russian corruption. He described how he always took a pride in not using contacts to access anything, not even during Soviet times. People used to say he is a very honest man, and therefore a very poor man. He described himself as a happy man.

The most common stories during interviews however include rather good knowledge of informal economic routines and procedures, including numerous different concrete examples. Their reasoning is also advanced. A taxi driver told me that people in Kaliningrad prefer their neighbors to be rich, albeit because of corruption, because then some of their prosperity might benefit them as well. Many of my respondents stated, that according to public perceptions it is not beneficial to be part of the formal economy only. This does not in any way mean that these respondents like the system. The pessimism I could see in Kaliningrad comprised a sense of futility in the general public; there were few reasons for trying to do things legally since few fellow citizens were acting that way, especially not politicians and rich people. Furthermore, it was uncommon for my respondents to articulate the view that most people, within an imaginable future, would benefit from leaving the corrupt system. And since from citizens’ perspective, the roots of and reasons for the widespread corruption emanate from the state, the everyday discussions on corruption also place very little focus on how things could be changed.

**IN SUMMARY,** my respondents in Kaliningrad were comfortable talking about corruption – a phenomenon that according to them is time-consuming, widespread, and increasing. During interviews, citizens presented good “knowledge” of how to

“act” in the informal economy, and pessimism about possible changes. Everyday corruption appeared to be a stable informal institution, and respondents often felt they lacked possibilities to create or even initiate change.

## Russia, Navalny, and public debate

I will now move on to illustrate some important aspects of Russian public debate and national media since 2011. Even if Kaliningrad does not border “Big Russia”, its inhabitants have commonly access to Russian TV channels and newspapers. It is said that Kaliningrad inhabitants are more critical of Russian politics and the Kremlin, as well as Putin and the party United Russia, due to historical reasons and the geographical separation.<sup>39</sup>

The Russian lawyer, blogger and political activist Alexei Navalny is known for playing a key role in encouraging the large-scale Russian demonstrations during the winter before the 2012 presidential election. The demonstrations in December 2011 were Moscow’s largest protests since the breakdown of the USSR.<sup>40</sup> The big demonstration on December 10<sup>th</sup> was partly organized through a Facebook event.<sup>41</sup> The gatherings on December 24<sup>th</sup> included rallies under the parole “For Fair Elections”. Reporters at The Moscow Times stated that approximately 80,000 protesters participated. Navalny gave a speech declaring there were enough people present to march and seize the Kremlin, but that they should avoid such violence.<sup>42</sup>

As early as February 2011, Navalny described United Russia as a “the party of crooks and thieves”.<sup>43</sup> The focuses of the winter demonstrations were Putin’s regime and leadership, the ruling party United Russia and the then upcoming so-called “stolen” parliamentary election (and after December 4<sup>th</sup>’s widely disputed election). Another focus, addressed during demonstrations and by civil society and Navalny, was widespread political and administrative corruption.

On March 3<sup>rd</sup> 2012 – the day before Russia’s presidential election – The Wall Street Journal published a well-cited weekend interview titled “The Man Vladimir Putin Fears Most”, referring





Housing area, Western Kaliningrad oblast, 2011.

to Navalny. The article stated that “in Russia, poking into corruption is a serious health risk”. Navalny is quoted as saying, “it’s obvious now that [Putin’s] system of power is based on corruption, and people around him depend only on money and corruption”.<sup>44</sup>

Navalny is founder of the Russian “Anti-Corruption foundation”, which has met with several attempts to stop its anti-corruption activities.<sup>45</sup> It unites several projects, such as RosPil (РосПил), based on voluntary contributions from citizens. RosPil urges ordinary citizens to report suspicious governmental contracts within public procurement, for instance.<sup>46</sup> In the info section of the RosPil blog it is pointed out that “this is our money”.<sup>47</sup> The present Russian situation – described as when the crooks in power grab money, while ordinary people barely survive – is compared with what could be an alternative situation, with normal medical care, high-quality education, safe roads, clean streets and better opportunities for everyone.

This is one of many examples of how the Russian anti-corruption movement focuses first and foremost on ways to combat high-level corruption, often in state-owned companies, and on framing high-level (political) leaders.

Another Russian initiative for curbing corruption was the smartphone anti-corruption application *Bribr*, launched in October 2012. It encouraged citizens to report incidents where civil servants demanded informal payment. One hypothetical example could be when traffic policemen “offered” drivers the chance to pay lower “direct informal fees”, instead of time-consuming procedures with formal traffic offences (which correspondingly most likely would be a more costly alternatives, since the “informal fees” are normally lower).<sup>48</sup>

The big demonstrations during the winter of 2011 were initially viewed as a possible start of “orange” Russian protests. In line with the tradition of naming post-Soviet protests, the 2011 to 2013 Russian protests began, mostly in foreign media, being called the “Snow Revolution” or the “Winter Revolution”. Now, however,

we know that no “color revolution” emerged in Russia, and that Navalny has struggled with lawsuits against him for a considerable time. We can moreover observe that the present Russian debate on corruption still focuses mostly on high-level corruption among politicians, leaders, and businessmen. Before the 2014 Sochi Olympic games the anti-corruption debate in Russia intensified somewhat, with signs of a possible public movement growing stronger. But with new Russian laws limiting possibilities for political debate, along with the annexation of Crimea and the development in Eastern Ukraine, the political focus in Russia gradually changed from social issues to other topics. During the winter of 2014/2015, daily life in Russia focused generally on trade sanctions, military matters, food shortages, the falling ruble, rising food prices, and other economic problems that affected both the state economy and the everyday lives of ordinary Russians. To sum up, the Russian media debate on corruption – where permitted or possible – focuses mostly on high-level and political corruption. Despite some attempts, including the large-scale winter demonstrations, there is currently no solid civil society movement involved in anti-corruption work. This is presumable partly a consequence of new laws and continuing punishments of oppositional activists and journalists.

## **Maidan, changing opinions, and new anti-corruption demands**

It is not hard to comprehend that the Maidan events and the war in Eastern Ukraine affected many Ukrainians dramatically. The discussions in Europe about how to label the development and occurrences in Ukraine continued. On August 24<sup>th</sup> 2014 – the 23<sup>rd</sup> anniversary of Ukraine’s independence – president Petro Poroshenko gave a speech, mentioning Ukraine’s “war against foreign aggression”.<sup>49</sup> The speech was translated and published online. Shortly afterwards, the Ukrainian Ministry of Foreign Affairs labeled the conflict an “invasion” on an official Twitter account.<sup>50</sup> The Ukrainian Minister of Internal Affairs, Arsen Ava-



kov, often uses Facebook for his first comments on events.<sup>51</sup>

During this time, the importance and impact of social media and the Internet in Ukraine increased. Ukraine's contemporary fight against corruption, including attempts to raise awareness of the problem, is partly viral. The creativity and good knowledge of social media among activists and Ukrainian journalists contributed to the impact of the movement and the spread of updated information. For instance, in 2014, foreigners could constantly stream online videos from central Kyiv.<sup>52</sup> Well-organized press centers were established, and Twitter, Instagram and Facebook were widely used to gather people or quickly share information.

It is noticeable how the cases of Ukraine 2009, Kaliningrad 2011 and Ukraine 2014 display significant differences. In the latest Global Corruption Barometer on Ukraine – which was based on surveys conducted in 2012, before the Maidan protests started – as many as 72% of respondents did “strongly disagree” or “disagree” with the statement that “ordinary people can make a difference in the fight against corruption”.<sup>53</sup> In 2009 my Ukrainian respondents described good common knowledge of how to behave in the informal sector, as well as a general lack of fear of getting caught for being corrupt. Corruption was often considered as common – and not rarely also acceptable – procedure. A young university student described in 2009 how acquaintances and classmates had paid approximately 400,000 dollars to be accepted into prominent Kyiv universities. She described that “a friend got help from a contact to get better result on a [university] test”, and others gave money for better grades. She stated that “it's not strange, it's normal”.

**INCORPORATING THE IMPACT** of informal institutions, attitudes and norms is helpful when looking at economic development (or the lack of it). A situation with widespread post-Soviet corruption can – from an outside and economic point of view – appear as a sub-optimal state of equilibrium.<sup>54</sup> We might wonder why those societies do not change, since in terms of economy and democracy they would most likely benefit greatly from leaving extensive corrupt practices behind. In institutional theory, institutions constitute the socially and humanly devised framework that defines, enables, simplifies and sometimes limits decision-making and interaction. Repeated interaction might form patterns and establish common expectations and mutual trust.<sup>55</sup> Political scientist Paul Pierson highlights path dependence and the importance of seeing institutional development as a long-term process. Economist Douglass North has furthermore stated that informal institutions often remain stable even when formal institutions change, and that informal institutions are much more resilient to intentional political actions, since they are deeply embedded in traditions and patterns of behavior.<sup>56</sup> Regarding the ability of actors to create change or affect institutional development, Pierson however points out, “institutions, once in place, may ‘select’ actors”.<sup>57</sup> Actors might, over long periods of time, adapt to different institutional arrangements. Soviet blat, an informal economic distributing system almost sanctioned by the state, could constitute such an institutional arrangement. Individu-

als invested an increasing amount of time on adapting, making and maintaining good relations with “useful people,” and accumulating knowledge. This presumably generated increasing resistance to change, making the possibility of a new social order increasingly remote – even if changes would bring greater future benefits. This feature is well captured in North's idea of “pirates” who will go on investing in becoming better pirates – in this case more corrupt or street-smart – in a society that lacks incentives for them to abandon their behavior.<sup>58</sup> Even if several reasons for the necessity of Soviet blat have disappeared, and the blat system has changed, contemporary ways of thinking, acting and calculating among citizens I have interviewed fairly often show great similarities with the Soviet era networks.<sup>59</sup>

It is generally problematic to compare different post-Soviet “color revolutions”, or to see them in isolation. The Maidan movement generated exceptional international publicity, but is also different from Kaliningrad's (and Moscow's) protests in other aspects. One important aspect regarding Ukraine is the remaining disappointment after the 2004 “orange revolution”. Ukraine's state bureaucracy did not become significantly more transparent, few anti-corruption mechanisms were fully implemented, and politicians and corruption remained dangerously intertwined. In *Orange Revolution and Aftermath: Mobilization, Apathy, and the State in Ukraine* (2010), the size and impact of the protests is described as surprising to both observers and participants. Back then, Ukrainian civil society was expected to exert active and significant influence on Ukraine and its democracy. Yet that influence weakened quickly, and corruption remained a major problem.<sup>60</sup>

In Ukraine 2014 one group of important actors – ordinary citizens – started talking about and describing informal economic practices in new ways. As a result of knowing that other citizens also talked about corruption, my respondents described feelings of increased optimism about future changes. People started to elaborate thoughts on how to “leave” current informal behavioral patterns of the corrupt system – instead of primarily describing either how they feel trapped in the informal system, or how one needs to act to survive in everyday life, which respondents often expressed during interviews in 2009. In 2014, Ukrainians seemed more open toward the idea of a new system, even if their “collected contacts” thereby would become less useful in the near future, or if things would get more costly; the “pirates” were discussing how to leave the system. Respondents described that both they, and their children, would benefit from changed informal economic behavior. One respondent in 2014 stated she wanted something different for her grandchildren as a reason for starting to act differently today.

**THE SURVEYS CONDUCTED** by the Kyiv International Institute of Sociology in 2007, 2008, 2009 and 2011 indicate increased and intensified corruption over these years, primarily due to an increased number of government bodies where ordinary citizens are confronted with not very secret extortion as part of the common bureaucratic routines.<sup>61</sup> In Ukraine, the common perception is that corruption is everywhere. In Kyiv, one

respondent, born during the time of Ukraine's independence, described: "People blame authorities [for corruption], of course! Maidan was a big demonstration of this. /.../ Business and the government can't draw a line between them. It's a mix." Ukrainian respondents, not only in Kyiv but also in Western Ukraine, described in 2014 how the Maidan events made them wake up, rethink, and realize they might have to start with themselves in the fight against corruption. However, this does not mean that levels of corruption have started to decrease. A middle-aged businesswoman in Kyiv explained that average citizens have also started to rethink and develop better knowledge about economic aspects of society. A female economist currently unemployed in central Ukraine described how in 2014, she began to engage in society and economy whereas previously she was never really interested.

Many young Kyiv citizens have started to describe corruption as morally wrong. In line with this, a Kyiv citizen in his mid-20s, with a degree in law, born in rural western Ukraine and active in the Maidan movement, declared:

**"I think that the word corruption derives from everything that is morally repugnant or wrong. /.../ Asking for a benefit when you are not entitled to it is wrong."**

**"I hope that corruption is not increasing. There are hopes for future leaders, but in order for corruption to decrease, peoples' values have to change. I mean all people, not only those who run the country. Because otherwise, if it is fuelled from down, there will be no real result. /.../ Of course, some people are immune to any changes. A person has to want to change."**

One Kyiv NGO coordinator stopped working as successful lawyer after two years because he felt the system was too corrupt:

**"I came to such decision that I don't like this; I don't like working as a lawyer because in our country a lot of people in a lot of state and government institutions, they don't follow the law; they don't want to work legally. For me, my future depended on being a non-legal man. I would need to make non-legal things to be a good lawyer. /.../ I was very angry. I don't want to 'help' the corruption in our country. I want to be out of this. /.../ It's quite difficult to work in Ukraine in a legal way. It's a pity. But if everybody don't care about laws, I don't want to work as a lawyer, so I quit my career."**

**"We had a revolution of minds. People just want to live in a new society with new legal rules. For example, some of my friends who wanted to get driver's licenses a year ago said: 'Oh, I don't need any exam, I'll pay a few hundred dollars and I'll get it in a few days'. After the revolution they say, 'We don't want to develop corruption, we don't want to give money for this; we will get these driver's licenses in legal ways'."**

In Ukraine 2009, in contrast, several respondents described citizens taking a pride in being corrupt and knowing the informal game. They also talked about corruption as a way of managing to get back at the immoral and rather hated state. As in Kalinigrad 2011, the state was the main "enemy" in my interviews in Ukraine back in 2009. A Ukrainian dentist described in 2009 how people and the state always have been enemies, and that people never expect to get anything good from the state. He stated that it therefore also became a pleasure to fool the state. A Ukrainian accountant correspondingly stated in 2009: "People think all the time about how to cheat". This is a contrast to 2014, when my respondents often described how Ukraine and Ukrainians are undergoing extensive changes, including changing opinions on how to curb corruption and the role individuals can play in this process.

The Maidan movement's as well as the citizens' stronger focus on new effective anti-corruption projects and improved legal frameworks was present to a considerable extent in everyday life and discussions among ordinary citizens in 2014. This marks a significant change compared to my previous interviews. Ukrainian respondents in 2014 also described and had good knowledge of minor initiatives for fighting corruption, such as guidelines online for how to make videos of traffic police workers demanding bribes and websites where these reports could be shared. There is, however, a fear that the ones who "should" monitor the "results" of Maidan, are now being sent to or volunteering as soldiers in Eastern Ukraine. Other activists are busy working extra to purchase equipment for the Ukrainian troops.

**UKRAINE'S FIGHT AGAINST** corruption is taking place in many arenas and levels of society. The different media landscapes in Ukraine and Russia however deeply affect the possibilities for citizens, politicians and civil servants to discuss corruption. In the article "Ukraine Fights Second Enemy: Corruption," published in *Foreign Policy* in February 2015, Ukraine's two wars are described. One is taking place in Eastern Ukraine; the other one is Kyiv's intensified battle against corruption, also within the state's own bureaucracy. A new electronic, streamlined and more transparent system aiming at combatting tax fraud is one example of new initiatives. Ukraine's finance minister Natalie Jaresko is quoted in the article, saying: "War is not a reason or an excuse to not reform. It has spurred us toward reform". The US-Ukraine Business Council's president, Morgan Williams, said that "Ukraine [is] fighting against the last 80 years of corruption and illegality".<sup>62</sup> This illustrates how new anti-corruption demands are found not only among ordinary citizens or activists, but also within state authorities and among high-profiled politicians. The "80 years of corruption" most likely refers to the period from 1930s Soviet Union, when blat practices emerged.

## Conclusions – how to frame and whom to blame

Based on my qualitative interview material, I cannot announce solid *reasons* for differences in citizens' opinions on corruption between Russia and Ukraine, or within Ukraine over time. In this



At the end of the metro line, Ukraine, spring of 2009.



Financial crisis, Ukraine, February 2009.

article, I have presented common and recurring descriptions and personal stories about corruption in my respondents' societies. When comparing the Ukrainian case of 2014 with interviews conducted in Ukraine 2009 and in the Kaliningrad oblast 2011, everyday discussions of corruption display distinct and interesting differences in these three contexts.

However, I want to stress that we need to comprehend that corruption cannot be treated first and foremost as a result of citizens' lack of morality. Important reasons for high levels of corruption are, in most cases, economic inequality, widespread bureaucracy, a history of informal arrangements, and restricted possibilities of acting as whistleblowers or of criticizing the state and corrupt practices freely and without fear.<sup>63</sup>

First, there are distinct similarities in the studied settings. The distrust, toward both the state, civil servants and fellow citizens, is obvious throughout my interviews in the different contexts. This is correspondingly clear in reliable Russian and Ukrainian surveys described in this article. According to Bo Rothstein, cooperation is based on trust, i.e. social capital, defined as "access to beneficial social networks and having generalized trust in other people".<sup>64</sup> The link between formal institutions, trust, and informal practices is understandable. A social trap is a situation where individuals or groups are unable to cooperate because of mutual distrust and lack of social capital – even if cooperation would benefit all parties and, from the outside, appear as a realistic solution. Individuals then act in order to obtain short-term personal gain, rather than promoting the best long-term public good. Pervasive corruption is an example of short-term individual benefit, existing at the expense of long-term development of the economy and formal institutions. One can see a negative spiral, where corruption leads to less trust, and less trust fosters

corruption. When social trust instead is widespread, economic transactions are made much easier.<sup>65</sup>

The roots of the post-Soviet corruption, in the eyes of ordinary citizens and as incentives for citizens to interact in the informal economy, are described in similar ways throughout my interviews in Kaliningrad and Ukraine. The recurring descriptions are also reminiscent of Soviet era narratives on everyday corruption as well as the historical importance of useful personal networks. As in the Soviet Union, both Russia and Ukraine have many professions, such as doctors, teachers, police workers and other civil servants, where salaries are very low, thus leading to informal payments and gifts as a "convention" or stable informal institution when in contact with those offices, sometimes with almost "official approval".<sup>66</sup> The common argument that corruption is best curbed by increased economic equality seems applicable to both Kaliningrad and Ukraine, and is articulated by my respondents. However the incentives for civil servants with low salaries to stop demanding bribes cannot be changed only by ordinary citizens displaying repulsion toward such acts or everyday "traditions".

**THE COMMON KNOWLEDGE** of contemporary corrupt practices in both Russia and Ukraine is rather good, as illustrated by my interviews and quantitative surveys. Corruption and informal practices as topics of discussion in everyday life, as well as within civil society and the media, appear to have become more common in both Russia and Ukraine over recent years. There has indeed been a rise in anti-corruption demands, although with certain differences in characteristics, dimensions and outcomes in Russia and Ukraine. While this development in Russia seems to have slowed down or ceased, Ukraine has displayed a growing focus on corruption.



There is a probable change now in Ukraine, based on the Maidan movement's focus on corruption, justice and transparency, along with the media debate and my respondents' descriptions of contemporary changes within Ukraine, both among ordinary citizens, civil servants, and politicians. The differences between the three contexts cannot be explained easily.

Firstly, we have the different demands for, and attitudes toward, anti-corruption projects and mechanisms. In Kaliningrad in 2011, the resignation toward possible changes was obvious during my interviews, even if the socio-economic protests shortly before gathered many citizens. Even if formal and intentional attempts to change the informal rules might take time to have real effect, Kaliningrad inhabitants did anyway not see such initiatives from above – or below. The anti-corruption demands in Ukraine of 2014, on the other hand, were raised and discussed both by citizens, civil society, politicians and eventually ministers. To some extent, the anti-corruption demands have become a natural part of Ukrainian political life and everyday discussions. This development did not start in Ukraine in 2014, but it became stronger.

Secondly, corruption as a phenomenon described by my Ukrainian respondents is today more commonly interconnected with politicians, members of parliament, political parties and certain high-stake professions – and not only “the state” in a wider sense, which was more common in Kaliningrad, and also in Ukraine in 2009. Whether this difference is a result of the oligarchs in Ukraine (and their political positions, power and wealth), of the Maidan movement's effects on society, or Ukrainian civil society traditions, cannot be answered with my interview material, but is a research question for future examination.

Thirdly, an increased sense of both “shared responsibility” and “personal/individual responsibility” in Ukraine in 2014 can be observed through my interview material. In contrast to Kaliningrad, individuals in Ukraine are starting to accept some of their share of the responsibility for widespread and pervasive corruption. My interview material is however coherent in the aspect that opinions and knowledge about corruption are not dependent on level of education or profession; the respondents arguing for “personal responsibility” do not represent particular categories in society. In Kaliningrad, in citizens' minds, the state was the main enemy and guilty party when it came to corruption. My Ukrainian respondents described Maidan as a crucial breaking point in terms of responsibility and blame. We thereby acquire new knowledge about the effects the Maidan events and dramatic Ukrainian era have had on Ukraine and its citizens – in terms of personal perceptions of corruption, new roles individuals picture themselves in, and opinions on power over change when it comes to informal economic institutions. Those tentative findings would benefit from future similar interview studies.

The stories presented by my respondents in Ukraine 2014 also show a possibility for abrupt changes in attitudes toward corruption, compared to what is often seen as a normally slow process. Even if Kaliningrad citizens told me in 2011 that the inequality in society was enough for a revolution, the situation regarding corruption seems rather constant. The sense of resignation in Ukraine during my fieldwork in the winter and spring of 2009,

parallel to the ongoing financial crises, was widespread. In Ukraine 2014, respondents instead often told me stories of how they already saw or envisaged changes within the near future, and explained how they could contribute and take active part. It remains to be seen if this positive mindset and these perceptions will endure over time. ✖

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- 20 I choose the term *former Soviet style economies* to avoid labelling, grouping and seeing



countries based on ideologies that actually never were the ruling ones. This term also places the focus on economy, rather than on ideologies that non-democratically “chosen” leaders stated they were implementing in those, to different extent, authoritarian or totalitarian states and unions. This region in no way was, or is, homogeneous.

- 21 This consists of 15 interviews from Ukraine in 2009, 15 interviews from Russia in 2011, and 14 interviews from Ukraine in 2014.
- 22 Ukraine was however already before 2014 a post-Soviet state with quite lively public and everyday discussions on corruption, similar to e.g. Georgia. Georgia's ex-president Saakashvili declared in February 2015 interest in becoming chief of Ukraine's anti-corruption bureau, with the background of Georgia's experiences of radical reforms aiming at curbing corruption.
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# Models, evolution & efficiency

## Regulation of financial markets in Russia

by **Alexander Abramov, Maria Chernova, Alexander Radygin**

**F**inancial markets play an important role in economies by connecting the demand for capital with its supply and channeling savings in the process of accumulation. The development of financial markets affects the choice of technology, the amount of labor and resources needed to carry out brokerage transactions, the intensity of research and development, and the extent of innovative entrepreneurial activity. All of these factors have impacts on the rate of economic growth. Additional opportunities for investment projects and more effective control provided by financial markets allow for more efficient use of available resources and increase total factor productivity.<sup>1</sup>

Currently, there is a wide set of regulation models for financial markets. Previous research on the development of financial markets<sup>2</sup> confirms the interdependence between the type of regulation model chosen and the historically achieved depth of financial structure as well as national institutional characteristics. An effective regulation model takes these factors into account and under favorable conditions can contribute to economic growth. The consistency between the regulation model and the depth of financial structure is important. The key issue of national financial market regulation is the choice between integrated and multi-sector models of supervisory and regulatory authority.

The World Bank describes the main challenges and differences between prudential supervision and regulation as follows: “A key challenge of

regulation is to better align private incentives with public interest, without taxing or subsidizing private risk taking. Supervision is meant to ensure the implementation of rules and regulations. It needs to harness the power of market discipline and address its limitations.”<sup>3</sup>

In the context of financial recession, the issues of improving prudential supervision and regulation become particularly relevant. These two functions can be separated into two agencies or to be integrated into one, which may be subject to a variety of regulation models and institutional solutions. Some countries chose to create integrated control models, while others established decentralized models. For example, in Australia, the government introduced a so-called Twin Peaks model. According to this approach, two main institutions have power and authority in different spheres. The Australian Prudential Regulation Authority (APRA) is in charge of prudential supervision while the

Australian Securities and Investments Commission (ASIC) acts as a corporate regulator. The Netherlands adopted the same approach and separated regulation and prudential supervision. In Canada, there are a number of departments, and each one of them supervises only one type of financial institution. In Denmark, the United Kingdom, Japan, Norway, etc., there is only one mega-regulator, which has all the prudential and regulation power. Countries like Greece, the Czech Republic, Portugal, and Singapore are moving towards creating similar systems.

### abstract

The paper examines the relationship between the degree of the integration of financial regulation and the level of economic development. The paper is based on a self-constructed dataset, including a Twin Peaks model, and ordered probit models estimations. The main finding is that factors such as population and economy size have negative effects on financial regulation integration, while quality of governance, the size of the non-banking financial market sector and regulatory quality have a positive impact. Post-estimation analysis shows that the new model of supervision and regulation adopted in Russia in 2013 does not take into account the level of institutional investors' development. This increases the risks of excessive administrative pressure on the non-banking financial sector and weakens its competitive environment.

**KEY WORDS:** regulation, prudential supervision, financial market, institutional investors.

This article analyzes the development patterns of regulatory and supervisory systems in financial markets based on a sample of 50 countries, with an emphasis on trends towards consolidation of regulation and supervision. The econometric analysis of the data presented in the paper evaluates how Russia fits the main models of prudential supervision developed in different countries.

After the fall of the Soviet system, the development of financial markets and institutions in Russia coincided with a long decline in economic activity in the 1990s. Since then, the Russian credit system underwent a transition from a centralized to a multi-tiered system while radically changing its structure and strategies of bank monitoring and control. Nevertheless, the problem of treating banking institutions primarily as instruments of resource allocation, which was evident during the 1998 and 2008 crises,<sup>4</sup> has not lost its relevance today.

The Russian stock market still has some institutional problems and is characterized by a lack of independent monitoring of the financial sphere. In 2010–2012, the government undertook some steps towards more rigid market regulation. The Federal Financial Markets Service (the FFMS) raised requirements for professional market participants in terms of the sufficiency of their financial assets to counter manipulation and introduce prudential supervision. Since September 1, 2013, the Central Bank of Russia (the CBR) took over authority from the FFMS to become a mega-regulator of the Russian financial markets. The definition of mega-regulator refers to the integration of the financial system regulation in the hands of one state agency and includes control over both commercial banks and the non-banking financial sector.

**TO EVALUATE THE CONSISTENCY** of government decisions with the current economic situation, we investigated first patterns of the development of regulation and supervision systems in the financial markets by using a data sample of 50 countries. Our primary attention was focused on trends in integration of regulation and supervision. Based on the analysis of regulatory structures in our sample of countries, we composed a data set that included 18 macroeconomic and financial indicators. In this paper, we used ordered probit regression to estimate and explain the main relationships and hypotheses from previous studies. This analysis allowed us to determine the impact of the main factors on the choice of the degree of integration of financial market regulation. The results obtained showed a strong link between almost all selected factors and revealed their degree of impact. This made it possible to construct an estimated formula to define a suitable degree of integration of financial market regulation.

The next step of our analysis included an assessment of the comparability of the chosen regulative regime in Russia with six degrees of supervision integration. Based on post-estimation procedures after the regression estimation, we constructed a series in accordance with the proposed World Bank classifications of financial market regulation, which represented the predicted probability of each category. The calculations show that the new model of rigid integration of the system of prudential supervision and regulation controlled by the CBR does not fully take into account the level of development of institutional investors.

It also increases the risks of excessive administrative pressure on non-banking financial institutions and weakens competition in the financial sector. Solving these problems requires an active effort on the part of government agencies and financial market participants.

The paper is structured as follows. Section 2 provides a further description of the role of financial market regulation along with institutional challenges relating to financial markets and current trends in their regulation. Section 3 describes data and methodology. Section 4 presents the main empirical results, and section 5 provides the main conclusions of the study.

## **The role of financial market regulation**

### **Institutional challenges relating to financial markets**

The existence of a correlation between economic growth and financial market development was first observed by studies in long-term economic historical trends.<sup>5</sup> Since the 1980s, a number of theoretical models were developed which combined endogenous factors of economic growth with endogenous development of financial markets.<sup>6</sup> Later, some representatives of mainstream financial economics concluded that financial development was the cause for improved business conduct and accelerated economic growth.<sup>7</sup>

Analysis of the relationship between financial system complexity and implementation of the competitive market principle indicates a strong positive correlation between these factors and the development of the commodity markets. Additionally, financial intermediaries play an important role in monitoring and overcoming information asymmetries.<sup>8</sup> The links between cross-country differences in financial market risks and economic growth has also been studied in works of R. La Porta, F. Lopez-de-Silanes, R. Vishny, and A. Shleifer.<sup>9</sup> More recent studies investigated the relationship between company financing and levels of investor protection,<sup>10</sup> and the interdependence between national stock market volatility, the level of investor protection and securities market development.<sup>11</sup>

**SOME AUTHORS WHO** studied developing and transition economies concluded that the theoretical model of financial economics, in which financial markets facilitate the transition to a more efficient allocation of resources, is not always consistent with the evidence presented on misbehavior, asset stripping, violation of minority shareholders rights and corruption. If the financial system simply attracts resources and transfers them to financially and politically connected individuals, it creates barriers to economic growth and affects the implementation of business initiatives.<sup>12</sup> Thus, the impact of the financial system on economic growth is not always positive. The financial market also requires appropriate micro-economic conditions, such as a "contract culture", enforcement of property and contract rights, the development of financial institutions with long-term goals, and transparency.<sup>13</sup>

The assessment of the financial depth of the Russian economy by a set of key indicators (representing the international standard for national financial systems) shows that the financial



depth is insufficient and even inadequate with exceptionally high risks and exposure to shocks in the international market.<sup>14</sup> The chronic imbalances are currently characteristic for the Russian financial market as well.<sup>15</sup> The main imbalance in its development lies between the impact of global investment booms, when the market has an optimistic view concerning the prospects of the Russian economy, and underlying fundamentals that provide rather negative estimates. Despite these contradictions, the transition to a state-capitalist economic model in the 2000s contributed to market growth and attracted investments. Capital repatriation into Russia became an essential component of the investment boom, though such factors as underdevelopment of the institutional environment, high risks, and weak property rights protection impeded an effective reallocation of resources. Investments in state-owned companies became a source of virtually guaranteed returns to investors since the state provided these companies with financial, regulatory and political support. This model of the financial market growth is speculative; it is not associated with significant capital investments in production and is only possible under the condition of capital inflows into emerging markets. It brings about revenues for large companies due to increasing prices and redistribution of available assets.

Most of the Russian stock market's institutional problems have not yet been solved. The basis for the growth of the financial market including sources of liquidity is very fragile. The largest public corporations increase capitalization by acquisitions of new assets; therefore the process is not accompanied by increasing efficiency. Large corporations have been rendered into elements of public policy; their decisions have been less predictable and depend on inner conflicts of interest. There is a lack of independent monitoring of the financial system's efficiency by investors and civil society. All this increases the risk of systemic crises in the financial market.

The accumulated experience in the development of financial markets and special aspects of the market economy in a number of developed and emerging economies suggest that the national model of financial market regulation begins to correspond to the economic growth goal after the introduction of new institutional rules. The consistency between the regulation model and the depth of financial structure is important. In particular, this applies to the key issue of national financial market regulation, which focuses on the choice between integrated and multi-sector models of supervisory and regulatory authority.

### Current trends in prudential supervision and regulation

The major components of regulation, supervision and monitoring of modern financial markets traditionally include:

- judicial and legal authorities that ensure enforcement of property rights, contractual rights, and obligations;
- supervisors and a Commission for the Securities Market;
- systems of independent and effective auditor control;
- private analytical firms and rating agencies;
- independent professional organizations that set standards and norms of behavior in their respective fields.

**Table 1: Classification by the degree of integration of prudential and conduct-of-business supervision**

Prudential supervision structure	Supervision index	Conduct-of-business supervisory structure	Regulation index
Sectoral supervision with banking and non-banking supervision in an agency other than the central bank	1	No business conduct supervision <sup>a</sup>	1
Sectoral supervision with banking supervision in the central bank and non-banking supervision in an agency other than the central bank	2	Separate institution(s) for business conduct supervision other than the prudential supervision agency <sup>b</sup>	2
Partial integration, where financial sectors are supervised by the agencies outside of the central bank	3	Sectoral supervision <sup>c</sup>	3
Partial integration, where financial sectors are supervised by the central bank	4	Business conduct supervision is held by the agency, which acts as an integrated supervisor	4
Financial Supervisory Authority – integration of prudential supervision into an agency outside the central bank	5	Twin Peaks model – one integrated agency for regulation along with a separate integrated agency for prudential supervision	5
Integration of prudential supervision into the central bank	6		

Notes: This classification excludes prudential supervision and conduct-of-business regulation of pension funds. <sup>a</sup> Assumes the absence of an agency with regulation authority including competition maintenance and consumer rights protection, in particular for the banking sector. Some stock and insurance market authorities may still exercise certain regulatory functions. <sup>b</sup> Partial market regulation, when there is an organization with financial consumers protection authority, including customers of banks. <sup>c</sup> A separate prudential supervision agency exists for each financial sector and is also authorized to perform a regulatory function.

Source: World Bank, 2013.

Financial regulation includes prudential supervision and conduct of business regulation. The former provides reliability and stability for financial institutions and reduces systemic risks, while the latter ensures an appropriate level of performance in competitive markets and protects financial consumers' rights. Prudential supervision monitors the behavior of individual firms and enforces legislation. Prudential supervision has four main components and includes licensing of new financial institutions,

on-going monitoring of the sound conduct of business by financial institutions (asset quality, capital adequacy, liquidity, management, internal control, etc.); sanctioning or imposing penalties in case of non-compliance with the law, fraud or other types of wrongdoing; performing the role of the lender of last resort such as provision of deposit insurance guarantees, and insolvency proceedings.

The conduct of business regulation concerns the process of rule-making and the legislation underlying the supervisory framework. The main focus of the conduct of business regulation lies on the activities of financial institutions, their market behavior and how they conduct business with their customers. This type of regulation deals with rule setting on appropriate behavior and monitoring its implementation.

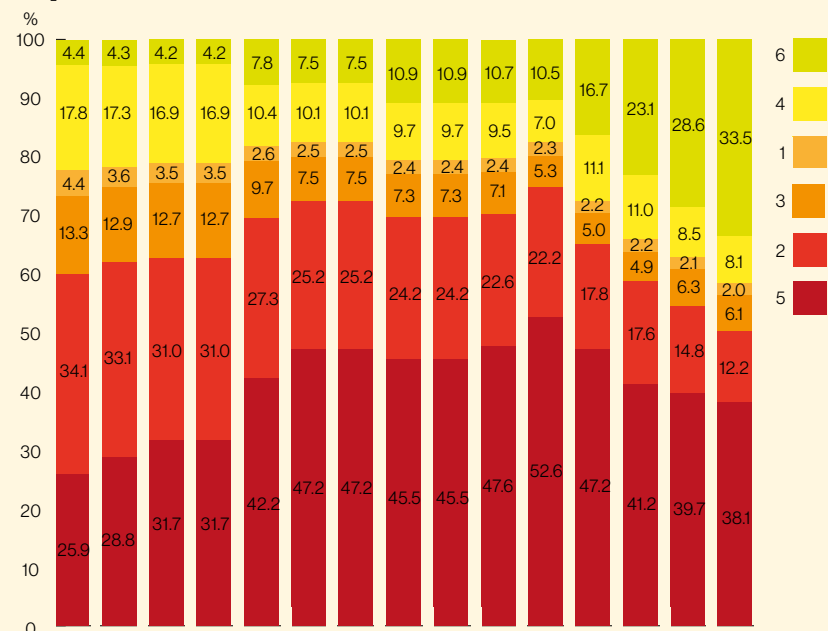
Financial regulation should be used to maintain a balance between prudential supervision and conduct-of-business supervision. Excessive strengthening of the former may undermine competition. On the other hand, weakening regulation can jeopardize the stability of financial institutions. Excessive prudential requirements usually lead to the shift of institutional investors' focus towards short-term strategies.<sup>16</sup> This can take effect in reduction of the asset holding period, increase in the turnover of investment portfolios, reduction of investment in less liquid and riskier assets, such as venture capital and infrastructure, and can lead to herd behavior among investors. In 2013, the EU Green Paper for Long-term financing of the European economy observed the importance of monitoring prudential reforms to minimize the negative consequences for long-term investment.<sup>17</sup> In particular, the system of regulation and supervision should maintain competition between banks and institutional investors.

The World Bank divides the systems of prudential supervision into six categories and regulation systems into five based on their level of integration. For further calculations, we arranged these categories according to increasing degrees of integration. Each category was assigned a corresponding number that increases along with the degree of integration. This mapping process is illustrated in Table 1.

**WE CONSTRUCTED A DATASET** for 50 countries. The relatively small sample size is explained by missing data for some countries. Previously, the World Bank had conducted a survey on prudential supervision and conduct of business integration up to 2010. We complemented the World Bank dataset with our own statistical calculations for the period between 2011 and 2013. The sample was maximally diversified to include both developing and developed countries.

Figure 1 illustrates the data on prudential supervision classifi-

**Figure 1: Countries with six regimes for prudential supervision in 1999–2013 (in %)**



Sources: World Bank dataset, authors' calculations. Numbers in the legend indicate the model of prudential supervision according to the classification in Table 1.

cation for 50 countries between 1999 and 2013. Before the 2008 crisis, the number of countries with more integrated models of prudential supervision was increasing. The proportion of countries with fully integrated supervision under the control of respective central banks (group no. 6 in the classification) increased from 4.4% in 1999 to 10.7% in 2008. The proportion with integration outside the central bank control (group no. 5) increased from 25.9% to 47.6% respectively. After the crisis, the group no. 6 continued to grow, reaching 33.5% in 2013, and the group no. 5 decreased to 38.1%. Therefore, the crisis has not resulted in a rejection of integrated prudential supervision. Nevertheless, in many countries, the opinion that central banks are, in general, better prepared for integration than other agencies became prevalent.

**FIGURE 2 ILLUSTRATES** that before the crisis, the number of countries with integrated prudential supervision regimes (group 4) grew more quickly. The group 4 countries increased from 10.7% in 1999 to 32.7% in 2008. Countries with integrated business conduct and supervision formed the largest group in the sample of 50 countries. During the same period, the proportion of countries applying the Twin Peaks approach (group 5) grew at a moderate pace, from 6.7% in 1999 to 9.1% in 2008. In 2008, Australia and the Netherlands were the only countries applying the Twin Peaks model.

After the 2008 crisis, significant changes took place regarding regulation. The proportion of countries using the Twin Peaks approach grew to 22.9% by 2013. Growth of group 4 slowed

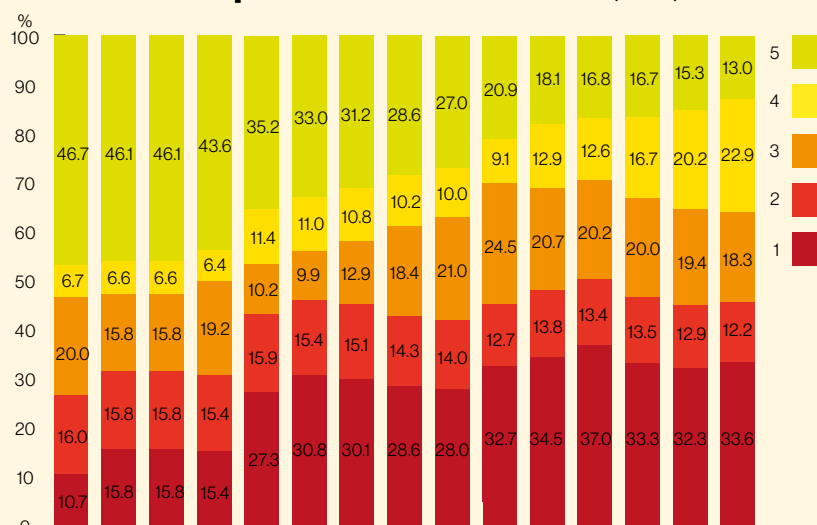
sharply, increasing to only 33.6% in 2013. Along with integrating prudential supervision into central banks, more countries made steps toward adoption of the Twin Peaks approach and transferred control functions to agencies independent from central banks. The aim was to create integrated supervision, which would not impede competition, financial institution development, or comprehensive protection of financial customers' rights. By 2013, countries such as Finland, Belgium, New Zealand and the United Kingdom fully or partially completed the transition to the Twin Peaks approach.

**THE CHOICE OF A PARTICULAR** regulation model and degree of integration is based on several factors of economic development and policy priorities. Melecky and Podpiera<sup>18</sup> investigated the relationship between prudential supervision and regulation models, on the one hand, and on the other, a number of indicators reflecting the development level of economic, political and financial systems in 98 countries from 1999–2010. They attempted to explain the choice of a particular prudential supervision and regulation model using 19 variables for prudential supervision structures and 21 for models of regulation. Their main conclusions were that countries with higher levels of economic development preferred more integrated systems of prudential supervision; improvement of the regulative efficiency usually led to a more integrated model. Melecky and Podpiera also found that the presence of a more sophisticated non-banking financial sector including capital markets and insurance companies resulted in a less integration while a high concentration of the banking system prevented the creation of an effective system of financial market regulation.

Based on the analysis of supervision structures in 102 countries in 2008–2009, another study shows that the unification and centralization of supervision negatively affect economic growth. Integration of macro- and micro-prudential supervision into two independent departments makes it more transparent and balanced.<sup>19</sup> A sample of 140 countries from 1998–2006 showed that the establishment of independent prudential supervision outside the central bank control reduced the share of nonperforming loans in relation to GDP, and such countries are less prone to systemic risk.<sup>20</sup>

The choice of a particular regulative model can affect economic performance in several aspects, including GDP, exports share of GDP, stock market capitalization, etc. The main rationale for choosing a regulation model and degree of regulative integration is to find a model that would correspond to the level of economic and institutional development. In the next section, we will demonstrate that our primary raw data analysis led to the hypothesis that the Russian economy was not ready to adopt a centralized integration model represented by the Central Bank as a financial market mega-regulator.

**Figure 2: Countries with five regimes of conduct-of-business supervision in 1999–2013 (in %)**



Sources: World Bank dataset, authors' calculations. Numbers in the legend indicate the model of conduct-of-business supervision according to the classification in Table 1.

## Data and methodology

In order to determine the effects of selected factors on the probability of choosing a certain degree of prudential supervision and conduct-of-business integration, the authors used an ordinal probit pool model. The model has the following general form:

$$y_{it}^* = X_{it}^T \beta + \varepsilon_{it} \quad (1)$$

where:  $t \in [1999, 2013]$  is the time period (year);  $i \in [1, 42] \cup (43, 50]$  – a code for each country except Russia (code 43), which is excluded from regression estimations and used later in analysis;  $\varepsilon_{it}$  – unobserved error, which reflects the impact of unaccounted additional factors,  $\beta$  –  $K \times 1$  coefficient vector and  $X_{it}^T = (X_{1,it}, \dots, X_{K,it})$  – row-vector of a matrix of  $K$  explanatory variables.

We used the ordered choice model as a key commonly used instrument for data analysis, in which the main (dependent) variable is discrete, i.e. takes the only limited set of values. In our case  $y_{it}$  has 6 or 5 categories (depending on classification in table 1). The estimation method for all regressions is maximum likelihood.

The estimates of the coefficients  $\beta_i, i=1, \dots, 18$  are interpreted as follows: a positive value indicates an increase in the probability of transitioning (or fitting) into the category with a higher number with an increase in the corresponding explanatory variable, and vice versa. The positive coefficient for any factor means that if in country 1 the value of this factor is higher than in country 2, country 1 fits into a group with a higher degree of integration than country 2. The opposite connection applies to negative betas.

For a set of explanatory variables, the authors followed the Melecky & Podpiera (2013) approach with some modifications.



We chose to include the following in the full regression model: population as a proportion of 50 countries (in %), GDP per capita fixed at constant 2005 US dollars (\$), the exports of goods and services to GDP ratio (% of GDP), the number of listed companies per 10,000 people, and the savings ratio as a percentage of disposable income. The purpose was to reflect the level of economic development of a specific country. The studies discussed above show that correspondence between the choice of an integration model and macroeconomic factors is crucial.

**IN ORDER TO INCLUDE** financial markets in the regression, we used a set of factors that describe its sectoral characteristics. These factors act as a proxy for estimating financial sector development. The banking sector is represented by a 5-bank asset concentration, which is defined by the Bankscope database as the assets of the five largest banks as a share of total commercial banking assets. Bank deposits to GDP ratio describes the total value of demand, time, and saving deposits at domestic deposit money banks as a share of GDP by International Monetary Fund, International Financial Statistics, and World Bank GDP estimates. The bank Z-score estimates the probability of default by the banking system and accounts for the volatility of returns. Deposit money bank assets to GDP ratio includes claims on the domestic real non-financial sector and comprises commercial banks and financial institutions that accept transferable deposits, such as demand deposits. Non-banking sectors are represented by the value of pension fund assets to GDP, the value of mutual fund assets to GDP, the life insurance premium volume to GDP, the total value of outstanding domestic private debt securities to GDP, stock market capitalization to GDP, and the stock market total value traded to GDP. Regulatory capital to risk-weighted assets measures the capital adequacy of deposit takers and is included in the regression as a proxy for regulatory government policy.

The last group of factors represents two government indexes: the government effectiveness index and regulatory quality index from The Worldwide Governance Indicators (WGI) project. The government effectiveness index captures quality of public services, quality of the civil service and its degree of independence from political pressures, quality of policy formulation and implementation, and credibility of the government's commitment to such policies. The regulatory quality index captures the government's ability to formulate and implement sound policies. All these factors can affect the transition to a more integrated model, since it demands high quality governance.

All explanatory variables, i.e. factors described above, are lagged by one period to avoid possible endogeneity. We do not account for autocorrelations, since this issue does not apply here. Countries make a decision on keeping or changing the model of regulation and supervision integration based on their macroeconomic and financial parameters in the previous year. Financial markets change rapidly, and governments need to react constantly by amending rules and by altering the regulative framework. Therefore, the problem of autocorrelation does not apply to this issue. In order to get robust results, we also created a set of

**Table 2: Determinants of the degree of prudential supervision integration**

Dependent variable: Prudential supervision integration classification			
Explanatory variables (L1: lagged by one year)	Estimated coefficient	Standard deviation	Probability
L1. Population as a proportion of 50 countries (%)	-0.0368	0.0265	0.1650
L1. GDP per capita (\$ at constant 2005 prices)	0.0140***	0.0031	0
L1. Exports of goods and services (% of GDP)	0.0230***	0.0025	0
L1. Government Effectiveness Index	-0.1800	0.2303	0.4340
L1. Number of listed companies per 10.000 people	-0.5637**	0.2730	0.0390
L1. 5-bank concentration (%)	-0.0043	0.0053	0.4160
L1. Bank deposits to GDP (%)	0.0042	0.0027	0.1240
L1. Deposit money bank assets to GDP (%)	-0.0013	0.0023	0.5550
L1. Z-score	-0.0093	0.0081	0.2480
L1. Pension fund assets to GDP (%)	0.0082***	0.0024	0.0010
L1. Mutual fund assets to GDP (%)	-0.0034***	0.0012	0.0040
L1. Life insurance premium volume to GDP (%)	-0.0469	0.0408	0.2500
L1. Outstanding domestic private debt securities to GDP (%)	-0.0028	0.0032	0.3910
L1. Regulatory capital to risk-weighted assets (%)	-0.0108	0.0226	0.6320
L1. Stock market capitalization to GDP (%)	-0.0079***	0.0017	0
L1. Stock market total value traded to GDP (%)	-0.0027***	0.0011	0.0140
L1. Regulatory Quality Index	0.7843***	0.21278	0
L1. Savings Ratio - % of disposable income	0.0016	0.0123	0.9250

Notes: \*\*\* - 1% significance; \*\* - 5% significance; \* - 10% significance

Source: Authors' calculation.

partial order probit models constructed as a simple one-on-one regression for each pair of classification and factor. After that, we applied post-estimation methods of probability prediction to a full regression model in order to check if Russia fit in estimated linkages. Since Russia was excluded from all regression estimations, the final formula is able to provide an unbiased estimation of the probability of Russia fitting into each identified regulative group.

## Determinants of the degree of integration

Our main analysis results concerning the determinants of the degree of prudential supervision integration are presented in table 2, which demonstrates the regression results for the full model.

We did not take into account data for Russia in order to analyze the compatibility of the Russian data and the chosen regime for each group after receiving a formula with estimated coefficients. All of the factors included in the model were lagged by one period in order to avoid possible endogeneity problems. The regular estimations of measures of the quality of models, such as coefficient of determination, do not apply to maximum likelihood methods.

Population has a negative influence on supervision integration in each estimated specification. An economy with a smaller population is more likely to have a smaller financial market, which makes the greater integration process easier and more affordable. The sizes of financial sectors are more likely to be small, so the integration of supervision into a single agency will provide savings on staff costs and several individual supervisors.

Greater development and openness of a country allows mobilization of the resources and enables a higher degree of supervisory authorities' integration. This is consistent with Melecky's and Podpiera's conclusions. Banks and other financial institutions in developed countries have more complex structures or may form financial conglomerates. Therefore, there is a need to organize integrated supervision over the organizations that are carrying out activities in several areas. Signs of the coefficients of GDP per capita and export of goods and services are predictably significant and positive in all estimated specifications.

Improvement in the quality of a country's governance leads to greater integration of supervision. As a proxy for this factor, we selected an index of government effectiveness. An increase in the number of listed companies leads to complications for prudential supervision being performed by a sole integrated agency. In this regard, a large number of companies increases the probability of choosing a less integrated model of supervision. This is also consistent with Melecky's and Podpiera's conclusions; the more developed a stock market compared to a banking sector, the less integrated supervision would be. The z-score compares the capitalization and profitability of banks to the volatility of their income. The estimated coefficient is not significant, but it is negative in all estimated specifications, which suggests the division of supervision in case of a banking system's default risk.

Stock market capitalization (the ratio of the value of all securities in the market to GDP) and the ratio of stock market total value traded to GDP both have significant negative coefficients in all specifications, reflecting the negative effect of the size of the securities market on the probability of prudential supervision integration. This is also consistent with Melecky and Podpiera's conclusions.

**Table 3: Determinants of the degree of conduct-of-business integration**

Dependent variable: conduct-of-business integration classification			
Explanatory variables (L1: lagged by one year)	Estimated coefficient	Standard deviation	Probability
L1. Population as a proportion of 50 countries (%)	-0.0630**	0.0280	0.0250
L1. GDP per capita (\$ at constant 2005 prices)	-0.0049	0.0034	0.1490
L1. Exports of goods and services (% of GDP)	-0.0056**	0.0022	0.0110
L1. Government Effectiveness Index	0.1584	0.2452	0.5180
L1. Number of listed companies per 10.000 people	-1.0434***	0.2930	0
L1. 5-bank concentration (%)	0.0146**	0.0058	0.0110
L1. Bank deposits to GDP (%)	0.0115	0.0128	0.2170
L1. Deposit money bank assets to GDP (%)	-0.0012	0.0023	0.6190
L1. Z-score	-0.0012	0.0087	0.8950
L1. Pension fund assets to GDP (%)	0.0151***	0.0025	0
L1. Mutual fund assets to GDP (%)	0.0017	0.0012	0.1660
L1. Life insurance premium volume to GDP (%)	0.0762**	0.0379	0.0440
L1. Outstanding domestic private debt securities to GDP (%)	-0.0046	0.0031	0.1350
L1. Regulatory capital to risk-weighted assets (%)	-0.0362	0.0241	0.1330
L1. Stock market capitalization to GDP (%)	-0.0047***	0.0018	0.0080
L1. Stock market total value traded to GDP (%)	-0.0034***	0.0013	0.0090
L1. Regulatory Quality Index	0.1247	0.2403	0.6040
L1. Savings Ratio - % of disposable income	0.0491***	0.0136	0

Notes: \*\*\* - 1% significance; \*\* - 5% significance; \* - 10% significance Source: Authors' calculation.

The regulatory quality index reflects the ability of the government to formulate and implement effective regulatory policy that promotes development. Significant positive estimated coefficients in all specifications for this factor means that the transition to a more integrated prudential supervision can be effective only if it is supported by high quality control and standards of governance.

The following factors characterize the size of non-banking financial market sectors: the ratio of pension fund assets to GDP, the ratio of mutual fund assets to GDP, the ratio of life insurance premium volume to GDP, and ratio of outstanding domestic private debt securities to GDP. Only the size of the pension sector is positive and significant in a full regression. Higher amounts of pension fund assets are usually more characteristic for more developed economies. Therefore, the higher this amount is, the more integrated supervision is.

In the same way, we constructed and evaluated a set of ordinal probit pool models in order to determine the effects of selected factors on the probability of choosing certain degrees of business conduct integration. Table 3 presents the regression results for full model.

Population has a negative impact in each estimated specification, as well as for supervision models. For a smaller economy,

it may be reasonable to integrate regulation into a single body to simplify the control system and to save time and personnel costs. Income level in all regressions has a positive influence on integration. When the level of development increases, countries need to introduce enhanced regulation and strengthen integration to improve the efficiency of financial sector monitoring.

An improvement in governance quality has a positive effect on the integration of regulation and supervision. The coefficient of the government effectiveness index in full regression is positive and not significant, but the coefficient becomes significantly positive in the partial specification, with this index and the number of listed companies. The number of listed companies significantly and negatively affects the integration of regulation in all specifications. When the number of market participants increases, the market structure becomes more complex, and a move to a more integrated regulative model becomes more difficult.

The stock market's size has a negative effect on the integration of regulation. The estimated coefficients of stock market capitalization and the ratio of stock market total value traded to GDP have a significant and negative impacts in all specifications. The sizes of non-banking financial market sectors, such as pension funds, mutual funds, and life insurance, have positive effects on the integration of regulation. The evaluation results show that the development of financial sectors needs a sophisticated and effective regulative model, integrated and unified monitoring processes, and common business standards rules.

The regulatory quality index has a significant positive effect in all specifications. Therefore, transition to a more integrated regulation model is possible only if there is a high quality of regulation.

## Prudential supervision and regulation in Russia

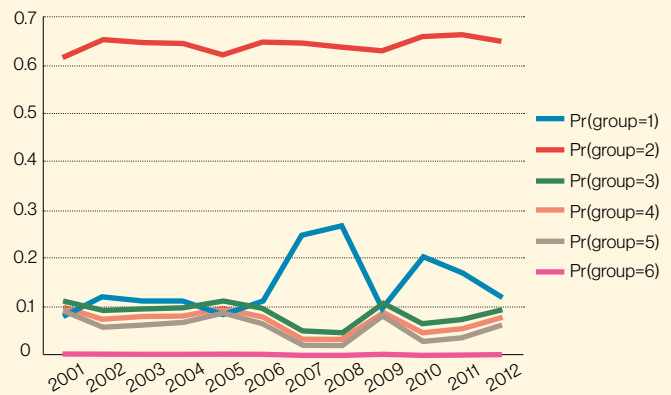
In the final stage of our analysis, we assessed comparability of the regulative regime in Russia with six degrees of supervision integration. Based on post-estimation procedures after the regression estimation, we constructed six series in accordance with the proposed classification of supervision during the 1999–2012 period. Each series contains data for the predicted probability of each category of dependent variable. This reflects the likelihood of adoption of each supervisory model in Russia in each year.

The results are illustrated in figure 3.

The predicted probability of how Russian data corresponds to each group of countries revealed that Russia most likely fell within the second group. Indeed, the Russian regulative framework before September 2013 coincided with this probability. The probability for fitting in the 6<sup>th</sup> group, with maximum integration of supervision within a central bank, is the lowest, close to zero. However, after September 2013, Russia opted for a transition towards a centralized mega-regulator model under the CBR control.

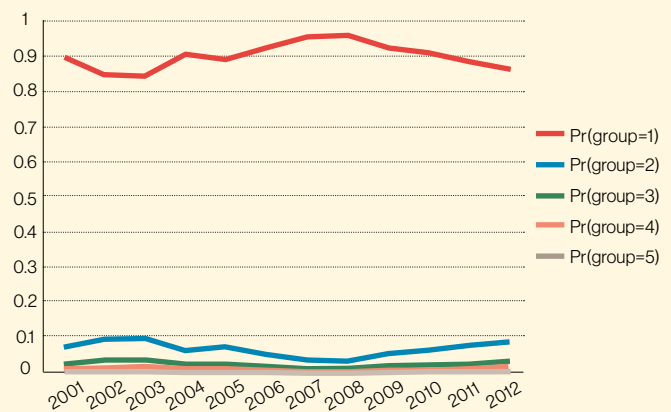
Using the same approach, we obtained estimates for the integration of conduct-of-business supervision in Russia during the 1999–2012 period. We constructed five series for each group according to the suggested classification of regulatory models.

**Figure 3: Predicted probability of Russia's compliance with six groups of prudential supervision**



Source: Authors' calculations. Numbers in the legend indicate the model of prudential supervision according to the classification in Table 1.

**Figure 4: Predicted probability of Russia's compliance with five groups of conduct-of-business supervision**



Sources: Authors' calculations. Numbers in the legend indicate the model of conduct-of-business supervision according to the classification in Table 1.

Each series reflects the likelihood of Russia falling within a corresponding group of conduct-of-business supervision for each year. Figure 6 shows the results of estimations.

**THE PREDICTED PROBABILITY** of the Russian data's compliance with each group of countries revealed that Russia most likely would fall within group no. 1. This corresponds to the time series data before September 2013. The probability for falling within group no. 4 with maximum integration of conduct-of-business supervision within a central bank as the only controlling authority rose slightly and remained close to zero throughout the period. However, in 2013, Russia moved into group 4, which implied a concentration of regulatory functions in one authority, the CBR, responsible for consolidated prudential supervision.



The quantitative analysis suggests that Russia is closer to the sectoral prudential supervision model. Additionally, Russia is fairly close to a relatively simple regulation model. The latter presupposes that separate agencies regulate non-banking financial institutions and that there is no special regulator of competition in the banking sector. This means that special attention should be paid to the effectiveness of the regulatory function, involving creation of conditions for fair competition between financial market participants and protection of financial consumers' rights. The excessive consolidation of regulation and supervision within one authority in combination with the weakness of non-banking conservative institutional investors impede development of the latter. This in turn contributes to a deficit of long money within the Russian financial system.

## Conclusions

A sophisticated and effective financial system is characterized by increasing integration of regulation and prudential supervision. It relies on an optimal balance between financial stability and maintenance of fair competition between financial intermediaries. Our analysis confirmed that the degree of integration of the regulation and prudential supervision models depends largely on the level of economic development, sophistication of the financial system and government effectiveness. The regression analysis has demonstrated that factors such as population and economy size have negative effects on the integration of financial regulation. Quality of governance, size of the non-banking financial market sector and regulatory effectiveness have positive effects.

Post-estimation analysis shows that a new model of rigid integration of prudential supervision and regulation that emerged in Russia in 2013 does not fully take into account the institutional environment of the country's financial system. Integration of financial market regulation into the CBR as the only mega-regulator involves a transition to a higher level of concentration of regulation and prudential supervision. This increases the risks of both excessive administrative pressure on the insufficiently developed non-banking financial institutions and weakening of the competitive environment. The results of the regression analysis presented here suggest that Russia is closer to the sectoral prudential supervision model. Russia would still benefit from a relatively simple regulation model with sectoral regulation and absence of conduct-of-business regulation. ✕

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