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Institutional development in 2000s

Among the formal terms and expressions that would characterize most precisely the year 2006, the following may be selected: “predictability”, “stability” and “prevailing trends of the past years”. The institutional trends of the several previous years, however, are pretty ambiguous. Moreover, by early 2007 some vague inconsistencies or, to be more precise, substitution of notions of institutional development that may play a principal role on a long-term basis came to the foreground.

5.1.1. Politics versus economy: asymmetry of mutual influence

All quantitative indicators of the development of the Russian economy in 2006 demonstrate an economic revival (for more detail see above)¹. By late 2006 capitalization of the Russian companies was \$908 billion; thus Russia may be considered one of the major developing markets, with China only being ahead for this indicator in 2006.

The dynamically growing Russian economy (by formal quantitative indicators) demonstrates higher economic (credit) ratings of the country. In 2006 according to the largest rating companies (Fitch и Standard&Poors), Russia had a “BBB+” credit rating denominated in foreign currency which meant that the country acquired a new “investment quality” at the international financial markets and reduced costs for Russian borrowers. Next expected step for Russia will be moving to A-level ratings. OECD Council at its meeting of January 26, 2007, included Russia in the 3rd (from the top zero down to seven) group of credit risks where such countries as South Africa, Israel, India, Thailand, Morocco, Latvia, Hungary, Bulgaria, Rumania and other states are present.

The economic growth coupled with higher financial indicators of the companies (the growth of consolidated returns and, according to the survey results of the Center of Economic Market Situation under RF Government, in December 2006, satisfaction of the companies with their financial position across the industry) was accompanied by an unprecedented increase of private capital net inflow. According to the RF Central Bank, in 2006 the net inflow of private foreign capital into Russia increased by almost 40 times vs 2005 (\$41.6 billion including \$25.1 into the banking sector vs \$1.1 billion in 2005 and

¹ Herein and in sections 5.2 through 5.5. the sources used are official web-sites, pres-releases and interviews with the Leaders of the RF Ministry of Economic Development and Trade, Federal Agency for Federal Property Management, Federal Antimonopoly Service, Federal Service on RF Financial Markets and other federal government authorities; information materials of “Prime-TASS”, “Interfax”, “RBK”, “lin.ru” Project, and regular publications such as “Commersant”, “Vedomosti”, “Izvestia”, “Vremya Novostey”, “Finance”, “Expert”, “M&A”; ratings of specialized agencies and organizations, corporate sites and other sources of 2006 – 2007. In writing this section of the report the author also used the relevant materials by A. Abramov, E. Apevalova, G. Malghinov, and K. Yanovsky and materials from numerous published research papers of Institute of Economy in Transition (IET) and Academy of National Economy under RF Government on the problems of institutional development (see: www.iet.ru).

outflow of \$8.4 billion in 2004). Repatriated Russian capital (see Section 5.4 describing the growth of investments from the traditional off-shores) apparently accounts for a considerable share in this inflow, however, no clear distinction can be made between residents and non-residents. Nevertheless the assessments of direct foreign investments into Russia in 2006 are pretty close ranging from \$28.4 bio (UNCTAD) to \$31 bio (Bank of Russia).

The year of 2006 also saw an essential growth of external financing of largest banks and companies (IPO and corporate bonded loans at the internal and external markets). In 2006 the external debt of non-financial companies and commercial banks amounted to \$135.4 billion and \$78.5 billion, accordingly. The external debt of the Russian corporate sector jumped up to \$57 billion against \$54.5 billion in 2005. In 2006 the aggregate value of 18 major IPO (including Rosneft) was about \$21 billion. Corporate bonds became a driver of debt market emission: their volume grew from RUR260.6 billion in 2005 to RUR465.3 billion in 2006 (or by 1.8 times). The overall amount of RUR-denominated bonds at the market including federal securities, corporate and regional bonds increased from RUR 1.5 trillion in 2005 to RUR 2.2 trillion in 2006 or by 1.4 times.

According to the analysts of some investment banks, in 2007 IPO total volume of the Russian companies may reach \$20–\$22 billion, and with account of Sberbank and Vneshtorgbank - \$30 - \$40 billion. Around 60 Russian companies plan IPO in 2007, however, (due to the market situation) only some 30 companies will be able to do this realistically. There is a more pessimistic outlook: according to Citigroup Global Markets, in 2007 the Russian companies will not be able to exceed the 2006 indicators (2007 forecast: 32 IPO and \$18.4 billion), after the 2008 presidential elections the situation will be close to that of 2005 (in 2005 - \$5.2 billion, and 2008 forecast is 18 IPO and \$4.7 billion). The current sharp growth of IPO is associated directly with the determination to be secured against *risks of a new phase of the political and business cycle* after March 2008.

The boom of initial public offering in 2006-2007 in the context of political risks finds its confirmation when the specific motivations of the Russian companies are being analyzed². It is the consumer sector (about 80% of the IPO participants recently) that gets investments for its business development; this sector unlike the feedstock companies does not generate major cash nor has a simplified access to bank credits. The sector began to show its interest in IPO back in 2003 when the companies in the absence of a proper loan base and considerable debt burden had to look at stock placement. The major part of the consumer companies who were actually ready for IPO *were using this practice*. Another motivation for the companies with no bright prospects for development or those in need of finances to support deals on acquisition of new assets, compensation of “exit” of the partners/shareholders from businesses, etc. was the fixed value of the company and

² Y. Korotetsky, L. Moskalenko, M. Talskaya. IPO is out of fashion // *Expert*, 2006, № 39, p. 19–27.

drawing up cash funds for the shareholders' needs. A huge number of major feedstock companies-issuers that have no need in getting investment resources via IPO strive to increase and fix their capitalization as an "insurance" against their exits if the largest shareholders will have to dispose their ownership due to adverse political reasons. Some of the companies have secured themselves already by fixing their values having sold part of the stocks and legalized the remaining assets. Apparently a bonded loan is a cheaper source of external financial resources, though it does not insure the company against political risks.

The global expansion of a large number of Russian major private companies (groups of companies) in 2005-2006 was associated not only with the rationale of corporate development, the desire to strengthen their positions on new markets and search of facilities for investment but also with their preparation for the upcoming political and business cycle in Russia.

These considerations apply to some larger state companies though the latter's motivations may be different (see section 5.2). At the end of January 2007 the Head of the Federal Agency for Federal Property Management, announced a possibility of another public offering of Rosneft stock up to 25% (worth around \$20 billion), however this announcement was almost immediately disowned by G. Gref, Head of the Ministry of Economic Development and Trade. These contradictory approaches, as some believe, are the evidence of more serious attempts to transfer the largest possible portion of the Rosneft state owned stock to private ownership by March 2008 with the subsequent legalization for the sake of a narrow group of the stakeholders.

The election cycle, according to some forecasts, will obviously push down the amount of direct foreign investments (where it is difficult to separate foreign and Russian repatriated funds) in 2007. The forecasts are unanimous concerning the expected decline however the driving factors are different. Standard&Poors believes the expected decline is linked to the ongoing processes of boom decline at the feedstock markets that stimulated investments into the feedstock assets of the developing countries and nationalization of energy assets in Russia, Bolivia, Venezuela and Ecuador. The Russian Union of Industrialists and Entrepreneurs explains the decline by future political risks related to parliamentary and presidential elections in Russia. There is also a problem of preparedness of the Russian companies³.

Political risks that are not directly related to the election cycle are pretty essential for most conservative foreign institutional investors unlike the Russian owners.

³ In 2006 Tatneft initiated delisting at NYSE. Tatneft example is indicative for the Russia's corporate sector. According to AIM (Alternative Investment Market) data of London Stock Exchange, in 2006 shares of 7 companies of Russia and some other post-Soviet states were listed here while in 2005 there were 15 such companies. This is an outcome of the absence of adequate financial control required for listing (consolidated reporting, financial statements, etc). Though 2007 trends are assessed as positive, the value results of 2006 will hardly be exceeded.

One can give a reliable example of a rating developed for a number of years by one of the largest and most conservative global investors – U.S. Pension Fund - California Public Employees' Retirement System (CalPERS) which assets amount to \$225 billion (see section 5.4.). Whenever CalPERS enters a developing market, it gives to the market a certain “quality mark” attractive for other major institutional investors.

In 2006 out of four BRIC countries (Brazil, Russia, India and China), Russia and China received less than 2.0 scores (CalPERS method) meaning that these markets are shut down for investments. The 2007 forecast (1.9 scores) shows that Russia will remain at the previous year level while China's score increased from 1.6 to 1.7. The main problems of the Russian market in 2006 were: low political stability, imperfect labor laws and insufficient openness of the market. In assessing civil liberty where 1 means the highest level and 7 – no liberty at all, Russia was given 5 scores. In terms of independence of courts and legal protection Russia received 1 score out of 3 scores possible which is much worse than in China. Russia was assessed at lowest scores in terms of courts independence, legal protection of property rights, inefficient fight against organized crime and biased courts' pronouncements issued in favor of the government authorities.

CalPERS method could be equally indicative if we tried to assess the input of the key factors impeding further improvement of the investment climate in the country. With account of impact of certain factors in building up ratings, *the negative impact of specific country (government) factors is increasing vs “market factors” quality.*

Similar negative assessments of the civil society and political system in Russia may be found almost in all traditional ratings for 2006 regarding these problems (Freedom House ratings of civil liberty and mass media freedoms; World Economic Forum of global competitiveness; Oxford Analytica of creditors' rights compliance; the Heritage Foundation and Dow Jones Co; Indem Foundation; World Economic Forum, World Bank, Transparency International and others - of economic indicators). *A number of ratings became much worse vs 2004-2005 (Table 1).*

Table 1

Changes in the ratings of political stability, economic and civil liberties in Russia in 2005 – 2006

Rating	2005	2006	Lower rank/scores or close to Russia (BRIC countries)
Civil liberties (by Freedom House)	5 – no liberty	5 – no liberty	China (6)
GCI, World Economic Forum (Global Competitiveness)	53 rank	62 rank	Brazil (66)
GCI, World Economic Forum (protection of property rights)	108 rank (in 2004 – 88)	114 rank	
Economic freedom rating, the Heritage Foundation and Dow Jones & Company, Inc.	4 th group – no freedom at large	4 th group – no freedom at large (54.01 scores out of 100, 120 rank)	China – 54.02 scores 119 rank India – 55.60 scores, 104 rank

	27.6		
Political stability (by CalPERS, weight in country rating, %)	(in 2003 – 20.5)	29.2	
		(30.6 – for 2007)	
CalPERS rating (investment threshold is 2 at maximum 3)	Total 1.8	Total 1.9	China – 1.6 scores
	(in 2002 – 1.15)	Country – 1.6	

Source: Rating Developers formal websites.

According to 2006 economic freedom rating made by the Heritage Foundation and Dow Jones & Company, Inc., out of 157 states Russia ranked 120, getting 54.01 scores (maximum was 100) which was lower than the 2005 rank. Out of other BRIC countries China was placed 119 (54.02 scores), Brazil and India – 70th (60.89 scores) and 104th (55.60). Russia scored least in the following areas: no corruption (24.0%), free investments (30.0%), property rights protection (30.0%), freedom of finance (40.0%). Low score in “freedom of finance”, according to the rating agency, was given because of inefficient banking system, deficiencies in banking supervision and transparency, and restrictions of access to banking and insurance business for nonresidents. The low rating in the property rights protection means that Russia does not ensure such protection properly: “the judicial system is corrupted and biased, and ensuring the implementation of contracts is a real challenge”.

As for *short-term trends*, the situation is rather trivial. The developed *asymmetry of economic and political factors of the Russian economic development* has been obscured so far by general indicators of economic rise, instable feedstock market situation and government finance parameters (budget surplus, Stabilization fund, and gold and currency reserves), and also by indicators of extreme profitability of the Russian stock market.

The *investors* may describe this situation as “Clod Frolo dilemma” (section 5.4): a high profitability temptation up to a certain limit is stronger than the economic freedom, investors’ rights and government interference concerns.

From the *government* point of view, economic wealth measured with formal current indicators and ratings proves the correctness of the selected political route (broadly, including the issues of protection of property rights, the judicial system, etc.).

It is worth noting that the *Russian companies* that as said above are most sensitive to potential political and business cycle risks are those that have least illusions.

The *population* is extremely perceptive of the abilities of the government authorities to take effective actions in the area of economic policy (Tables 2-3).

Table 2

Why there is no sizable economic growth in Russia now?

2003-2006 population survey results, in %

	2003	2004	2005	2006
1. Red tape, corruption and bribery with the highest bodies of state authority	34	34	31	34
2. Plunderous policy of the major Russian businesses/oligarchs and their disinterest in the national economic revival	38	34	29	33
3. Incorrect economic policy of the government	27	22	34	32
4. The government does not have an economic program	22	22	29	27
5. Capital outflow from Russia/flight to off-shores	25	27	26	26
6. Theft of managers (profits withdrawal and appropriation)	28	20	21	24
7. Fixed assets worn-out	13	11	11	17
8. High taxes on entrepreneurial activity	15	10	13	13
9. Russian goods are not competitive with Western goods	9	10	10	12
10. No investments into the Russian economy	11	11	12	12
11. Business is not legally protected	9	7	7	9
Other	7	7	6	5
Difficulties in responding	12	12	9	11

Source: "Levada-Center", www.levada.ru.

As Table 2 shows, for the entire period of 2003–2006 the weight of such factor as “bureaucracy, corruption and bribery in the high echelons of power” remained unchanged (and the largest among all other 12 factors). At the third and the fourth places are the factors “incorrect economic policy” and “the absence of the economic program” which were strengthening their significance in 2003 through 2006. The second factor – “the plunderous policy of the major Russian businesses/oligarchs and their disinterest in the national economic revival” – was losing its value in the same period. “The absence of legal protection for the business” is not significant for the community; this may be explained by confusion of notions (the respondents seem to mix up legal protection and corruption). Table 3 apparently demonstrates that during 2000 – 2006 not less than 2/3 of the population kept thinking that the Russian government was not able to develop a substantiated economic program for Russia⁴. In any case the data in Table 3 add up to the conclusion that the “government” and the “market” in Russia has been moving into opposite directions during 2000’s.

⁴ We’d like to cite a statement made during the period of launching the 2004 administrative reform: “...while the government authorities having decided to increase their impact on the economy, demonstrate certain incompetence. There is a simple explanation to this. The government has not been dealing with economy at least for twelve years. It was involved in solving budget-related issues. There are no people in the current government who might know the real problems of the economy and how to deal with those problems... Therefore any attempt of the government to remove private capital from the solution of strategic issues in the sectors where this capital operates would lead to stagnation” (T. Gurova, “Give me the wheel, Party” // *Expert*, 2004, No 15, p. 34).

Table 3

Has the Government of Russia got a well defined economic program?

The 2000–2006 survey findings, in %

	2000	2001	2002	2003	2004	2005	2006
	May	April	August	August	August	August	April
The Government has got a well defined and thoughtful economic program	22	21	16	18	21	19	24
There is no well defined program but only very high-level outline of what shall be done	38	37	39	38	35	40	33
There is no such program, and decisions are taken given current circumstances	22	30	33	34	34	31	33
Difficult to answer	19	13	12	10	11	11	10

Source: “Levada-Center” www.levada.ru.

The problem of asymmetry of economic and political factors of the development of the Russian economy becomes highly critical if viewed from a long-term perspective, moreover if to assume that the sources of the current economic growth, budget revenues and funds to support social programs are closely related to the market situation.

5.1.2. Political versus economic institutions: public polls and their problems

In the 1990’s which one could call a period of initial establishment of a new institutional structure of economy in Russia the following components (criteria) were typically used: privatization, legislation (the scope and quality of the new legislation and the law institutions) banking sector status (independence of banks, their business skills and practical distribution of credit resources, and also the level of supervision and the payment system), and the role of the government (whether it is market-oriented or not and how efficiently it manages the state owned sector). All subsequent additions were highly specialized, we believe. This standard was expanded in the 2000’s by including various assessments of “the corporate governance quality”, of “economic and legal factors of the financial markets development” and “the boundaries of the institutional capacity”. Apparently significant was also a growing interest to the problems of effective courts and enforcement in general⁵. The most acute current issue is a systematic problem of adequate quality of the political institutions.

Since various groups and individuals typically derive benefits by “exploiting” economic institutions, a conflict tends to arise between various options of the public choice which is eventually resolved in favor of the groups having more political power. The distribution of the political power in the society is defined by political institutions and depends on the dis-

⁵ See, e.g.: The establishment of the institutional framework of the market-based economy, World Development Report, 2002. World Bank, 2002; From plan to market. World Development Report 1996. The World Bank. Oxford University Press, 1996; EBRD Transition Reports 1995–2006.

tribution of resources. *Economic institutions that promote economic growth emerge where political institutions, firstly, give the power to those groups that are interested in having a highly diversified ownership rights enforcement system, and, secondly, where political institutions set up effective restrictions for the actions of the power authorities and, thirdly, where the power authorities have no possibility to generate considerable rent for themselves.*⁶

The said restrictions are true for assessing institutional changes in Russia during 1990–2000. In terms of application, the most important issue is how realistic is the *today's* discussion of the development of the above positive effects. Indeed we are not able to discuss the whole range of the functioning problems of the Russian political system in this paper. The above requirements to the quality of political institutions speak for themselves and apparently are the subject matter of the remote future for Russia.

Let us discuss only one issue as a possible argument – are there in the current Russian society any groups that could ensure the existence of a diversified system of ownership rights enforcement, given the above assumptions. Whatever approaches may be used, it makes sense to discuss primarily the problem of “the middle class”.

There are various methodologies to identify “the middle class” (“normative” of “relative”, “market-based” or property-education based”, etc.). Using then one can receive a wide range of estimates. Even in the ex-USSR the quantitative estimates in the period of 80-90's of the last century varied from 11% to 30% of the population. The estimates spread for Russia of the 1990's is also large – from 6% to 25% (prior to 1998 crisis). As for the period 2002 – 2004, the majority of estimates tend to coincide: 14% to 25% of the working population.⁷

According to Institute of Sociology of the Russian Academy of Sciences⁸, in 2003–2006 given the inflow of “oil dollars” into Russia, the size of the middle class keeps reducing – from 25% down to 20% (economically active urban population)⁹. The marginal growth of the middle class up to 1/3 of the population size may take 10 – 15 years (provided the structure of the

⁶ See: Acemoglu D., Johnson S., Robinson J. Institutions as the Fundamental Cause of Long-Run Growth. – In: Aghion Ph., Durlauf St., eds., *Handbook of Economic Growth*, North Holland, 2004.

⁷ See e.g.: E. M. Avraamova and others. Edited by T. Maleva. *Middle classes in Russia: economic and social strategies*. Moscow Carnegie Center. Moscow, 2003. (“the share” of the middle class is recorded at 20%). The data of All-Russia Center of Life Level and “KOMKON” (2004) go beyond the domineering estimates – 9%, and Rating Agency “Expert” which estimates of the middle class segment vary from 14% in 2000 up to 25%-30% in 2005.

⁸ “Urban middle class in modern Russia”. Analytical report. M., Four criteria were used to identify middle class representatives: education, profession, income and integrated self-assessment of the social status. It should be noted however, that the income threshold for the middle class is only RUR10.5 thousand/month/household member. The report makes a distinction between “the old middle class” (small businesses) and “new middle class” (primarily top managers in the fuel and energy complex and other sectors of economy).

⁹ A reverse trend prevails in the world: annual surplus of the middle class makes about 1%, according to some estimates.

economy remains unchanged). The authors of the report believe that the chances of the middle class to grow at the expense of “the old middle class” are close to zero since the latter is decreasing which is a paradox. In other words it becomes clear that in the developing economic model (of state monopoly type) there is a trend to reduce this middle sub-class. As a way out of this situation it is proposed to focus on the enhanced development of high technologies sectors rather than small and mid-size businesses. This trend likewise a growing social and economic indifference of the middle class has been noted by T. Maleva, Head of Institute of Independent Social Studies¹⁰.

The specific mechanisms leading to this reduction are of secondary interest for us. What is essential for us is that in 2000 *no positive dynamics of the potential social base was observed (supported by empiric evidences) for indirect (via political representation) formation of effective economic institutions.*

Moreover, those institutions that in 1990-es opposed the expansion of demand for effective economic institutions are functioning today though in modified form. If prior to the early 2000'es (we recognize that the terms are conventional) the model of oligarchy capitalism was pursued, now we are typically speaking of the “state capitalism” in its Russian variation (see below for details).

In this context the model of negative interaction (vs efficient market relations) establishes itself where some entrepreneurs (not a very representative segment) hold political power *de facto* or have a monopoly access to the center of political decision making. Afterwards these entrepreneurs using the judicial system as a tool against their competitors stop being motivated to establish and strengthen private property relationships¹¹.

According to the new institutional economic theory, the bureaucracy, its low productivity and absence of accountability which have been frequently criticized may be analyzed, on analogy with separation of property from control in a company, as a two-tier system of the principal and the agent where the government officials play the role of agents (controllers and employees) and the electorate that of the principal. However, unlike the corporate owner, the electorate may not

¹⁰ Stagnation of the middle class. 24.01.2007, <http://abarus.ru/news>

¹¹ Unequal distribution of wealth and relative inefficiency of production creates situations where most wealthy owners are not interested in solid protection of property rights: see Polishchuk L., Savateev A. Spontaneous (non)emergence of Property Rights. – *The Economy of Transition*, 2004, Vol. 12, №1. S. Guriev and K. Sonin write: “While the rich have the advantage in setting up a private guards company and establishing good relations with the government officials, they are not encouraged to lobby the establishment of good government institutions, and therefore there is no demand for such institutions that would protect the property rights and moreover support competition. The problem is that the middle class (in this particular event associated with the small business) can not create the political demand for the good institutions due to the insignificant share it holds in the national economy and because of high costs on coordination”. (S. Guriev, K. Sonin. *The wealth and the growth // Expert*, 2003, № 24, p. 46–47. See also: K. Sonin. *Institutional theory of unlimited re-distribution. // Issues of Economy*, 2005, № 7, p. 4–18.

have a clear common goal, and this restricts their abilities to organize an effective monitoring of the politicians and government officials¹². This brings us back to the issue of the formation in modern Russia of an adequate social base that would be objectively interested in public control and monitoring and would have sufficient economic resources and the level of political power.

5.1.3. *Protection of property rights versus finance*

Primarily we should clarify why the idea of the protection of the property rights has been persistently placed at the core of any problem related to institutional development¹³. Recently in analyzing private property historical and geographical factors have been more often selected as a focus. By the beginning of the 21st century new-classic and new institutional researchers elected to determine the key features of the markets under their review at least partially by the established property relations and the system of enforcement of the property rights and the contractual obligations. The expansion of the new-classic models manifests in particular in the coverage of the “in-depth” level (according to O. Williams) where the basic institutional structures like ownership and law enforcement are installed.

“The new comparative economics” that have recently claimed to be an independent trend of the new institutionalism made a thorough research of the genesis of the law systems and how they affect the property relations and their enforcement¹⁴. The following conclusions are proposed based on the findings of the econometric analysis in various countries:

- the higher is the level of development of the private property institutions (the level of guarantees that would not be expropriated by the government and the ruling class), the larger is their positive impact on the long-term economic growth, investments and the efficiency of the financial markets¹⁵;
- the improved implementation of the principles of the private property is an absolute requirement for more intensive development of the financial markets;

¹² E. G. Furuboten, R. Richter, *Institutions and the economic theory*. – St-Petersburg, 2005, p. 547.

¹³ See also: works by V. Mau and K. Yanovsky in “Institute of Economy in Transition: research papers” dedicated to the regional and international comparison of the primary (basic) set of the political rights that absolutely prevail over any other political and economic freedoms such as life safety, security of property and independence of the judicial system and mass media.

¹⁴ For details see, e.g.: R. Enton, A. Radygin and others. *Corporate governance and self-regulation in the system of institutional changes* – M, IET, 2006, section 1.

¹⁵ See.: Acemoglu D., Johnson S., Robinson J. *Institutions as the Fundamental Cause of Long-Run Growth*. – In: Aghion Ph., Durlauf St., eds., *Handbook of Economic Growth*, North Holland, 2004.

- protection of the property rights ensures preconditions for more intensive expansion of investments and higher rates of the economic growth¹⁶;
- in those countries where the courts enjoy more independence, the property rights are better protected and an improved environment is created for intensive economic growth¹⁷;
- the successful transplantation of the legislative norms and law institutions is connected not only with the choice of a legislation system but rather with the law enforcing practices in the given country (as in Russia);
- the more corrupted are the government officials the smaller is the chance to strengthen market-related institutions and competition mechanisms (given that the administrative discipline remains at the same level).

The protection of the property rights (sometimes this notion is used as a synonym of the law enforcement) and the financial system are considered base economic institutions. Each of these is a subject for a separate study in terms of their relevancy and conformity of their current status in Russia to the economic rationale¹⁸. What is meaningful in the context of our analysis is that the mutual influence of those institutions in their current status seems to be *negative*.

A weak system for protecting property rights (due to the absence of a clear government strategy regarding state sector and privatization transactions, inertia meaning that the law is considerably behind economic activity; high degree of uncertainties and contradictions in the business law; low quality of judicial and law enforcing practices; the expansion of rights of the departments and ministries to interpret the law; poor government supervision; opposition to the establishment of self-regulating institutions; ongoing banks and corporate risks associated with protection of deposits and securities; absence of regulation in the area of new financial tools; current and long-term problems with land and real estate markets, etc.) , curbs back the development of the financial system as a key long-term tool of transformation of financial resources into capital.

In their turn, a high level of concentration, fragmentary and close nature of the Russian financial system in general, the absence of coordination and strategy of its development¹⁹, regular disproportions and non-transparency of the banking

¹⁶ La Porta R., Lopes-de-Silanes F., Shleifer A., Vishny R. Legal Determinants of External Finance // "Journal of Finance", Vol. 52, 1997.

¹⁷ La Porta R., Lopes-de-Silanes F., Pop-Eleches C., Shleifer A. Judicial Checks and Balances // "Journal of Political Economy", Vol. 112, 2004.

¹⁸ See: Russian economy in 2005. Trends and prospects. M, IET, 2006, section 4.

¹⁹ Modern economic literature traditionally divides financial systems into "banking" (bank-based financial system, relationship-based financial markets) and "market" (market-based financial system, arm's length financial markets); but this classification has become obsolete primarily due to the development of securities' markets within the traditional banking systems. The recent studies performed in 150 countries have not revealed any obvious advantages neither of the "bank loan model" nor of the "securities model". According to the financial services view, it is the quality and accessibility of financial services that have prime importance, and secondly, the structure of the financial system may have secondary importance

system, still high dependency of the Russian stock market on the international liquid cash flows and short-term portfolio investments tend to weaken long-term demand for a stable protection of the property rights (investors). The modern economic literature generally recognizes that in the assessment of the level of law enforcement and protection of the property rights the *financial market plays a key role* (since unlike the commodity market, long-term relations between the borrower and the lender are at stake).

According to the Frazer Property Index, Russia refers to the group of least developed countries. Its index value is between 4–5 (where 10 is the top value, and 0 – is the lowest), which is similar to the indexes of Nicaragua, Philippines, Syria, Pakistan and Ukraine.

According to IET this is in line with the current level of investments. Elasticity of the investment growth for Property Index statistically estimated on the basis of international comparison is 0.4 with a 5-year lag. In other words 1% Index growth results on average in 0.4% during the next five years. Thus for Russia with 4.4% Index growth (2004 estimate) up to 6 (this is the level of Greece, Korea, Slovakia and India) or 7-8 points (Mexico, Hungary, Hong Kong, Italy, Spain and Israel), the increase of investments by 2-3 points (of GDP) may be expected. Following the method of Index calculation we may assume that as a result of the development of the judicial reform (higher independence of courts via radical increase of costs of removal of judges appointed by the new procedure, and introduction of a new procedure of appointment of federal judges: qualification board with the participation of the entrepreneurs' trade union, law defenders and Human Rights Commissioners) the Frazer Property Index may grow by 3-4 points on the average (up to 7-8 points).

It is worth noting that uncertainty both macroeconomic and institutional has always affected investments negatively. A number of empirical studies proves the existence of a stable negative link between the level of investments into GDP and institutional variables characterizing the degree of protection of the property rights²⁰. The review results of a large number of countries show that in the countries with the favorable situation in the area of the property rights the investment processes get accelerated with a time lag of 5 years. This means that *the absence of institutional changes or moreover the aggravation of the investment climate by certain directions may lead to negative consequences for investments in the near future or serve as a limitation of investment growth into major capital of the Russian economy.*

since the banks and the securities markets deal with similar economic tasks; thirdly, banks and securities markets may effectively supplement each other and enhance competition in the area of corporate control by providing alternative options of funding investments; and finally, the division by the type of the financial system does not explain the differences in the rates of the long-term growth and establishment of new companies. However, the relationship between the law system and the financial system is an axiom. The review and the data by Expert, 2005, № 44, p. 70–76.

²⁰ Clague C. Introduction, in Clague C. ed., *Institutions and Economic Development: Growth and Governance in Less-Developed and Post-Socialist Countries*. Baltimore: Johns Hopkins University Press, 1997.

This is an endless topic; and only two examples will be discussed here. In 2006 during IPO process the Russian companies engaged not less than \$17 billion from Russia and another \$17 billion by placing ruble-denominated bonds. According to Rosstat, out of \$17 billion received from the distribution of shares only \$2.5 billion (or 14.7%) were invested into fixed capital. As for how the \$17 billion generated from the placement of corporate bonds were used, statistics show that only \$60 million (or 0.4%) were employed for the creation of the new fixed capital. Of course, one may account for inaccuracies of the official statistics, however the basic conclusion will hardly be changed: the funds received by issuing shares and bonds are not invested into fixed assets and therefore do not affect economic growth. One can assume that the core cash flow is used for refinancing and acquisition of debts from their current owners. There are processes at the current Russian stock market that are similar to those at the U.S market in the late 1980's known as LBO (leverage-buy-out) transactions funded from the issuance of IPO and "junk" bonds. These transactions were actually mass-scale borrowing of funds at the stock market by using a credit lever to buy companies and their assets. The key risk of such transactions is a low efficiency of the acquired companies which may not be enough to repay the debts. In the U.S. this junk bond market crashed in 1989 with borrowing companies becoming bankrupt.

Here is another example: in 2006 the share of GDP market capitalization increased up to 92.7% against 61.5% in 2005. The same year Russia became one of the world leaders in attracted direct foreign investments. The internal loan share in GDP for the year which dropped in 2005 from 25.9 down to 20.6% of GDP, remained in 2006 almost at the previous year level. The gap between the indicators of capitalization and internal loan is an evidence of serious disproportions between the level of development of the banking system and the growth of the Russian companies (for more detailed analysis, see section 5.4).

The problem of mutual influence of the property rights protection and the financial markets may be also viewed in the context of transplantation of the legal norms. Some analysts believe that the legal system in the ex-USSR was least perceptible to such transplantation. The difficulties in that case could be explained not by that in the course of the post-communist law reforms ineffective legal norms were implemented at least from the viewpoint of economic efficiency. According to K. Pistor, M. Raiser and S. Gelfer, many former USSR states received technical assistance from the USA, and now can boast of remarkable protection of the investors' rights. On paper, if these documents are trustworthy, these rights are better protected than in some highly developed Western countries like Finland and Germany. It is unlikely that the level of development of the financial markets will correspond to such high level of legal norms support²¹.

²¹ Pistor K., Raiser M., Gelfer S. Law and Finance in Transition Economics. – Economics of Transition, July 2000, Vol. 8, N 2, pp. 325-368

5.1.4. Legislative system versus protection of the property rights

Two directions of this topic may be identified – quality and appropriateness of the law and constraints set by the systematic corruption that decrease efficiency of the law enforcement practices (in addition to the quality of the enforcement tools). This topic is highly comprehensive and diversified and we will discuss just a few representative trends.

In terms of the problems solved by the legislation, the evolution of objectives set in the mid-term programs of social and economic development during the 2000'es is very specific. (Table 4).

Table 4

Basic objectives and tasks of the major institutional transformations in the 2000'es Programs of the Russian Government

Areas of the economic policy	Plan of Actions of the RF Government in the area of social policy and economy improvement for 2000–2001 approved by RF Government Resolution of July 26, 2000, No 1072-r (with amendments)	Program of a mid-term social and economic development (2002–2004), approved by RF Government Resolution of July 10, 2001 r. No 910-r	Program of a mid-term social and economic development (2006–2008), approved by RF Government Resolution of January 19, 2006 r. No 38-r
1	2	3	4
Protection of the property rights	Implementation of actions for active protection of the property rights to assist in the creation of the favorable business climate	Establishment of the favorable business climate based on protected property rights and actual mechanisms ensuring the transfer of the property rights	Reliable protection of the property rights, reforming of the law protective and judicial system; development of independent and public mass media and institutions of the civil society
Privatization	Privatization of the major number of the federal government companies and federal government owned shares	Privatization is founded on the principle of buyers' equality	Increase of the efficiency of privatization and acceleration of the reforming rates of the state sector
State property management	Increase of the efficiency of the state property management	Qualitative increase of the efficiency of the property management and performance of the state enterprises	Law improvement to optimize the state sector, and increase profitability of using property
Corporate Governance and protection of shareholders' rights	Development of a Business Ethics Code	Creation of mechanisms for protection of the shareholders' property rights. Improvement of the applicable laws and formation of judicial tools for protection of shareholders' interests	Improvement of the mechanisms for protection of shareholders' rights.. The law sets the balance of rights and interests of various groups of shareholders
1	2	3	4

Bankruptcy and protection of creditors' rights	Protection of the rights of creditors, owners, shareholders (participants) of the established and liquidated companies ликвидирuемых организаций	Formation of the legal environment ensuring effective protection of the interests of creditors and owners	Balance of rights, interests and responsibilities of the participants of the bankruptcy cases and procedures
Development of a stock (financial) market	Creation of the environment ensuring the development of investment institutions, increase of the number of financial tools. Development of infrastructure and tax treatment. Improvement of the tools for stock market regulation	Enhancement of the role of the stock market in attracting investments. Creation of the environment for development of institutional investors. Encouragement of investment activities. . Development of infrastructure	Expansion of the range of financial tools. Creation of equal competitive and comfortable conditions for the financial market players. Improvement of the system of market regulation, tax treatment and infrastructure.
Development of a land and real estate market	Creation of the environment for effective use and development of real estate to meet the needs of the community and individuals	Essential expansion of the legal framework for the real estate market development. Establishment of the system of legal federal and municipal regulation of the real estate market	Land and real estate are involved into business turnover

Indeed, the formal progress by specific directions of institutional transformations (that were also fixed in the mid-term programs as objectives and dealt with gradually in some way) is obvious. Among most remarkable achievements of the 2000'es is a modification of the Federal law "On the Joint-Stock Companies" (2001), new laws "On Bankruptcy" and "On the Federal and Municipal Unitary Enterprises" (2002), new wording of the law on competition (2005 – 2006); the Concept of improvement of the corporate laws by 2008 adopted in summer of 2006, several clauses of which have been implemented already (modification of Article 80 of the Law "On the Joint-Stock Companies"); the development of a number of procedural innovations in the area of corporate conflicts in 2006-2007, etc.

Nevertheless, as seen from Table 4, for 2000–2008 *the basic objectives change but insignificantly*. The general conclusion on the stagnation of the institutional transformations based on the formal grounds only would be ambitious, however, the comparison above gives grounds for the assumption of insufficient legal and regulatory support of the processes of the development of economic institutions in the long term period.

A list of several meaningful legal acts which need has been discussed since late 1990'es can serve as the evidence of this conclusion: "On the restructuring and liquidation of commercial entities", "On the affiliated persons", "On the responsibility for execution of transactions using confidential corporate information" ("On the insiders' transactions"), "On the self-regulating entities", "On nationalization in the Russian Federation", "On the central depository" etc. The reasons for a long delay in passing these legal acts are diversified, however the need in the establishment of transparent legal framework on these issues remains acute.

There are some examples below of how *the law lags behind the economic reality* (protection of the property rights) (Table 5).

Table 5

Inertia of the Law in 1990–2000

Issue	Most acute period	Legislative decision	Basic (probable) grounds for the decision	Impact
Minorities' stock dissolved	1995–2000	Amendments to the law "On the Joint-Stock Companies", 2001	Consolidation in major companies mainly completed	The issue ceased being a problem due to economic reasons
Transfer prices against minorities	1995 – early 2000' es	Changes in the Tax Code early 2000 'es	Political reasons	Selected pressure on major companies
State-owned assets removed; no control over the state companies' management	1990'es – early 2000'es	3Law "On the federal and municipal unitary entities", 2002	Strategic decision of gradual liquidation of unitary enterprises	For those state enterprises that have the administrative resource formal restrictions are introduced
Bankruptcy as a tool for company appropriation	1998–2002	Federal Law 'On bankruptcy", 2002	Public campaign against appropriations via bankruptcy	The appropriation market use other instruments like courts, registers, falsification of documents, etc.
Raiders (unfriendly acquisitions)	2002–now	Draft amendments in the procedures, 2007	Public campaign against raiders	–
Unfriendly appropriation of land (forecast)	2006 – mid-term	Current projects enhance uncertainty and corruptions	The issue of intensification of conflicts in this area does not actually exist	–
10-year statute of limitations for privatization transactions	2000–now	The period is reduced to 3 years, 2005 r.	Demonstration of efforts to strengthen property rights protection	In court practices the statute of limitations changes are easily overcome. The court decision is considered to be enough

Mergers and acquisitions called "raids" in the popular press is one of the most broadly discussed topics of today. Unfriendly acquisitions were not surprising back in the 1990'es, and the 2000'es were characterized by a stable growth of M&A transactions (with no state holdings). According to the available data, in 2006 the amount of mergers and acquisitions with the participation of Russian companies amounted to \$55-\$60 billion which roughly corresponds to the 2005 level (www.mergers.ru); Ernst & Young analysts speak of \$65 billion (the growth is higher by 1/3 vs 2005). In 2007 the M&A market with the involvement of the Russian companies may increase by 25-30% or more if in 2007 there will be large-scale transactions with the shares of energy companies and abroad.

The problem of "alien acquisitions" (only those that do not refer to the corporate law and classic raid – which is a purchase of shares but based on falsification of documents, and therefore subject to the criminal law for corruption) is not significant. According to the Ministry of Internal Affairs, in 2005 the value of disputable assets was about RUR200 billion

or 12% of the total amount of 2005 M&A transactions. However, it is these transactions that recently have been causing significant public (or pseudo public) protest. The RF Government introduced to the State Duma a whole set of amendments in the Arbitration and Procedural Code of Russia, RF Code of Administrative Offences, Tax Code and other laws in January 2007. (the notion of a corporate dispute was introduced; the possibility for minority shareholders to join their claims into one “collective claim”; all the elements of a corporate dispute could be united into a sole process at the arbitration court at the place of registration of a claimant; settlement of security actions, etc). The problem, however, may not be solved in the framework of corporate and procedural amendments given criminal nature of most notorious acquisitions.

As many believe, in 2006-2007 the ‘raider’ problem became more serious in the area of land property. According to IET estimates (see section 5.3), the current legislation does not create proper conditions for taking land into private property but on the opposite has a trend to enhance ambiguity of interpretations and expand arbitrary actions of administrations. As an example let us see look at the most acute problems²² of appropriation of land under privatized enterprises:

- unjustified exclusion by the federal and regional authorities of the considerable number of land plots from the list of lands subject to buy-outs;
- unacceptable costs of land buy-out for the majority of the enterprises; absence of reduced prices for small and mid-size businesses, or payments by installments as well as crediting tools to provide access to land for a bigger number of enterprises;
- marginally high prices of land buy-outs established in some of the regions and overestimated cadastre values of land;
- administrative subjectivity in setting boundaries of land plots as a result of deficiencies in the urban development legislation;
- problems of interaction between the federal and regional authorities in the area of delineation of land ownership and distribution of revenues from land sales and rent.

²² Equally serious problems exist in other areas of land relations. In Moscow, for instance, in spite of the provided by the Housing Code rights of owners to the residential premises, it is so far unrealistic to “form” a land plot under a multi-storey building (with the privatized housing stock, not for a new development) in order to implement further the right of land common ownership. One of the formal invented reason to refuse to do this is the need to preliminary delineate Moscow territorial units. The city development plans of the Moscow administrative areas are not approved by the law *in detail* and for a long-term period which gives rise to “current” updates and amendments depending on the market situation and specific interests. In both cases this may lead to spontaneous development of lands including those that are currently under apartment houses. Well known are the conflicts in the 2000’s connected with enforced removal of residents from the buildings in the central zone of Moscow pretending these buildings are in the state of emergency.

The principle of distribution of authorities as a basis of a modern law-abiding state seems to play a most important role in the “political and legal infrastructure” as it ensures proper environment for a sustainable economic growth. The decisions of those authorities that in practice act as an arbitrator who supervises property sales, implementation of contractual obligations and rules of the market game should be the evidence of the “actual” independence of the courts from the executive power.

The formation of a “double standard” and various rules of the market game for different classes of the participants is a specific feature of the institutional development in 1990’s and 2000’s. Such double standard for private owners at the federal and regional levels creates very serious obstacles on the way of the establishment of the favorable institutional environment and local institutional changes in the area of property rights protection, corporate governance, financial markets, budget limitations, etc.

In other words the existence of this “double standard” results in that the market mechanisms work well in the limited space which has a trend to reduce itself in the context of the concept of the formation in Russia of the “state capitalism model’ (see section 5.2). Though the long-term objectives of creating sustainable and flexible institutional environment (applied to the market mechanisms) remain unchanged, an undisputable priority is the formation of basic pre-requisites for their implementation – legislative, judicial, procedural and regulatory framework to assure the unified market rules. It should be stressed that the only relatively effective limitation in application of various rules in the “double standard” system may be an independent institution of courts that would have to take over the function of unification of the rules for all market players. Therefore the prospect of the development of economic institutions encouraging economic growth in Russia to a great extent depends on the adequate functioning of the existing political institutions.

An ideal illustration of the “double standard” and of what is private property in Russia and how valuable is its relation with the supreme political power like in the ancient oriental countries (unlike in the modern Western world) may be two radically different alternatives of ending a business established by almost equal methods (though not always legitimate) during one and the same period (about 10 years) provided this business is quite solid and profitable. The first alternative is that the company gets destroyed and its assets are nationalized, with no discussion of the market price of the transaction and possible ways of moving the proceeds outside the country (like in “Yukos” case). The second alternative is the transaction of acquisition of “Sibneft” by “Gazprom” where the beneficiary received \$13 billion together with the opportunity to legitimately dispose the acquired assets both in Russia and abroad including new asset acquisitions in Russia in 2006. Between these two extreme options there is a wide range of possible compromises that are traditionally considered in Russia as “proposals which one can hardly decline”. The said transactions can not be called market ones since they had only an illusion of a fair market price, and the government still keeps its arguments from the “Yukos” case.

Finally, one should mention *corruption* as a systematic factor that affected institutional changes during 1990 – 2000's. As mentioned before, the higher level of corruption is in the government authorities, the least opportunities remain to strengthen market institutions and competition mechanisms.

These dependencies creating a vicious circle result from potential changes in the distribution network when the establishment of new political and economic institutions is opposed (directly or indirectly) by those officials who usually generate benefits (illegitimate) from the current norms and provisions. In certain cases effective market relations are substituted for competition at the "political markets". Naturally the players do not manifest their real aims. Therefore certain "regulators" keep appealing to the interests of various groups while pursuing their own interests and aspirations.²³

One citation seems to be relevant here: "In characterizing the Russian economic and political system it is hardly enough to apply the "neutral" term "corruption". This term is senseless. One should describe the system as a mechanism functioning on the principles of corruptive loyalty".²⁴

Presently there are various estimates of the corruption scale in Russia; and all the analysts speak of the corruption growth in the 2000's. According to A. Buksman, Deputy, General Attorney of Russia, the corruption amounts to about \$240 billion per year (the method of assessment is unknown). "Indem" Foundation believes that the intensity of business corruption in 2001 – 2005 dropped by 20% however its volume increased manifold (in 2001-2005 the gross amount of bribes was up to 90%); this is explained by the increasing involvement of the government in the economics and redistribution of rent.

5.1.5. State capitalism versus de-nationalization

The problem of interference of the government in the property relations is as old as the property itself²⁵. John Lock believed that political power represents the right "to create laws...for regulation and maintenance of property"²⁶. According to E. Furuboten and R. Richter, an economic institution must recognize a key fact that the transfer of individual property

²³ See: A. A. Yakovlev. Possible strategies of economic agents regarding corporate governance institutions. / Development of demand for legal regulation of the corporate governance in the private sector. Research Papers, MONF, № 148, 2003, p. 51.

²⁴ K. Rogov. Loyalty mechanisms // Kommersant, 2006, 13 of November.

²⁵ In D. North classification the first economic revolution took place when there was a transition from nomads to a settled way of life and when for the first time a centralized (at the level of first prototypes of the government establishment) protection (guarantees) of the property rights to land was required that would provide to the owners stimuli for higher productivity and efficiency. See: North D. Structure and Change in Economic History. – New York and London: Norton, 1981, p. 81.

²⁶ J. Lock. Works in three volumes. – M: "Thought" 1988, V. 3, p. 343.

rights should be made voluntarily. The basic constitutional rules therefore should be based on the principle of inviolability of the private property rights. The state, however, has the power which may be directed not only at the protection of private property but also at its withdrawal²⁷. Therefore, the basic condition of the functioning of a market-based economy in addition to the constitutional framework is a valid commitment of the government to respect private property²⁸. A successful market requires, in addition to the adequate system of property rights, a *politically safe foundation* that sets up rigid constraints to possible confiscation of wealth by the state²⁹.

In the modern world the neoclassical (neo-liberal) approach to the state as a main source of economic instability becomes more and more exotic both in the English-American and European research tradition. “There are not many grounds to believe that the market can function in a situation with a non-state economy”³⁰. A standard new constitutional set of the state functions well where the state receives, together with the right of enforcement in the respective areas including specifications and property right protection, minimization of the information asymmetry of the market players, provision of the material channels of the commodity and services exchange, judicial (and otherwise, in the role of “a third party”) settlement of contractual and other relations, standardization of measures and weights and provision of public benefits (defense, science, education and healthcare). The government interference is reasonable even in those situations where a need arises to compensate for certain external factors and delineate “worthy” and negative public needs³¹.

By the end of 1990 – early 2000’s the government involvement in the corporate sector of Russia was quite unfocused and existed in the form of numerous scattered unitary entities with bad management or no management at all and blocks of shares of newly established joint-stock companies almost in all sectors of the national economy. Integrated structures formed by the state initiative and with the state participation at the initial stage of privatization functioned mainly in the fuel and energy complex and also in natural monopolies.

The period of 2000–2004 was characterized by certain actions to increase efficiency of management of the scattered assets by integrating them into state holdings in such sectors as nuclear energy, railways, defense industry, support to the air and marine transports and postal communications. Any increase of the government stake in the capital of individual

²⁷ E. Furuboten, R. Richter. Institutions and economic theory. – STP 2005, p. 335–337.

²⁸ North D.C. Economic Performance Through Time // American Economic Review, 1994, 84, pp. 359–368.

²⁹ Weingast B.R. Constitution as Governance Structures: The Political Foundations of Secure Markets // Journal of Institutional and Theoretical Economics, 1993, 149, pp. 286–311.

³⁰ E. B. Atkinson, J. E. Stiglitz. Lectures on economic theory of the state sector. – M., Aspect Press, 1995, p. 18.

³¹ См.: Eggertsson T. Economic Behavior and Institutions. Cambridge, 1990; Transaction Costs, Markets And Hierarchies. Oxford, 1993 и др.

companies outside the integration processes was an exception. Restructuring of natural monopolies began in parallel to this process.

In the same period the attempts to establish (expand) control over main financial flows of the Russian economy and to make business dependent on the state institutions became more pronounced in spite of the decisions to de-regulate, administrative reform and further privatization plans. The key feature of the period 2005–2006 was a shift in priorities in favor of direct government involvement in the economy³². The following trends may be identified in this process:

- increasing activity of the operating state holdings and companies that decided to expand their businesses and make it diversified through mergers and acquisitions (“Gazprom”, “Rosneft”);
- involvement of new players (“Rosoboronoexport”, RAO EES of Russia”);
- the strategy of integrating scattered assets still owned by the state into holdings becomes secondary; however the new structures begin acting, though on a selected basis, at the corporate control market as independent entities;
- expansion goes beyond the fuel and energy sector, though it is still premature to talk about multi-sector conglomerates;
- the interests shift from the assets of “problematic” or “unfair” companies (from the viewpoint of the state) towards the assets of “neutral” or “loyal” owners;
- a more extensive practices of such methods as increasing shares in the charter capitals of the companies up to the amount allowing to make a decisive impact on the companies’ activity;
- active participation of largest state banks (crediting, guarantees, direct purchase of shares) in the processes of expansion of the government involvement in the companies’ capital;
- a need to get a political consensus regarding possible major deals inside the country and with involvement of foreign companies as a necessary component of such business decision.

Back in 2005, according to some forecasts, it was envisaged that in 2006 – 2007 the following companies might become the subject of nationalization by the state companies: “Norilsky Nickel” (51 % of shares, \$8 billion), “Promstroybank” (\$1.5 billion), the Urals Mining and Enrichment Company - UGMK (\$5 billion), “Suirgutneftegas” (62% of shares, \$20 billion), “Vossibneftegas” (\$130 million), “Tomskneft”, “Samaraneftegas” “Achinsk NPZ”, Angarsk Oil Petroleum Company

³² For details see: A. Radygin. Russia in 2000–2004: on the path to the state capitalism? // Issues of Economy, 2004, № 4, p. 42–65; A. Radygin, G. Malginov. Corporate control market and the state // Issues of Economy, 2006, № 3, p. 62–85.

(jointly \$8.5 billion), Syzran NPZ, Kuybishev NPZ, NovoKuybishev NPZ (\$0.5 billion), TNK-BP (50% of shares owned by the Russian shareholders: \$9–10 billion), “Syloviye Mashiny” (\$450 million), “Uralkaliy” (\$2 billion), “Silvint” (\$1 billion)³³.

The bigger part of those transactions has not been executed, but this does not mean that in 2006 the state expansion weakened (see also sections 5.2 and 5.4). According to Alfa-Bank analysts, during one year the share of the Russian companies' stock owned by the state grew from 29.6% to 35.1%³⁴.

“Gazprom” activity in 2006 (against the growth of the company's external debt) is quite expressive:

- Shtockman field development was monopolized;
- Shell, Mitsubishi and Mitsui consortium bought a control block in “Sakhalin-2” project under the threat to stop the project because of non-compliance of the environmental law (in 2006 it was announced that the right of development of all new fields of the energy carriers at the shelf would be granted to state companies only);
- The companies engaged in the development of a largest in Russia Yuzhno-Taibei gas field were taken over;
- Large blocks of shares of energy companies (RAO EES of Russia, Mosenergo, OGC-1, OGC-2, OGC-4, OGC-6 and others) were acquired;
- Early 2007 a control block of shares of the Siberian Coal and Energy Company (SUEK) producing 1/3 of the energy coal in Russia was acquired;
- “Gazprom” and “Rosneft” was offered to buy out the shares of the Russian shareholders in TNK-BP while “Gazprom” expressed interest in getting rights to a 75% block of shares in Kovykta gas condensate field (simultaneously the tax, environmental and other regulatory authorities should issue claims to TNK-BP). The analysts note an obvious slow down of the production rates in the oil and gas industry in 2005 – 2006 as compared to 2000–2004 as a result of the oil and gas assets placed under control of the state corporation³⁵, and due to gas shortage for internal consumption in the national gas balance starting 2007.

One of the 2006 deals at the M&A market with the involvement of the state companies was the purchase by FGUP “Rosoboronoexport” last fall of 66% of shares of a leading titanium and magnesium producer (30% of the world production) JSC “VSMPO-Avisma”³⁶ (the deal value is \$700 million). In the shadow of this event was the acquisition by “Oboronprom”, a “Rosoboronoexport” subsidiary, of the control block in “LEPSE” (Electric Engineering Company in Kirov), one

³³ Mergers and Acquisitions, 2005. № 12 (34). p. 13–15.

³⁴ B. Grozovsky. Chief owner of the country. // Vedomosti, 13 of February 2007

³⁵ V. Milov. The echo of ownership re-division. // Forbes, February, 2007, p 30.

³⁶ In 1998 the control block of “Avisma” shares (Berezniki of Perm region) was acquired by Verchne-Saklinsk Metallurgical Production Consortium (VSMPO) in Sverdlovsk region after which two companies actually integrated.

of the major Russian companies producing electric equipment for the defense and car building industries. Further plans of “Rosoboronexport” expansion may be related to metallurgy and not only in Russia. In summer 2006 the “Rosoboronexport” management raised the issue of the establishment of a state holding that would be a monopoly in the production of specialized steels. Early 2007 CJSC “Russpetstal”, a “granddaughter” of “Rosoboronexport” purchased 100% in JSC “Metallurgical Plant “Krasny Ochyabr” (Red October) «in Volgograd. Among possible future acquisitions there may be Chelyabinsk Metallurgical Plant (JSC “Mechel”), Zaporozhie titanium and magnesium plant, Volgorsk and Irshansk mining and enrichment complexes (GOKs) in Ukraine, Metallurgical Plants “Electrostal” (in the city of Electrostal of Moscow region), “Serp i Molot” (“Hammer and Sickle”) (Moscow) that are producers of specialized steels for the defense industry.

Since “Rosoboronexport” increases control over the assets and diversifies the sector structure as a result of various profiles of the respective companies (helicopter manufacturing, metallurgy, car and defense industries), the company may be encouraged to restructure itself by setting up a managing company that would be completely owned by the state. The companies under its control including “Rosoboronoexport” as an entity that received the monopoly right to exercise military and technical cooperation with foreign countries may become subsidiaries. In future some of the subsidiaries may issue shares additionally.

The functions of a major state financial institutions – Vneshtorgbank (99.9% shares owned by the Russian federation) – are not limited to the processes of expansion of the state into the banking sector where the total amount of the M&A transactions did not exceed \$3.5 billion in 2006 (e.g. the take-over of “Promstroybank” in St-Petersburg). In 2006 this bank participated in the buy-out of ALROSA shares and in the mergers made by “Rosoboronexport” structures.

During 2005-2006 privatization was noted for quite opposite processes. In the 2006 spring message to the Federal Assembly Russia’s President confirmed again the need of privatization (“the state should keep in its ownership only the property which is absolutely required to perform its functions”).

In spite of a formal number of blocks of shares put for sale and the decisions to reorganize unitary enterprises, the situation is close to critical. Every year not less than 50% of transactions is suspended due to the absence of demand, and the quality of management of the state owned property is hardly different from that of the 1990’s. It looks like the situation in this sector is closely connected with modification of views regarding the role of the state sector in the Russian economy³⁷.

³⁷ In April 2006 Yu. Petrov, Head of RFFI, announced that as a result of the privatization some 30-40 major state holdings should appear in the strategic sectors of the Russian economy.

From the one hand, one of the tasks of 2006 – 2008 is to create at least the “illusion” of completing the privatization as a component of the institutional reforms – to sell federally owned blocks of shares and to restructure the sector of state unitary entities. –The effect of the process both for the government and the concerned entities is secondary as compared to possible political gains. On the other hand, the increasing state expansion which manifests itself either in the overall economic strategy, or a trivial re-division of property in favor of groups close to power, or opposition of the concerned ministries, objectively removes from the privatization process major and most profitable state owned assets.

5.1.6. Stability versus stagnation

The problem of stability of the ownership structures and the appropriation rules the reverse side of which is the protection of property rights is most critical in the present Russia. David Hume, a famous Scottish philosopher and economist, stated that no one can doubt that the agreement of the distribution of property and the *stable possession of this property is the most needed condition*, and after such agreement is concluded, not much is to be done. “Stability of possession” like “the transfer of property by consent” and “fulfillment of commitments” are three basic natural laws (in the terms of the natural right doctrine)³⁸. The significance of stability of these relations for the economy in transition is reassured in certain cases by similarity of the institutional issues and the formation of a developed system of private property relationships.

The most pessimistic forecast of the development of the property-related relationships in Russia looks like the following³⁹. Indeed there are no constructive decisions in Russia to go away from the power-property re-division reality⁴⁰. The latter has all the grounds to reproduce itself. All individual fluctuations of corporate or local business models similar to private property will, times and again, fall under this power-property continuum because of its immanent logics which sets up the behavior model of the so called private entrepreneurship. The practical logics behind this is like this: the property represented by particular persons will start linking itself with the power to realize its private interests and eventually merging with the power using the latter as a guarantee from possible “flaks”, while the power, if the private property is “legitimate” in the country, will continue attempts to possess private property being caught in corruption and getting prestigious

³⁸ Hume D. A Treatise of Human Nature. Ed. by Mossner E.C. London, 1969, p. 578.

³⁹ See: N. Popadyuk. Is the private property in Russia really private // Issues of economy, 2006, № 1, p. 152–153.

⁴⁰ The notion of the “power-property” introduced by L. Vasiliev means primarily that this economic category applies to the entire society; this is “a syncretical integrity of the power and property where they are inseparable making a sole phenomenon which is “the power-property”: the power (possession) generates the notion and the concept of the property while the property emerges as a function of the possession and power”. (L. Vasiliev. History of the East. – M., High School, 2001, Vol. 1, p. 42.). The term “re-distributional property” is a variation of the “power-property” in the specific historical context of the Russian state.

top management positions in the so called big private business. The Russian power-property may be called redistributional because new teams of the government officials who periodically come to power with the help of “democratic procedures” resolve the previous problems in a more “fair way (transactions of privatization, even when the statute of limitations is reduced to 3 years, etc.). Such is the framework setting the rules.

In the modern new institutional economic theory the stability of the institutional environment is described by the following main criteria: 1) general stability of the established property structures and the appropriation rules during the entire period of *long-term investments as a key feature*; 2) political and legal stability; 3) valid capacity of the judicial system; 4) the culture of contracts and “commitments” inspiring confidence”. None of the said criteria permits speaking about maturity of the institutions established in Russia during the last 15 years. On the contrary, all the above gives grounds for the following conclusions:

1) The asymmetry of economic and political factors of the development of the Russian economy in the 2000’s is obscured so far by the general indicators of the economic recovery, unstable feedstock market, and the indicators of the state finance (budget surplus, Stabilization Fund, gold and currency reserves), and of exceptional profitability of the Russian stock market. In the 2000’s a negative impact of the “state” factor increases while the quality of “the market factors” gradually decreases. The conclusion of the actions of the “state” and the “market” going into opposite directions in Russia during the 2000’s is confirmed by the data of sociological surveys and country ratings.

2) In a *long-term perspective* this problem of asymmetry of economic and political factors of the Russian economic development becomes critical primarily in the context of the roles of the political institutions required for the formation of effective economic institutions, if to assume moreover that it is the market that is the source of the current growth of the economy, budget revenues and funds for social programs support.

3) During the 2000’s a *contraction of the potential social base* for indirect (via political representation) formation of effective economic institutions is observed. Those institutional mechanisms that in the 1990’s opposed the expansion of demand for effective economic institutions are functioning now but in a modified form. If before the 2000’s (the terms are conventional) we talked about “oligarchy capitalism”, presently the most common term used is *the “state capitalism” in its Russian modification*.

4) In the mid of the 2000’s the risks brought into entrepreneurship (in its legalized forms) by the institutions and regulative function of the government remained significant, however, the impact of a new factor became more pronounced: the government was obviously restoring its *direct interference into the economy*. There was also a strong probability of the relationship between the expansion of the direct and indirect interference of the government and *the growing corruption* in the 2000’s.

5) The mutual influence of such institutions as the property rights protection and the financial system in their present form is rather *negative*. The absence of institutional changes or aggravation of the investment climate by certain directions may have negative consequences for the investment dynamics in the near future or curb the investment growth into the fixed assets of the Russian economy.

6) During entire period of 2000–2008 *the basic objectives of mid-term social and economic programs change but insignificantly*. The general conclusion on the stagnation of the institutional changes based on such formal base only would be too ambitious, however the above comparison gives grounds to assume that the legislative and regulatory support to the processes of the development of economic institutions in the long-term is inadequate. One can talk of *a chronic gap between the legislation and the economic reality*.

7) A specific feature of the 2000's institutional development is the *formation of the "double standard" and different rules of the market game for various classes of the players*. The establishment of the double standard at the federal and regional levels creates insurmountable obstacles on the way of the formation of the favorable institutional environment in general and also put brakes to local institutional transformations in the area of the property rights protection, corporate governance, financial markets, budget restrictions, etc.

8) By the end of the 1990's - early 2000's a situation emerged in the country where the economic laws were relatively well developed but the law enforcement remained very critical. In the mid 2000's the focus apparently changed: though the diseases of the Russian system of law enforcement were still acute a certain shift took place in the framework of the economy legislation (and its interpretations) which, on the one hand, increased uncertainty of implications of various economic actions for the business in terms of the government reactions, while from the other hand, tightened the relations between the government and the private business. The problems of the Russian law enforcement system supplemented with the trends of expanding uncertainties and restoration of rigid legislative norms *apparently increase the risk zone in the property rights area*.