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Is there a 'new deal' in state-business relations in Russia?



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Andrei Yakovlev¹

Is there a 'new deal' in state-business relations in Russia?²

Abstract

This paper considers the reasons for increasing the interest of Russian leaders in improving the investment climate in Russia. The paper shows that this change in economic policy is connected not only to the natural rent decline but also reflects the search of the ruling coalition for a new social base represented by successful medium-sized business. These new trends can be interpreted in terms of the “limited access order” concept developed in the recent works of Douglass North and his co-authors.

Keywords: Russian transition economy, rents, bureaucracy, large and medium-sized business, response to the crises, investment climate

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² This article is based on the results of the projects “Collective actions of firms: compensation of state and market failures or rent seeking” and “Institutions and economic development: the role of bureaucracy and experiments as a method of reforms analysis and assessment”, which were conducted by HSE Institute for Industrial and Market Studies as part of the HSE Program of Fundamental Studies in 2012. The author is grateful to Vladimir Gimpelson, Evsei Gurvich, Yakov Pappé and Tseren Tserenov and to participants of the seminar at East China Normal University (Shanghai, December 2012) for their comments and suggestions.

Introduction

The fact that business conditions in Russia are unfavorable has been discussed for a long time (see Puffer et al, 1998; Hellman et al, 2003; Kuznetsov and Kuznetsova, 2003; Yasin et al, 2006; Golikova et al, 2007, etc.). However, Russian authorities recently began to make visible efforts to change the investment climate. Thus, in February 2012, Vladimir Putin announced the 100 steps program, which is aimed at shifting Russia's ranking up from 120th to 20th in the Doing Business rating compiled by the World Bank and at establishing a position for a special ombudsman for entrepreneurs' rights. That announcement was followed by the development of road maps for the simplification of getting access to electricity and obtaining construction permits, change of customs regulations and exports promotion. In September 2012, a special presidential decree was passed regarding governors' activity evaluation regarding the business climate in their regions. What caused turnaround toward business, and why had it not happened earlier?

To answer that question, it would be useful to consider the situation in Russia from the point of view of a new concept formulated in the latest works of Douglass North and his co-authors (see North et al, 2007; North, Wallis and Weingast, 2009; North et al, 2012 – hereinafter these works are referred to as NWW), which pretends to interpret the recorded human history.³ According to the NWW concept, well-functioning markets and developed democracy are ideal, but the absolute majority of modern societies are functioning within the framework of imperfect institutions. The state in such societies does not have a monopoly on legitimate violence using the terms of Max Weber; rather, the state is a coalition of influential social groups, each of which has its own violence potential.

Under the NWW concept, such influential social groups historically form the society elite. Additionally, influential groups have a choice. The groups can refrain from using violence against their fellow citizens and protect them against external threats or with the help of their force potential, take away the assets and incomes of other less influential groups. The "war against all" described in the latter case kills any productive activity incentives and reduces the total income. Therefore, elites tend to mutually agree to terminate hostilities and form the ruling coalition. However, such a non-aggression pact can be stable only if its participants obtain sufficient compensation for their abstention from violence and are able to suppress collectively any breaches of the agreements. NWW define such societies as 'limited access orders' (LAO) and stress that social and political stability (as precondition of economic growth) can be supported in LAOs only through creation and distribution of rent. But at the same time, capture of all rents by ruling coalition and excessive barriers for newcomers will reduce incentives for economic activity and can lead to regress and crisis of LAO.

A sharp reduction in rent, especially if it is one-time, affords ground for the revision of agreements and changes in the ruling coalition. When rent decreases, elites either start a "war against all" again or attempt to reach a new agreement. The latter outcome is more probable if the ruling coalition comprises of a wide circle of social groups, which are capable solving the problems that the society is facing. Thus, social and economic development may be considered as the process of gradual access extension, as the involvement of new participants results in greater stability. The stability of the rules is especially important in the context of shock impact – when a country faces economic crises, social or political shocks.

³ It should be noted that this concept has already become popular with experts in Russian studies. Particularly, different aspects of Soviet and post-Soviet development based on this concept are analyzed in the papers of Paneyakh and Titaev (2012), Orekhovskiy (2012), Zweynert (2012), Yakovlev (2012a, 2012b).

The NWW approach is quite different from the ideas and principles that underlay the World Bank recommendations for conducting reforms in developing and transition economies in the 1990s. Specifically, the World Bank programs of privatization and deregulation of economy, and foreign trade liberalization resulted in removal of barriers to business activity and led to increases in economic efficiency. However, the removal of barriers diluted rent sources, which set the basis for the existence of the ruling coalition, and the groups that possessed violence potential had an incentive to use violence. For this reason, in many developing countries, liberal and democratic reforms were accompanied by crime waves, serious social conflicts and civil wars. Such trends were also typical of many countries in the post-Soviet area.⁴

Rules of the game in the 1990s and early 2000s

It has been well-established in the literature that the size and stability of rent flows are the essentials of the Russian economy that determine the interrelationship among society, the development of institutions, and economic dynamics (see, e.g., Åslund, 1995; Boone & Rodionov, 2002; Åslund, 2004; Gurvich, 2010). In the 1990s, the main sources of rents were privatization, an enormous price difference for the same goods in the domestic and world market, and domestic and international borrowing. The key players were the federal and regional bureaucracies and oligarchic businesses. However, all of the rent sources were largely temporary. By the second half of the 1990s, the most attractive assets had been privatized, the difference between domestic prices and world market prices for consumer goods and raw materials started to disappear, and the Russian debt burden reached a critical level. Meanwhile, the lack of agreements among elites regarding mutual consideration of interests and the non-observance of uniform rules led to chaos and entailed widespread non-payments and a permanent property redistribution. Such a “virtual economy” could not last long and it collapsed in August 1998.

The default of short-term state treasury bills (GKO) and sharp devaluation of ruble not only became an economic shock but also resulted in serious political changes when, for the first time since 1991, the government was comprised of representatives of the communist party.⁵ As a result, the 1998 crisis became type of a cold shower for the new Russian elite. The largest loss from the crisis was inflicted on the middle class. Nevertheless, representatives of the elite understood that in the case of another social cataclysm, they could lose their status and their assets. The awareness of that threat motivated different groups of elite to negotiate the new rules of the game, which created conditions for economic development.

Highly typical is the “Gref’s reform” case, particularly its tax component. Technically, all tax reform drafts were written in the Centre for Strategic Research under the direction of German Gref in spring 2000. But, in fact, this reform’s basic agreements were reached earlier – in active informal negotiations, which had been ongoing since the end of 1998 between different elite groups on different grounds (including the Council for Foreign and Defense Policy, Club-2015 and several others).⁶ Those negotiations brought the understanding that an economy cannot exist without a state, but a state cannot function without taxes.

⁴ Respective statistics for many developing countries and an explanation of the upward trend in political violence from the economic theory point of view are given in the recent work by Besley and Persson (2011).

⁵ Thus, Yuri Maslyukov became the first vice-premier in charge of economic policy and all economic agencies in the government of Yevgeny Primakov. Before this appointment he was a notable CPRF figure, the former Chairman of the USSR Gosplan and a member of Politburo of the CPSU Central Committee.

⁶ One of the results of that dialogue became the project ‘Scenarios for Russia’, implemented by Club-2015 in 1998-1999s (see <http://www.club2015.ru>).

However, business was unable to pay taxes under the irrational rules that had been introduced in Russia in the 1990s. Those rules had to be changed, but it was not sufficient merely to adjust the taxation rules in accordance with common sense. In exchange for payment of taxes, the business elite wanted the state to establish at least minimal order and provide law enforcement, investments in infrastructure and the social sphere. The mutual consent of the bureaucratic and business elite became a precondition for the quick implementation of a radical tax reform (with simplification of tax administration, introduction of a flat income tax rate and regression of the unified social tax), further business legalization and sharp growth of tax revenues. All of those factors together, to a large extent, induced the successful development of the Russian economy in early 2000s.

Such agreements on the new rules became possible only because of the 1998 crisis, which destroyed the old rent sources (connected with the GKO pyramid, exchange rate, tax arrears and non-payment offsets) and revealed new potential rent sources based on economic growth. Specifically, after the ruble devaluation and the disappearance of the "GKO pump", it became clear that enterprises privatized in the 1990s, which were often considered by their new owners only to be sources of asset-stripping, could bring profits from their core business. That understanding, on the one hand, caused a new wave of property redistribution (with manipulations of the norms of bankruptcy law and law on joint stock companies). However, on the other hand, the change of external conditions became an incentive for businessmen to start developing production, investing and to negotiate the new rules.

The period of 1999-2003 is interesting because the state attempted to create new organizations for the collective representation of business interests, and it adhered to the rationale of the NWW concept. Particularly, the Russian Union of Industrialists and Entrepreneurs (RSPP), the largest and most influential business association established by Arkady Volsky in 1990, was reformed. Initially, RSPP united directors of large state-owned and privatized enterprises, but mostly did not include representatives of new private companies. In the 1990s, RSPP was in opposition to the government (Hanson & Teague, 2005). In the 2000s, the RSPP management structure was reorganized and the Bureau of RSPP Board was set up, which was comprised of owners of all of the largest private and state-owned companies. Since summer 2000, meetings of Russian President Vladimir Putin with the Bureau of RSPP Board were held two times a year, where the board discussed problems facing business and governmental initiatives in economic policy. Although no formal decisions were made at such meetings, they were objectively extremely important for the coordination of plans on both sides - the state and big business. These meetings undoubtedly facilitated the development of more adequate economic policy and reduced uncertainty and risks facing businesses.⁷

Along with the RSPP reform in 2000-2001, two new all-Russian business associations were established: OPORA of Russia expressed the interests of small business, and Delovaya Rossiya ('Business Russia') represented the interests of medium-sized companies. These associations' activities led to reforms aimed at reduction of administrative barriers to small business (including simplification of registration and licensing procedures and reduction of the number of supervisory bodies' inspections). In addition to the previously mentioned tax reform (with simplification of the taxation system, introduction of a flat income tax rate, and regressive rates of the unified social tax), material alterations were conducted in the customs regulation system, such as unification and reduction of customs tariffs. On a whole, all of those measures resulted in noticeable legalization of Russian business and significant growth of payments to the federal budget.

Restoration of the law enforcement system capacity led to the suppression of criminal activity and squeezing crime bosses out of business and politics. The early 2000s were also characterized by decreasing levels of violent pressure on business, which was facilitated by the restructuring of

⁷ The Yukos affair ended this practice of regular high-level consultations between government and big businesses.

accumulated tax debt, simplification of the tax system, and liquidation of the Federal Tax Police Service.

Thus, in Russia in the early 2000s, there was a trend of constructive dialogue between the state and business, which created preconditions for economic development and forming of the "rule of law for the elite" under the NWW concept. However, since the mid-2000s, those tendencies have been explicitly reversed. What caused that turnaround?

Natural rent, the Yukos affair and changes in the state-business interrelations model

With all the positive changes of the early 2000s, certain gray zones remained in the relations between the power and business. One of these gray zones concerned property relations. The famous "shashlik meeting" between Vladimir Putin and oligarchs in June 2000 resulted in an informal contract between big business and the state: big business should not interfere in politics and the government will not revise the privatization results (Hanson and Teague, 2005). However, unlike the tax discussions, which resulted in the tax reform, that arrangement remained strictly informal. Moreover, oligarchs understood property guarantees to mean the right to obtain full income from properties, while representatives of the top bureaucratic elite thought otherwise. That ambiguity became the ground for revision of the arrangements when the social differentiation started growing, and the rise in the global market oil prices entailed the occurrence of a new significant rent source.

It should be noted that fast economic growth nearly always intensifies social differentiation. That process was also observed in Russia in the early 2000s when, the gaps between rich and poor regions, different sectors and social groups started to increase. The federal bureaucratic elite perceived that tendency as dangerous because maintenance of social stability was one of the fundamentals of the existing political regime.

As a result, the state needed additional resources to decrease the social differentiation, and the natural rent was considered to be the main source of such resources. Therefore, by introducing a new mineral resources extraction tax, the state tried to redistribute oil export earnings in its favor. Big business resisted the tax because such policy was perceived as an encroachment on its profits. The business resistance (most evident on the part of the largest Russian oil company, YUKOS) became apparent in stonewalling, through "friendly" State Duma deputies, a number of bills initiated by the government and in financial support to opposition parties, including CPRF and Yabloko.

Nevertheless, the power balance between the state and business had already changed by that time (Hanson, 2005; Sakwa, 2009). The top members of the bureaucratic elite de facto nationalized YUKOS and send its former owners to prison by relying on security services and law enforcement agencies (*siloviki*) as part of building a power vertical. Criminal cases initiated against the owners of YUKOS were obviously a selective application of the law, considering that almost all large companies used similar schemes of tax optimization at this time. Nevertheless, as the results of the 2003-2004 parliamentary and presidential elections demonstrated, the public broadly supported the state's actions against YUKOS (Yakovlev, 2006). In my opinion, this support derived from the widespread feeling in society that the results of the privatization process were not just, which was a sentiment that big business had ignored.

In the beginning of 2000s, specific model of negotiations between business and state supported high economic growth and provided for many elite groups access to the rent associated with this growth. But some influential actors considered this type of state-business interactions as

too costly – especially in face of opportunities to capture and control the rent associated with natural resources. In my opinion it was the main reason for YUKOS affair. However this conflict led to the collapse of relatively equal dialogue between the state and business that took place at the beginning of the 2000s. In 2003-2004 this model was replaced by the undoubted dominance of the state. Big business became a junior partner, subordinate to the state, and the key players became the top federal bureaucracy and siloviki. During this period, the “state people” believed that they knew everything and did not need any outside advice. Evidence of this supreme confidence appeared after the resignation of Prime Minister Mikhail Kasyanov’s government when the state adopted an active industrial policy (e.g., creating the Investment Fund, special economic zones and state corporations) and forced big business to secure state approval for all international agreements.

2008-2009 crisis and its consequences

Many liberal experts did not like this state-dominated model of capitalism (see, for instance, Ledeneva, 2012). Nevertheless, it is necessary to admit that much of what the government did coincided with the interests and expectations of a significant number of market players. For example, the restoration of a unified economic space, which was the result of bringing the regional governors in line, was profitable for most ordinary businesses. The same profitability was observed concerning the relations between the government and large business. While it is possible to support various opinions regarding what was done to YUKOS, most players did not like the Seven Bankers era of 1996-8, when economic policy was obviously subordinated to the interests of several large companies. Therefore, most business people perceived dominated role of the state in the new rules of the game, as the lesser evil.

An important factor in support of this policy was that in the beginning and middle of the 2000s, the state primarily did what it had previously promised to the public. While one could disagree with the methods used to remove the oligarchs from participating in politics or with forcing the regions into the “power vertical” system, the state set specific goals and subsequently implemented them. As a result, people began to share a feeling of consistency and predictability in policy, which facilitated the formation of positive expectations for long-term social and political stability and opened a door to active foreign investments into Russia in 2006-7. Representatives of the middle class who were not happy with the situation within the country had the opportunity to leave Russia, due to the high demand for specialists in other countries. This migration allowed the country to let off steam.

However, the 2008-2009 crisis demonstrated that the state capitalism model was inherently unstable. In reality, the system of vertical power relies on federal bureaucracy as its main social base. Even before the crisis this system had worked only when signals from the top level met the interests and expectations of the people at lower levels of the bureaucratic hierarchy. At the same time, a serious built-in defect of that model was the asymmetry in information signals passing, which is typical to large hierarchic systems: the lower-level bureaucrats readily reported their success, but were in no hurry to inform the higher authority about problems or failures in their areas of responsibility. Accordingly, during the crisis, it became clear that the authorities knew far from everything what was happening and had only limited capability to take action.

Particularly up to December 2008, the government leaders on all central TV channels were telling the audience that Russia had only a few problems with the stock market and banking sector caused by the bankruptcy of American companies and financial institutions. However, in reality, large enterprises in metallurgy and chemical industries in summer 2008 came across a sharp drop in demand and prices on global markets, and in August–September, these companies started to put

workers on forced leave. Under these circumstances, owners and top managers understood that the government was not aware of what was happening in the real sector. Later the sense of inadequacy of the economic policy only strengthened, when the government began to extinguish fires with such measures like promises to save everybody and the on-budget expenditures sequester with the simultaneous rise of unemployment benefits, which exceeded the average salary level in a number of regions.

Due to the government measures and global financial crises, many company owners quite rationally preferred to put their businesses on hold and wait until the government clarified its economic policy. As a result, in 2009, the Russian economy lost 8 percent of its GDP, a figure that was out of line with contemporary economic indicators. In contrast to the Eastern European countries and Mexico, Russia did not have a significant external debt, did not face a large budget deficit and was not suffering from high inflation. Rather, contradictory signals from the government resulted in negative expectations regarding government policy drove the economic contraction.

That destruction of expectations happened not only among market agents but also on the side of the state machinery itself. During the fat years of the mid-2000s, representatives of the bureaucracy gained informal control over cash flows of many entities in both the public and the private sectors. Before the crisis, these representatives had expected to draw dividends from that control for many years, which, to a certain extent, decreased the current corruption load on business. However, under sharply increased levels of uncertainty, these people determined that it was more prudent to extract maximum revenue as quickly as possible, which entailed increased corruption and violent pressure on businesses (Firestone, 2010; Zhalinsky, Radchenko, 2011a and 2011b; Gans-Morse, 2012). These changes provoked businesses to respond with an intense capital outflow from the country.

Finally, the crisis also induced a change of mood in the society. Qualified specialists belonging to the middle class, who did not accept life under the managed democracy and who earlier could consider the possibility of emigration, now observed that because of the global crisis, the demand for their services in developed countries dropped. It meant that they and their children would have to live in Russia. Therefore, it is possible to view the massive protests against the electoral fraud at the end of 2011 as a result of the crisis – the protests represented an outburst of accumulated social tension, which earlier would have resulted in emigration.⁸

⁸ Changes in economic agents' behavior, which took place in Russia after the 2008-2009 global economic crisis, can be correlated with the strategies described as 'exit' and 'voice' in classical work (Hirschman, 1970). According to Hirschman's approach, the exit strategy is shown in the fact that an agent (whether it be a firm, an employee, a household or an elector), unsatisfied with that market functioning conditions, leaves it (votes with the feet). On the contrary, the voice strategy assumes that an agent tends to influence the market in order to change the rules and bring them in line with his interests. A. Hirschman shows that the lower the competition in the system is and the narrower the exit possibilities are, the higher the probability is that the agent will choose the voice strategy. It is worth noting, that realization of both strategies is influenced by the degree of loyalty – to a brand (in case of consumers' behavior), to organization (for employees), or to a country (for citizens and investors). In our opinion, for the 2004-2007 period, we can speak of the simultaneous purchase of loyalty and broad options for implementation of the exit strategy or voting with feet. That situation changed in 2009 when, due to the change of the external economic situation and increased social expenditures, the rent volume sharply dropped, and the pressure on the elite increased for the purpose of its redistribution. At the same time, the exit strategies for successful representatives of the middle class shrank, due to the reduction of demand for skilled foreign specialists in developed countries.

New trends

Despite all of the points listed above, in my view, there are several reasons for optimism. The theses about modernizing the economy announced by President Medvedev in 2008 and the series of serious reforms conducted in 2004-8 (including the reform of public procurement in 2005-6, the decision to force public employees to declare their income, and others) demonstrate that the authorities understand the need for change. However, before 2008 in the absence of significant pressure from outside or below (from non-elite layers of society), the ruling coalition was not ready to change the rules of the game or impose limits on the elite.

The 2008-2009 crisis and the resulting changes in the world market led to increased pressure on Russian authorities. Initially, that pressure originated on the outside – due to reduction of the natural rent available for distribution and intense capital flight to countries with a more favorable investment climate. However, the pressure later began to strengthen from the inside – due to the change in expectations and a split among elites and the change of the public mood. At the same time the authorities understood that they could not rely on bureaucracy (or the power vertical system) as the regime's social base. During the crisis, it became obvious that the bureaucracy, including the law-enforcement system, which was built up vertically in the 2000s did not correspond the interests of society or the will of higher-level decision-makers.

As a result, the authorities had to adopt significant policy changes in reaction to domestic and international pressure in the post-crisis period. The authorities recognized that economic growth is necessary for preserving social stability, which is a key requirement for the functioning of the regime. However, supporting the high rates of economic growth against the background of unstable international market conditions can only work in conditions of a radically improving business environment in Russia. This situation, in my opinion, led the authorities to turn toward a dialogue with business and to seek feedback from the business community beginning in 2010 and 2011.

The government is clearly focusing on the medium-sized businesses and hopes to integrate them into the social base of the regime. Contrary to the broadly diffused opinion, this group of Russian firms is not small. According to a special project initiated by the Expert magazine, in 2006 there were approximately 13,000 companies with annual revenue of between 10 and 400 million dollars and the total sales of these firms were about 80 % of the large enterprises (Vin'kov et al, 2008). Moreover, the medium sized enterprises have the greatest growth potential, which has also given motive to the new focus of governmental policy (Yakovlev et al, 2010; Kuznetsov et al, 2011). At the same time, due to the lack of sufficient political connections, this group of firms becomes an object for violent pressure from bureaucracy and law enforcement structures. Before the crisis, the side effects of the bad business climate were compensated by the high profitability, but that high margin does not exist anymore, while the business barriers remain in place.

The first signs of this change in policy toward dialogue with medium-sized business were the meetings between Putin and Medvedev and representatives of the 'Business Russia' association in the fall of 2010. Another indicator of the "new policy" of government is the fact that by the end of 2010, at the order of the RF government, the World Bank began implementing the project 'Doing Business in Russia' with comparison of conditions for setting up companies, registering property, obtaining construction permits and getting access to electricity in 30 regions (see www.doingbusiness.org/russia). Additionally, in 2010, important amendments to the Criminal code and Criminal procedure code came into effect. These amendments restricted the pretrial arrests and other application of criminal sanctions on entrepreneurs (Firestone, 2011).

In summer 2011, Vladimir Putin ordered the Agency for Strategic Initiatives (ASI) to be established. The agency's main function is to define the problems hindering the development of business and identify solutions to these problems together with the business community and the

relevant governmental agencies. The further tasks of the ASI were defined in Putin's February 2012 campaign statement (see <http://premier.gov.ru/eng/events/news/17888/>) and subsequent decrees on economic policy, which foresaw an improvement of Russia's position on the World Bank's Ease of Doing Business ranking from 120th to 20th place, change the way the governors and federal agencies are evaluated and other measures. The practical result of the work of ASI was the development of roadmaps for reducing barriers in getting construction permits, changing customs regulations, stimulating exports, and also introducing new standards for the activities of regional governments for providing an attractive investment climate.

However, I cannot say that all those measures have resulted in a real change in the business climate. Moreover, ASI experts believe that regional governments and federal agencies have quickly learned how to build "dummy panels" with a purely formalistic response to the orders from above without any changes in the real practice of interaction with business.

Therefore, the central task for both the authorities and the country is to increase the efficiency of the public administration so that the state machine would begin to work for the public benefit and start to respond to the higher power signals. As the post-crisis development experience shows (including police reform, reform of government-financed organizations and other measures), it is impossible to achieve that efficiency and responsiveness only with orders from above – especially under the conditions of the split elite. The question of principle for the future of the Russian society is: to what extent will the ruling coalition (represented today mainly by the top federal bureaucracy, the siloviki and new oligarchs) be able to build the mechanisms of a constructive dialogue and interaction with broader elite groups – including not only medium-sized business but also regional elites and heads of large public entities in education, healthcare and other social services. In the terms of North, Wallis, and Weingast, launching such a dialogue would mean broadening access and creating the pre-conditions for sustainable economic growth and stable society.

The government still has an opportunity to form a new coalition composed of the most active social groups which could currently propose new solutions and take on the responsibility for their implementation. The main question is to what extent the top elite is ready to take such a decisive step and, first of all, to restrain itself.

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