Institutions and economic growth: some realities of contemporary Russia

Any well-substantiated account of the progress of or impediments to economic growth in Russia and of the presence or absence of signs of an end of the transition period must be based on an unbiased appraisal of the institutions involved. Institutional change in a transition economy is such that the characteristics of any one institution (or institutional arrangement) can only be adequately understood within the overall context of institutional change. No study of any one institution – even if it is a product of fundamental research – can get round this problem. In other words, when using the term *institution* an economist should, whenever possible, describe specific *institutional arrangements*. The term *institutional change* is usually applied to the study of a particular institution, but never, as a rule, to describe the *institutional structure* as a whole. We shall try to overcome this analytical dilemma as we describe some of the most painful institutional changes that have taken place in Russia – those that are of key importance both from the point of view of current issues and of the long-term goals of ensuring economic growth.

**Stability and adaptability of the institutional environment**

Economic institutions conducive to economic growth arise, firstly, when political institutions grant some power to groups that have an interest in establishing a broad and well-developed system for the enforcement of ownership rights; secondly, when they accept some effective restrictions on the actions of the ‘powers that be’; and thirdly, when there are no opportunities for payoffs deriving from positions of power. In the late 1990s – early 2000s there was much concern that institutional reform in Russia was receding into oblivion. Of course, the existing performance, reliability and efficiency levels of the institutions that have so far been created have become targets for sharp criticism, and rightly so. However, critics have neglected the fact that, by contrast with some Central East European countries, Russia had never possessed...
any such institutions – whether historically or in more recent times\(^5\). One must also bear in mind that institutions conducive to economic growth have to be truly endogenous: they will always be – at least in part – determined by society or by elements within it.

The 1990s and 2000s was for Russia the period a new institutional framework for the national economy began to be formed. The typical criteria for assessing progress were privatization, legislation (the volume and quality of new legislation and legal institutions), the condition of the banking sector (degree of independence, level of business skills, performance in placing credit resources and the quality of supervision over the system of payments), and the role of the government (its commitment to market and management efficiency in the public sector)\(^6\). In the early 2000s, this standard set of criteria was augmented by various estimates describing the quality of corporate governance and economic and legal factors in the development of financial markets. There was a significant growth of interest in issues relating to the performance of the judicial system and in law enforcement in general.

Once the period of initial and more or less formal reception of traditional market institutions was over, – both in terms of scientific research and normative practices – the goal of ensuring the stability of institutional environment assumed priority. The basic properties that determine the stability of evolving economic relations, including ownership relations, have been examined in studies by O. Williamson. Following L. Davis and D. North\(^7\), Williamson has suggested that a distinction should be made between institutional arrangements and the institutional environment\(^8\). Characteristics of an institutional environment can include such basic features as general stability of the existing ownership structures and appropriation rules over the whole period of long-term investment; political and legal stability; the performance capability of the judicial system and the culture of contractual relations and credible commitments. According to the famous Scottish philosopher and economist David Hume, “the stability of possessions”, “the transference of property by consent” and “the obligation of promises” are “the three fundamental laws of nature” (in the terminology of the doctrine of natural law)\(^9\).

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For an economy in transition, a favorable institutional environment is of fundamental importance. The complexity of this problem derives from the fact that some of the remaining ‘socialist’ institutions for a certain period of time retained their significance (the “legacy of socialism” problem). In Russia during the 1990s, there were additional factors such as political instability and weak government. During the early 2000s the performance of the judicial system and the enforcement of contractual obligations and ownership rights assumed pre-eminence. Political stability, in the judgment of many, remained a priority issue as late as 2004 – 2005\(^\text{10}\). The non-economic motives that were capable of influencing an act of law enforcement – including forms of ‘selective’ law enforcement (‘by special order’) – by no means receded in importance when making a choice of a suitable object. To some extent, notwithstanding a stable institutional environment, one can even speak of the existence of an institutional crisis.

Against this background, it is no easy matter to identify the political and legal conditions that will influence the formation of a positive institutional environment. As B. Weingast has pointed out, there is a ‘fundamental political dilemma for an economic system’ when a government, while being powerful enough to protect ownership rights, is also strong enough to confiscate its citizens’ property. With certain reservations, this is the predicament of present-day Russia\(^\text{11}\).

The stability (maturity) criteria that have been devised for assessing an institutional environment as a whole can also be very helpful in dividing transformation processes into separate phases. Judged by these criteria, no maturity level worth speaking of has been achieved by any of the institutions created in Russia, although the first phase of institutional development has already been completed. There still exist many ‘gaps’ to be filled in respect of formal institutions (most importantly, in terms of law and its enforcement by state agencies), but there is no more need for further radical innovation. However, a key long-term goal today is to ensure stability of the existing institutional environment. Another task of fundamental importance is to achieve adequate adaptability of the new institutions – that is, to make them capable of ‘fine tuning’ in accordance with the changing economic realities. In the absence of a reliable institutional foundation economic growth will be only short-term and it will be vulnerable to changing circumstances.

\(^{10}\) Thus, half of the respondents participating in a poll of entrepreneurs conducted in December 2004 pointed to the worsening political situation as one of the major factors determining the overall lack of stability in the national economy. The Business Activity Index project launched by the Russian Managers Association (www.amr.ru).

Ownership relations in transition

The malfunctioning of ownership relations in post-Communist states following large-scale privatization was by no means due to the excessive liberalism of the reformers. This problem is typical of any economy in transition. Amongst the causes we can identify the profound gap existing between formal ownership rights and opportunities for exercising proper control over them; the absence of serious sanctions for infringement of ownership rights; inefficient bankruptcy procedures; and the existence of legal and semi-legal forms of property redistribution benefiting political decision-makers. The attitude towards the institution of property that was formed during the Soviet era was another reason for the ineffective functioning of ownership relations and this was more powerful than theory and schemes that derived from theory. The following observations are very apt: 'In Russia all property has been obtained “by wheedling”, or “was acquired as a gift”, or “has been stolen”. There is very little labor underlying property and that is why it is not robust, and is not respected.'

None of the traditional theories of property incorporates a methodology for promoting economic growth. The radicalism and socio-political emphasis of the Marxist conception of property ownership fails to provide instruments for microeconomic regulation. The timeserving market orientation of functionalism (the various schemes of ownership by employees) – represents its principal limitation, especially in terms of a transition economy. Ethical concepts of ownership, involving constraints deriving from religious or other spiritual principles, are of a considerable value when it comes to providing motivation in favour of systemic transformation; but the practical ‘prescriptions’ developed on their basis are usually remote from the realities of economic life.

Neo-institutionalism (the theory of ownership rights) in its Pigouvian or Coasian versions implies that economic growth should be regulated through the introduction of certain norms and rules for the behavior of economic subjects, by the specification and differentiation of ownership rights; by reducing transaction costs, minimizing the quantity of resources spent on stabilization of the economic system and by ensuring an efficient distribution of resources in general. However, these guidelines are of limited value when it comes to promoting economic growth: no mechanisms of macroeconomic regulation are provided, the creation of some primary institutions and procedures is required, and there is a distinct bias towards legal regulation.

Some reasons for the inefficient functioning of the system of property relations in a transition economy can be inferred from the theory of ownership rights developed by S.

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Grossman, O Hart and J. Moore\textsuperscript{13} or from new institutional theory (D. North, O. Williamson, and others). In accordance with traditional neoclassical theory (and with new institutional theory), changes in the structure of ownership relations are, as a rule, evolutionary, which is to say they take place gradually and spontaneously. Demsetz, in \textit{Towards a Theory of Property Rights} argues that the evolution of ownership rights can best be understood by investigating their correlation with a number of beneficial or harmful consequences\textsuperscript{14}. According to Demsetz any abrupt change in relative prices, primarily in the prices of natural resources, inevitably gives rise to ‘external effects’ (or externalities). In the course of subsequent operations involving the purchase and sale of corporate and personal property the structure of ownership can be altered in such a way that the problems previously perceived as externalities become ‘internalized’. The switchover to a new ownership structure results in a more efficient allocation of resources.

In such circumstances it is desirable that the institutional environment should provide sufficiently clear ‘rules for changing the rules’ – at least as regards changes that are immediately envisaged. The institutional environment should also comprise some economic mechanisms (in an ordinary situation – primarily market mechanisms) that are capable of implementing change.

The theoretical models developed by Grossman, Hart and Moore are compatible with this approach. Ultimate rights of control cannot be determined by a contract and thereby be transformed into ordinary contractual rights. Sometimes (for example, in cases of specific investments and accumulation of human capital) this can result in a situation when in a given ownership structure an optimal balance simply cannot be achieved as the outcome of a free game of competitive forces on the finished product market.

The limits that provide a framework for the reliable functioning of market forces described by the Coase theorem are well-known\textsuperscript{15}. The inferences that can be drawn from that theorem are still very attractive for many economists. However, the experience of some of the experts who advised on privatization in Eastern Europe suggests that the question of who precisely will become the owner of property being privatized is of little practical importance. It is the chain of


market transactions that results in an increased value of the privatized assets that will ultimately ensure their most efficient utilization.

Such views are to a certain extent shared by proponents of the new institutional theory. Knight and North have argued that in the short term the managers of enterprises previously owned by the State can be eager to choose patterns for distributing their ownership rights that provide them with the highest benefits, even if Pareto’s criterion later shows that their schemes have turned out to be ineffective. However, in the long run, if they persist in preserving what is (by Pareto) an ineffective distribution of ownership rights, the pressure of competition will result in their replacement by other participants who apply a more effective pattern of distribution. In Russia the view that market forces as described by the Coase theorem will ultimately achieve the beneficial effect of privatization is shared by many economists.

As Demsetz has shown, in the study mentioned above, strictly defined private ownership rights constitute one of the necessary preconditions for achieving the efficient functioning of market relations. However, according to Demsetz, the results produced by the action of market forces during an initial period of private property formation can differ considerably from those described by the Coase theorem. For example, when the system of relations typical of ‘institutional regularity’ cannot guarantee the proper functioning of creditable commitments, let alone a more or less reliable enforcement of contractual rights and ownership rights, the Coase theorem will be invalid. It should be noted that failure properly to execute obligations can occur in respect of the kind of side payments that play such an important role in Coase’s models of the effective redistribution of ownership rights. In a majority of countries with transition economies, Russia included, the absence of adequate economic mechanisms for the reliable enforcement of contractual and ownership rights that would at the same time engender confidence in the obligations entered into following mass-scale privatization raised some serious questions about ‘Coasian processes’ – that is to say the reallocation of resources through the operation of market mechanisms and the formation of a new, more effective, ownership structure. Nor, when analyzing an economy in transition, should we overlook the possible influence of those market processes (“Coasian markets”) which, if we are to follows Coase’s logic, can result in an internalization of market externalities.

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The Protection of ownership rights

During the early 2000s, the problem that has been plaguing contemporary Russia – the need for an adequate protection of ownership rights – became particularly acute. An example was the Yuganskneftegaz share deal of December 2004 – January 2005. What is striking, in our opinion, is not that the deal lacked proper legal basis - the sale was, most probably, in formal terms, perfectly legal but – however paradoxical this may sound – it is precisely in such circumstances that there are the highest risks for businesses in Russia as far as the protection of ownership rights is concerned.

Also relevant in this connection are certain amendments made to economic legislation in 2005: the restrictions imposed on the activity of the RF Federal Tax Service (FTS) with regard to audit (this was the only innovation of potential benefit to the business community); the belated initiative to shorten the limitation period for challenging privatization deals; the introduction of new measures designed to obstruct business activity and an increase the role of the State in the private sector (the introduction of control over transfer pricing without provision of any clear guidelines; the new norms introduced into the RF Criminal Code regarding confiscation procedures; conditions of access to tenders for the right to develop new deposits of mineral resources). The significance of all of this was clearly understood by the more liberal-minded representatives of the authorities 18.

These were signs of a forthcoming qualitative shift in economic legislation. During the late 1990s – early 2000s economic legislation had been relatively well developed and it was law enforcement that had been “problematical”. Subsequently, interactions between the State and private businesses over economic legislation (and the interpretation of legislation) became significantly more conflictual, and uncertainty for businesses as to the outcome of actions undertaken by the State increased. From this point on, the only way of providing reassuring prospects for the development of business activity and of demonstrating a positive attitude on the part of state authority would be for the state to revise RF legislation in order to rid it of all ambiguities in the sphere of rights of private ownership rights and abrogate any re-establishment of the punitive norms that had been abolished in the immediate post-Communist period and to forego any recourse to coercive, as distinct from civilized measures of law enforcement.

18 Speaking in February 2005 at the Council of the Federation, RF Minister of Economic Development and Trade German Gref admitted that no relaxation of the tax regime (least of all, a tax amnesty) was to be expected and that privatization deals that had been completed would be reviewed.
The possibility that the privatization process might be reviewed is a matter of continuing concern for big businesses. Most senior officials have insisted - at least once – that this is not in prospect. However, none of the constructive proposals that were made during the early 2000s (publicly to declare a general moratorium on revision of the results of privatization; to shorten the period of limitation for challenging privatization deals; to treat privatization deals differently according to whether or not there was a criminal dimension; to adopt detailed rules for nationalization) has ever been implemented.

Let us take the example of the limitation period for challenging privatization deals. On 24 March 2005, during a meeting with representatives of the Russian business community, the President of the Russian Federation expressed agreement with the idea of shortening the period of limitation. Yet the draft law that has been prepared by the Executive Office of the President, if it is adopted, can only worsen the existing situation. On the one hand, it is proposed that the limitation period is to be shortened from 10 to 3 years for all deals that are null and void, privatization deals included. This would represent significant progress, albeit from a purely formal point of view, in so far as the State, in order to secure the return of privatized property, has been actively applying extra-legal methods to companies by initiating bankruptcy proceedings and re-nationalizing. On the other hand, the limitation period for seeking to establish that a deal is “subject to review” is to be extended from 1 to 3 years dating from the time when the plaintiff learned or must have learned of the circumstances providing the grounds for alleging that the deal is null and void. Technically, it is by no means difficult to transfer almost any privatization deal from the category “subject to review” into the ‘category “null and void”. This would make possible a revision of privatization deals over an almost indefinite period of time (to be fair, it should be noted that such a possibility existed previously, albeit with a limitation period of only one year).

Publication of the report ‘Analysis of the Processes of Privatization of State Property in the Russian Federation during the period 1993 – 2003’ prepared in 2004 by the RF Audit Chamber triggered a large-scale discussion of these issues. Most of the negative features of Russian privatization are attributed by the authors of this report to specific gaps in the then current legislation. In our opinion, the authors did not pay sufficient attention to the political context and to the role of systemic corruption and the notorious ‘administrative resource’ during the

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implementation of privatization\textsuperscript{20}. Even so, the general lessons that the RF Audit Chamber drew for the future are indisputable – analysis of mistakes committed in the past must serve to prevent future mistakes when it comes to privatizing mineral natural resources, land, power engineering projects, or railways\textsuperscript{21}.

Experience of the early 2000s indicates that there is indeed a certain amount of ‘applied demand’ for a negative appraisal of the results of privatization. We do not believe that the list of enterprises attached to the RF Audit Chamber’s report provides sufficient grounds for selecting candidates for speedy de-privatization, but as far as big businesses are concerned it is clear that some selective ‘targeting’ can be expected, in which three simple criteria will be applied: the degree of ‘statism’ / ‘cosmopolitism’ of the present owners; the ‘political loyalty’ of these owners; and the degree of interest in their property expressed by prospective ‘new oligarchs’.

All things considered, it is becoming increasingly obvious that there should be a public political moratorium on revising the results of privatization. This moratorium should extend to all privatization deals with the exception of those that infringed the legislation of the time, including deals where there is prima facie evidence of corruption and crime. The prima facie grounds should be very clearly defined in a special normative-legal act. To the extent that law enforcement complied with these legal guidelines, such legislation would place important constraints upon any pseudo-legal large-scale redistribution of property.

**Law enforcement, contractual culture and creditable commitments**

Despite much progress in recent years in the field of judicial reform (at least at the level of legislation), the critical situation that exists in the sphere of law enforcement by state agencies provides no grounds for assuming that an adequate institutional environment can be formed in even in the long-term\textsuperscript{22}. Indisputable manifestations of this crisis in recent years include numerous poorly substantiated court decisions in corporate disputes, the perpetual endeavours of state departments to extend their powers of control and the delivery by state law enforcement agencies of a kind of private law enforcement on commercial terms.

\textsuperscript{20} But the most vivid proof is provided by the following data published by the Audit Chamber: 89 % of all violations (uncovered by the Chamber itself) committed during privatization resulted from the acts of state agencies and only 11 % of the violations were committed by private businesses.

\textsuperscript{21} Interview with Chairman of the RF Audit Chamber, S. Stepashin. – Rossiiskaia gazeta [The Russian Newspaper], 2004, 20 December.

The present-day judicial system is commonly described as ‘inefficient and corrupt’ (in its systemic aspects), ‘given to providing judicial services on a market basis’ and ‘disastrous’. Needless to say, these opinions tend not to be shared by representatives of the judicial authorities but similar judgments are from time to time made by senior officials of various other branches of authority. Systemic corruption was referred to by the Chairman of the RF Constitutional Court, V. Zor’kin in 2004; the situation in the judicial system was described as disastrous by the RF Presidential Representative in the Southern Okrug, D. Kozak, in 2005. Kozak had previously been responsible for the implementation of judicial reform.

What we have here is a kind of constantly self-reproducing contradiction: on the one hand, the effective prevention of violations of the law requires an efficient system of law enforcement. On the other hand, effective enforcement is objectively undermined by the mass character of these violations. We have to give thought, therefore, not only to the need for a competent judicial reform but also to the actual economic and legal preconditions for creating an adequate institutional environment. This will require a ‘fine tuning’ of existing institutions.

In the Russian economy in transition (as in many developing economies) the traditionally established system of bribes and kickbacks that often significantly influences the decisions of law and order agencies has to be taken into account. Paradoxically, in a transition economy we may often observe circumstances where bribery in the judicial sphere (the role of payoffs) in some cases actually ensures the proper execution of ownership rights. But where legislation and judicial procedures are imperfect, such payoffs can just as easily lead to violation of these rights. In this way, corruption acquires a systemic character, an indirect sign of which (over and above explicit indications) can be the emergence of a sort of ‘Table of the Ranks’ based on the hierarchy of incomes in the civil service and the private sector. In this way, the rotation of officials comes to be based on the amount of ‘rent’ that can be derived from a particular post.

One of the main obstacles to the development of market relations in Russia is the absence of any implicit (‘self-executable’) contracts and informal behavioral norms that reflect the participants’ trust in each other. As early as the end of the 19th century, Alfred Marshall wrote: “Thus, for instance, the normal arrangement of many transactions in retail and wholesale trade, and on Stock and Cotton Exchanges, rests on the assumption that verbal contracts, made without witnesses, will be honourably discharged; and in countries in which this assumption cannot legitimately be made, some parts of the Western doctrine of normal value are inapplicable”23. It is evident that absence of such trust inevitably results in legal formalism and excessive regulation.

This leads us on to the very important problem of the ‘formalism’ of a judicial system. During the early 2000s Djankov, La Porta, Lopes de Silanes and Shleifer, in collaboration with the international association *Lex Mundi*, conducted a comparative study of the legal systems of more than a hundred countries\(^\text{24}\). They paid special attention to the degree of formalization of judicial procedures and the development of ‘legal formalism’. They found that in the most developed countries a number of simplified procedures were applied, because they were sufficient for ensuring a more speedy and satisfactory resolution of disputes brought before courts of justice. By applying a system of statistical parameters (such as the required degree of professionalism of the main actors in the juridical process, the requirement that complaints should be submitted in written form, the requirement of calling witnesses, and others), the authors devised a zero-to-seven index that provided a quantitative measure of the degree of ‘legal formalism’ in a system. Applied to cases for dealing with the collection of bounced cheques, the formalism index for cheque collection in the United Kingdom was 2.58, in the USA – 2.62, whereas for the post-socialist countries the median value was 3.99 (in Russia – 3.39, in Ukraine – 3.66).

Excessive formalization of legal procedures has a negative effect on the enforcement of contractual rights. In the regressions describing the factors influencing the efficiency of such enforcement the influence of the formalism index was invariably negative and statistically significant at a level of 1%. The index describing the quality of enforcement of contractual obligations in the post-socialist countries was the lowest among all of the groups studied (median = 5.0), whereas in the countries with the ‘Scandinavian type legal systems it amounted to 8.25, and in countries with “Anglo-Saxon” legislation - to 7.09\(^\text{25}\). The index of trust in the judicial system in post-Communist countries was found to be lower than in all the other groups.

The economic theory of ownership rights identifies only certain fundamental (basic) relations of acquisition. However, the role of every particular economic institution largely depends on the importance in a given society of *traditions and informal norms of behaviour*. John Stuart Mill, writing of his own era, noted that product distribution – and the system of economic relations that reveals itself in specific forms and methods of distribution – can be viewed as the outcome of the interaction of two groups of factors – competition and tradition (‘custom’). Economists usually take into account only the first group\(^\text{26}\).


\(^{25}\) Ibid, p. 58. Researchers come to the same conclusions by comparing the degrees of legal protection of contractual rights of creditors in different countries.

The currently accepted approach to the analysis of ownership rights has been developed specifically for the study of economies that are endowed not only with a well-functioning structure of contractual agreements capable of formalizing the results of market deals, but also with a ‘contractual culture’ that relies on a system of norms that has evolved gradually over a long period of time. The very notion of such a norm has been aptly defined by one of the most eminent economic law experts, R. Pozner. In his opinion, it is a “rule that is neither promulgated by an official source, such as a court or a legislature, nor enforced by the threat of legal sanctions, yet is regularly complied with”\textsuperscript{27}.

Most current theoretic models and empirical studies have concluded that the enforcement of economic rights can often be ensured when an interest in such enforcement is shared by the participants in the economic process. Participants appeal directly to judicial authorities only in exceptional cases, in view, mainly, of the high cost of court proceedings. The most effective ‘regulator’ of relations between companies is usually held to be the spontaneous processes of self-organization that ensure a gradual perfection of the contractual relations obtaining between participants in the economic process.

Efficient functioning of the mechanisms for enforcing contractual and ownership rights implies that participants in the economic process are convinced that these rights are secure and stable. North describes this state of affairs as one of “credible commitments”\textsuperscript{28}. This notion has not been formally developed; rather it is a kind of metaphor and so one can hardly hope to find any strict definition of these sorts of obligations. Commenting on North’s concept, one well-known advocate of the new institutional theory, G. Libecap, notes that in a narrow sense of the term “credible commitments” implies enforcement of contractual rights in commercial dealings. In a broad sense, however, they should be understood as constraints upon arbitrary actions imposed by the State with a view to ensuring the reliability of ownership rights to the point that is necessary if there are to be long-term investments\textsuperscript{29}. The existence of creditable commitments, according to North, can be inferred from a sufficiently low level of transaction costs on the capital market as well as on other markets.

New institutional theory rests on the assumption that, throughout history, economic relations have only rarely given rise to “creditable commitments”. Even now such commitments are by no means widespread. *These types of commitments can become established only over a lengthy period of time.*

Especially significant from this point of view is the following: contrary to the opinion of many economists, including some of the Western experts who helped to developing the economic reforms implemented in Central and South-East Europe, the behavioural standards capable of ensuring the adequate functioning of creditable commitments do not (and indeed cannot) automatically emerge in the aftermath of a general liberalization of economic life.

It is only recently that the importance of the need for efficient non-formal institutions in the Russian transition economy has become apparent. Here we shall mention only those *institutional practices that exist at the borderline between formal and non-formal institutions.* The role of these practices (legal, or unrelated to criminal activity) – non-state forms that serve the interest of a relatively broad community of economic agents – becomes particularly important when the institutional environment is unstable (when is consists of weak or imperfectly functioning state forms).

First of all, there is the institution of self-regulation. The formation of a system of self-regulated organizations (SRO) that would be a fundamental component of a comprehensive enforcement system in Russia, has been deliberately restricted by the state authorities. This can be seen in the continuing prevarication over the adoption of the Law ‘On Self-Regulated Organizations’, in the negative attitude of the judicial system towards any form of alternative dispute resolution and in the attitude of government agencies towards those SROs that aspire to act independently in the interests of their members. Yet, the formation of, say, an effective two-tier enforcement system (involving both arbitration courts of self-regulated organization and the state judicial system) would mean that at least part of the burden borne by the judicial system could be shared. However, even liberal-minded researchers differ in their attitude towards self-regulation: the view that any self-regulated organization should function only as an extension of a ‘corresponding’ state agency is fairly widespread.

Between 2003 and 2005 the ability of the *Russian business community to defend its interests in its relations with the State* became clear. On the one hand, big businesses almost uniformly displayed a tolerant attitude (no doubt, deliberately) to various innovations of the State – for example, in ‘acts of goodwill’ in respect of their tax burden. For example in 2003 some oil companies refused to apply any of the available schemes for minimizing their taxes and in 2004 LUKoil ‘voluntarily’ lowered petrol prices by 5%. The issue of ‘corporate social responsibility’
has become topical, though what this means for an organization that in any case conscientiously pays all of the taxes required by the law is not entirely clear.

At the same time, the associations of entrepreneurs (the Russian Union of Industrialists and Entrepreneurs, OPORA “Russia”, “Business Russia”, and others) that de-facto accepted the rules of the game established by the authorities during the period 2003 – 2005, assumed the posture of a supplicant, not that of an independent political force. A more civilized option would have been of the creation of a political party that expressed the interests of the independent Russian bourgeoisie (not necessarily only the big bourgeoisie). However, the emergence of any such a party is highly unlikely at present. Does contemporary Russia really possess a business community that is independent of authority; and how high is the probability of the emergence of such a political party without an element of sham? It is unlikely that a political party will emerge from the currently existing associations of entrepreneurs.

**Corporate governance**

The postulate as to the positive macro- and micro-economic effects (economic growth; investments and capitalization) of a transparent and well-balanced corporate governance model has by now become nearly an axiom. Despite some variations (in country-based models), its essence remains the same. An effective system of corporate governance is one of the principal institutional components of economic growth. Russia, as much as other transition economies, has experienced some evolution of its economic and legal institutions and corporate governance is considered also to have evolved, as may be see from the vast body of literature on the subject published in Russia and abroad.

**Foreign institutional investors** in Russia during the 1990s (as was the case with institutional investors in the USA during the 1980s) were, in fact, the only stimulus behind public interest in this subject. During the early 2000s, by contrast, it was the largest Russian companies (privatized or newly created) that displayed most interest. It is their activity over the past decade that explains the emergence of a very versatile corporate governance infrastructure, which has its subdivisions in international financial or other organizations, rating agencies and associations for the protection of investor rights. Despite a certain decline in the number of corporate initiatives on the part of Russian businesses in 2004 – 2005, that infrastructure has already begun to function independently and to ‘feed’ numerous research centers, legal and consulting companies.

Typically, **state authorities** have either indirectly opposed the smooth implementation of positive changes taking place within individual companies (emitting the kind of ‘negative signals’ that were characteristic of the investment climate as a whole during the mid-2000s) or
have been chronically laggard in their response to the kind of urgent problems arising in the sphere of corporate governance (examples include nearly all of the amendments introduced in the Law ‘On Joint-Stock Companies’ relating to arbitration procedures. Events during the 2000s also demonstrated a very high correlation between the State’s activity in that sphere and the interests of particular individuals.

At the same time, the ‘corporate governance’ theme has retained its significance since this is one instrument available to the government in a rather limited repertoire of means enabling it to demonstrate its intentions in the sphere of institutional reform.

There has also been some evolution in specialist (academic) research on the subject. The results of the first studies on corporate governance in countries with transition economies were published concomitantly with some of the large-scale privatization programs. Corporate governance was treated as an important, but by no means key component of the process of enterprise reform and interpreted mainly in terms of its general educational value. By the late 1990s – early 2000s, however, the focus of discussion had shifted somewhat: the topic now became a priority on the agenda for further reform of the transition economy. Simultaneously, it had become obvious that the corporate governance models emerging in different countries (and not only in the transition economies) were far from perfect, even in instances where the privatization schemes implemented could be considered as models.

By the mid-2000s, discussion of general goals had gradually given way to study of some of the more spectacular failures of corporate governance or to the setting of specific objectives. Much empirical data became available on the implementation of norms and standards in corporate governance and on the ways in which corporate governance could influence transformations occurring at the level of individual enterprises. Even so, the range of problems studied under the rubric “corporate governance” remained, as before, excessively broad. Furthermore, recent years have seen publication of a number of monographs and articles ostensibly dealing with ‘corporate governance’ but which, have nothing to do with corporate governance whatsoever. In these studies ‘corporate governance’ is quite often understood as corporate management, corporate law or the restructuring of a company, perhaps in one particular sector of the economy. At the same time, many important but highly significant issues have remained outside of the framework of academic research.

A breakthrough occurred only in the early 2000s when issues of corporate governance began to attract the attention of some of Russia’s biggest companies (or corporate groups). The continuing concentration of joint-stock capital, mergers of enterprises and reorganization of existing business groups (or holding companies), expansion within and between different sectors,
and access to some genuinely external sources of financing (from abroad) was the principal trend of institutional development in Russia’s corporate sector during the 2000s.

During that period, a number of the biggest companies (Yukos, LUKoil, Wimm-Bill-Dann, AFK Sistema, Open-end Joint-Stock Company Norilskii Nikel, Magnitigorsk Metallurgical Combine, SUAL) disclosed information on their beneficiary owners. The number of independent members on the boards of directors of some Russian companies was on the rise and their ranks were augmented by representatives of foreign businesses. Yukos became the Russia’s first company in whose board of directors independent members constituted a majority, whilst the Open Joint-Stock Company Ob”edinennye mashinostroitel’nye zavody [United Machine-Building Plants] was the first to have a majority of independent foreign directors on its board. A number of Russian companies were paying substantial dividends to their shareholders (even though the dividends, amounting to billions of rubles in some cases between 2002 – 2005, owed nothing to improved corporate practice). LUKoil was the first Russian company to publish a statute on its dividend policy; Norilskii Nikel was the first to disclose to the public the remuneration received by every member of its board of directors; and RAO UES introduced special rules for transactions in shares held by its CEOs and members of its board of directors.

Some changes were also made to decision-making procedures. From the 1990s – to the early 2000s all key decisions were made on a partnership basis, that it to say, were confined to the circle of partners who were in full control of a given business group. The appearance in some of the biggest companies of genuine external shareholders (outsiders) who were, as a rule, foreign and held a block of shares representing at least 3 - 4 percent of the share capital created conditions for the formation of a new, genuinely corporate mechanism, for strategic decision-making: decisions now had to be taken with due regard for the opinion of these newcomers. Incidentally, it is clear that the entry of outsiders into a group would be initiated by the partners, and was by no means a consequence of large-scale privatization or the intermediate phase of a corporate takeover. In one sense, one can speak of the emergence of a new type of outsider in the Russian system of corporate governance. In a broader sense, one notes a transition from ‘oligarchic’ to ‘public’ corporate principles on the part of some of the biggest private companies or groups. Against such a background, a further call for innovations in the sphere of corporate governance was to be expected. However, the perception by companies of the need for such innovations was somewhat narrow.

30 See, for example, Golikova V., Burmistrova M. Obzor tendentsii v oblasti korporativnogo upravleniia vRossii. [An overview of the corporate governance trends in Russia] / Corporate Governance in Russia (a round-table discussion) (OECD). Moscow, 2 – 3 October 2003.
Firstly, the emerging structure of the largest corporate groups (and the degree of their transparency) and the goals set in the course of restructuring programs were largely determined by the specific phase of development that each enterprise (or a group of enterprises) was undergoing. As a rule, the development of corporate governance standards directly depends upon how a company’s owners perceive its reorganization goals and long-term strategy.

Secondly, there evidently existed a quantitative gap between companies who are capable of innovation in corporate governance and those who had little knowledge of the subject. In the early 2000s, as different opinion polls indicated, the vast majority (80 – 90 %) of Russian ‘rank-and-file’ companies had only a vague idea of the advantages of, or of the principles (or standards) involved in, effective corporate governance. Later such companies became noticeably more knowledgeable on the subject, but their preparedness for implementing change has remained at almost the same level. In the large and largest companies the ability to implement change was on the whole initially at a higher level than in the others. However, within this group there were substantial differences in the degree of preparedness for change, as shown by the annual surveys of levels of information transparency in the largest Russian companies conducted by Standard & Poor’s in. From 2002 – 2005, the leaders were mostly those companies that, firstly, had been created ‘from scratch’ (independently of the privatization process), and secondly, belonged to the small group of companies that openly attracted resources on the international financial market and, were as a rule, listed in the USA.

Thirdly, the progress that has been made so far is of a rather formal character (the formal image that a company presents to the outside world is very often remote from that company’s actual practice). The positive changes that one can observe have been mostly quantitative: the volume of information to be disclosed has increased as has the number of independent directors on companies’ boards of directors and committees. This was a response, primarily to new requirements and recommendations made by the Federal Financial Markets Service (FFMS) for the 2004 listing. On the other hand, there were few qualitative innovations (in such areas as minimization of the risk of violation of the rights of minority shareholder rights; optimization of managerial bodies; dividend policy; internal control; position of beneficiary owners). To a certain extent, this is due to the predominant preference of many Russian companies for attracting loan capital rather than for short-term joint-stock funding.

Mainstream economic theory maintains that the degree of market development can be measured by, among other things, the amount of information that the market can obtain through

decentralized mechanisms. The more developed a market, the greater is the volume and reliability of information published by a company on a regular basis concerning its own affairs. Although Russian corporate legislation, despite several serious gaps, can be considered to be fairly fully developed, legal innovations alone will not improve the quality of corporate governance. No less important are internal corporate initiatives and the corporate culture. Achievements in the sphere of corporate culture are a product of a long history of development, and initiatives at the level of an individual company are shaped by the cultural environment.

Finally, progress in the sphere of corporate governance is clearly dependent upon the extent of protection of ownership rights or, more narrowly, upon the signals emitted by state authorities. The importance of the latter is illustrated by the ‘freezing’ of new corporate initiatives by the largest companies during the mid-2000s. Qualitative innovations (transparency of the ownership structure, beneficiary owners, financial openness) are mainly influenced by political factors. Even so, there have been some independent developments: the creation of a complete and adequate infrastructure (depending on the specific ideas of particular companies) for maintaining a corporate image (codes, internal regulations, quotas for independent directors, committees, corporate secretaries, and so on). But any further innovations in infrastructure can only be decorative – for quite objective reasons. At present, there is a limited demand for innovations that is expressed ‘by inertia’ mostly within a relatively narrow group of companies of ‘the second echelon’ that are now ready for entry onto the financial market.

Financial markets and economic growth

When examining the extent to which market mechanisms are ‘inbuilt’ in the system of corporate governance in Russia at present allowance should be made for the so-called specificity of initial phases of development. In recent work, what used to be the general approval of experts of the role of financial markets has been tempered by a degree of caution, largely because the theoretical assumption that financial markets are always conducive to a more efficient allocation of resources has been difficult to reconcile with recent instances of assets being withdrawn from corporations, expropriation of small-scale shareholders and depositors, the ‘kleptocratic behavior’ of some company CEOs and of corruption and ‘crony capitalism’.

In a transition economy, the main problem in the financial sphere is the incompleteness of the financial markets. In Russia, a corporate bond market emerged for the first time only in the early 2000s. Since the crisis of 1998 the market for derivative instruments is either disintegrating or does not exist at all. This is a direct consequence of imprecision in the definition of property ownership rights and of the fact that measures designed to ensure investor protection have been essentially declaratory.

As Pistor, Raiser and Gelfer have noted, many of the former USSR republics now boast their own splendid systems for protecting the rights of investors. If one is to believe the authorities investors’ rights are protected in these republics than in some countries enjoying the highest level of development (for example, France or Germany). It is unlikely, however, that in these republics the high level of legal norms that is claimed will be matched in the foreseeable future by an equally high level of development of financial markets34.

Berglof and Bolton have advanced the thesis of ‘a great divide’ in the economic evolution of post-Communist countries, in the first instance in terms of the development of their financial systems35. The financial systems in Czechia, Hungary, Poland, Slovenia and the Baltic States, despite a multitude of complex problems during the initial phases of their development, are still considered by these authors to be more or less satisfactory: there is at least some ‘weak evidence’ of a positive relationship between financial development and economic growth. However, in Russia, Ukraine and some other former Soviet states, they argue, the development of financial relations provides no foundation for economic growth. The development of the financial system in these countries has sometimes even been counterproductive, in so far as it undermined incentives for restructuring the outdated economic system. We do not think that all of the authors’ assumptions are well-founded, but the problem that they address is quite important. Financial market mechanisms can have a disciplining impact on the behaviour of economic actors given the existence of not only macroeconomic preconditions (liquidation of budget deficit, stabilization of prices) but also of the necessary microeconomic conditions: ‘contractual culture’, enforcement of ownership and contractual rights, a structure of financial institutions capable of achieving long-term goals and the transparency of ownership relations and economic transactions.

Some better substantiated estimates and more academically formulated conclusions can be found in a work of 2003 by J. Minier\textsuperscript{36}. In his work of 2003, Minier found no statistically significant \textit{correlation between economic growth and the level of development of financial systems} in a group of countries with comparatively low levels of capitalization. However, he included in the group of countries with comparatively low capitalization levels both some small countries with relatively well-developed financial markets (Sweden, Austria) and countries with huge populations (India, Indonesia) (a total of 11 countries). Also, as he himself points out, his conclusions cannot be considered to be sufficiently reliable since they are based on a limited number of observations.

According to theoretical models of endogenous growth that take into account financial markets, a country whose economy is most distant from the technological frontier has the greatest need of economic institutions capable of supporting the implementation of long-term investment projects based on borrowed advanced technologies (investment-based institutions)\textsuperscript{37}. Such institutions can help rapidly to bridge the gaps in growth rates. By contrast, countries with economies that are closer to the technological frontier can boost their rate of growth only if they introduce the most flexible economic norms and develop institutions capable of comprehensively supporting entrepreneurial initiatives and hi-tech research (innovation-based institutions). This entails, among other things, a high degree of openness of the national economy, financial outsourcing and intensive development of the securities market and of venture businesses.

There is one other circumstance that should be considered: statistical data on the scale of borrowing or security issuance are in themselves an insufficient measure of the actual level of development of financial markets. Some calculations have shown that \textit{it is not the scope of market capitalization but the liquidity of the securities market that correlates positively with the rate of economic growth}\textsuperscript{38}. In transition economies, and especially in Russia, stock markets display a low level of liquidity. The ill-defined character of ownership relations, insufficient protection of ownership and contractual rights, the circuitous routes of credit flows and unreliability of banking services, the non-transparency of reports published by borrower corporations all restrict the operation of financial market mechanisms in the institutional structure of a transition economy.


Economic growth since the crisis 1998 and relative macroeconomic stability have had, on the whole, a positive impact on the Russian securities market. But there are no grounds for overestimating the medium-term prospects for the development of markets. First of all, the Russian stock market, as in the past, is incapable of adequately performing the function of spillover of investment resources. There are, moreover, many disproportions and other features that are specific to the Russian market: a high proportion of oil and gas companies in overall capitalization; high market concentration (the domination of a small number of major issuers); over-concentration of trading institutions (the domination of the MICEX on the domestic market for Russian securities); limited potential sources of financing available to corporations and underestimation of the potential of many companies by the market; the tendency of the Russian market to rely on borrowing; and the historical tradition of the ‘big block market’ (the market for corporate control).

The appearance of non-resident outsiders on the Russian share market in 2003 – 2005 did not produce any significant qualitative changes. As before, unresolved issues with regard to protection of ownership rights and a currency regulation regime that could be convenient for non-residents reduced the competitive capacity of the domestic share market and shifted the liquidity centers for transactions involving shares onto global markets with stable jurisdictions. Between 1998 and 2003, the share of the London Stock Exchange (LSE) in the aggregate on-exchange volume of trading in shares and depository receipts issued by Russian open-end joint-stock companies corresponded exactly to fluctuations in the investment risk index of the shares of these companies. The correlation coefficient of both indices over that period was 0.93, or close to the maximum value. By the end of 2004 the situation had changed dramatically: despite a considerable decline in the volatility of the Russian share market, the share of the LSE increased from 47% in 2003 to 74%. By the autumn of 2005, the monthly volumes of trade in

39 This point of view is shared by an overwhelming majority of Russian experts. See, for example, Analiz i prognoz razvitiia finansovykh rynkov v Rossii [An analysis and forecast of development of financial markets in Russia]. M.: TACIS, 2003. For a more optimistic opinion concerning the state and development of the market, see Danilov Iu. The Role of the Stock Market at the Micro and Macro Levels (or On the Myths of the Stock Market). A report at the SU-HSE Seminar “The Institutional Problems of the Russian Economy” on 25 April 2003. Similarly upbeat is A. Abramov: “sharing the assessments of Russia given by American researchers A. Shleifer and D. Treisman, I dare affirm that the Russian stock market is normal. This means that, having been placed in conditions of market economy, this country has managed to develop a stock market sufficiently adequate to her needs, which demonstrates its competitivity in the contest with the biggest developing markets.” (Abramov A. Rossiiiskii fondovyi rynok v perekhodnyi period. [The Russian stock market in the period of transition] // Sotsial’no-ekonomicheskaia transformatsiia v stranakh SNG: dostizheniia i problemy [Socio-economic transformation in the CIS countries: achievements and challenges]. M.: IET, 2004, pp. 575 - 598).

40 According to some estimates, the “contribution” of non-residents (first of all the hedge-funds) to the over 100%-percent growth of the Russian stock market’s capitalization in 2005 amounted to about 70 %, but it should be noted that approximately the same level of activity non-residents is also typical of other developing markets.

Russian ADR on the LSE dropped approximately 2 – 2.5 times (on average to 6 billion USD), which can be accounted for by a re-calculation of political risks. However, the share of the LSE share still amounts to about 50% of the aggregate volume of trade.

Finally, the absence of any historic memory within the Russian population of the market institutions of the pre-Socialist era is most marked when it comes to stock markets and collective investments. Comparative data on investment funds for Russia and certain East European countries are particularly indicative of this. In absolute terms, the aggregate net asset value of investment funds in Poland, Hungary and Czechia in the early 2000s exceeded by 5 – 7 times the same indices for Russia; in per capita values, the gap amounted to nearly 80 times. As an example, we can point to the failure of pension reform in Russia in 2003 – 2004 (when part of pension savings was handed over to private asset managers).

The inertia of Socialist institutions

An obvious manifestation of this inertia has been the preservation of the institution of ‘state unitary enterprises with the right of economic jurisdiction’. This right originated during the planned economy, when the State, had to ‘release’ certain independent legal entities – enterprises and institutions, in the course of a property transfer and to consolidate to them state property with certain limited ownership rights. In 1993, a government commission put forward a radical solution to this problem: a vast majority of state enterprises should be transformed into joint-stock companies and a few of them into treasury enterprises. But this proposals was never implemented and from 1995 onwards the category of ‘state unitary enterprise’ (SUE) was added to the RF Civil Code.

It was intended that detailed regulation of the activity of such enterprises would be governed by a specially adopted Law “On state and municipal unitary enterprises”, but this law was finally adopted only in 14 November 2002. The mechanisms for protecting the interests of the State as property owner that were enshrined in this Law were to provide incentives, among other things, for abandoning that particular organizational-legal form. It should also be understood that that the law took so long to be adopted firstly because the legal status of the SUE was convenient from the standpoint of “unaccountable management” (the subjective factor), and secondly, because much time was indeed needed for a radical reappraisal of legal procedures and thinking (the objective factor).

It was expected that by 2008 – 2009 the SUEs would cease to exist. However, as the experience of the reforms of 2000 – 2005 has shown, the organizational potential of the State is

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subject to some certain serious limitations that are determined by the size of a particular sector. The inefficiency of SUEs is explained by the asymmetry of powers enjoyed by the SUE and is owner – the State. The reduction of the number of SUEs at all levels would provide a ‘quantitative’ but limited solution to the problem. The problem is that the principal consumer of the goods and services of many SUEs is the State and the population as a whole and that a substantial proportion of the assets of the SUEs have a low level of liquidity. It will therefore be easier gradually to reduce the number of state and municipal SUEs (over a specified ‘transition period’), while at the same time implementing a package of measures designed to improve the quality and accountability of their management.

**Bankruptcy: from imitation of a market institution to macroeconomic functions**

According to the EBRD, legislation on bankruptcy proceedings in countries with transition economies is less developed than other branches of commercial law\(^{43}\). This is particularly true of enforcement. Efficient bankruptcy proceedings can help to avoid delays that might be harmful for both the debtor and the creditors and could overload the judicial system. In Russia, however, bankruptcy proceedings quite often become protracted and yield no practical results. Externally appointed commissioners are often of dubious competence and their ability properly to exercise their powers cannot be taken for granted. There have been few improvements in applying existing bankruptcy legislation to companies and so, at present, the institution of bankruptcy cannot make a stable and efficient contribution to the financial and managerial rehabilitation of companies, even though all the necessary legal norms and procedures are in place.

*The imitative* nature of the institution of bankruptcy in Russia was especially apparent during the period 1992 – 1998, when the bankruptcy first law was in force. At that time, legal requirements prevented bankruptcy proceedings being effectively applied. The second law, which was in force between 1998 and 2002, made matters worse and during this period bankruptcy proceedings functioned an instrument of property redistribution and asset withdrawal rather than as a method for ensuring financial discipline\(^{44}\). A paradoxical situation developed, whereby bankruptcy proceedings were applied to enterprises that had sufficient potential to survive, whereas companies that had been hopeless debtors could not find a buyer since bankruptcy proceedings had reduced the prospects of debt recovery. There were other paradoxes when enterprises, in their attempts to prevent a hostile takeover would create fictitious creditors.

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whilst at the same time take steps to improve their payment discipline and adopt a more strict attitude to their financial obligations.

In the new Law “On Insolvency (Bankruptcy)’, No 127-FZ, of 26 October 2002 (the third law) the protection of creditor rights (and primarily the rights of the State) was strengthened: the rights of honest owners of a debtor enterprise in bankruptcy proceedings were enhanced; the status of the commissioner in bankruptcy and that of state agencies was altered; and a new procedure for financial recovery was introduced. On the whole, this law (albeit, once again very belatedly) placed certain barriers in the way of using bankruptcy for the purposes of hostile takeovers, but even under the new law opportunities remained for corruption and confiscation of property.

The dramatic drop, during 2003 – 2004, of the number of petitions for bankruptcy filed against debtors was due both to a declining interest in bankruptcy as an instrument facilitating corporate takeovers and to a ‘freezing’, in 2004, of the activity of the State in initiating bankruptcy proceedings. This, in turn, was due to the implementation of administrative reform and to a requirement under the new law to allocate budget funding to cover the cost of bankruptcy proceedings (funds had not been earmarked for the years 2003 – 2004). Since March 2004, the State has never been the initiator of bankruptcy proceedings. At present, about 50 – 60% of the aggregate debt of enterprises undergoing bankruptcy proceedings is shouldered by the State. Any change in this situation (even after existing administrative, legal and financial issues have been resolved will result in an upsurge of the incidence of bankruptcies. In the foreseeable future, the State may become the principal ‘client’ initiating bankruptcy proceedings. There is already an urgent need to define criteria for initiating these proceedings.

Extra-economic decisions and double standards

The predominant trends of the early 2000s were an increase in the rate of acquisition of property by the state, attempts to establish (or extend) control over the main financial flows in the Russian economy and, more generally, attempts to secure the dependence of businesses upon state institutions, despite declarations to the contrary made in programmes for deregulation, administrative reform and privatization. A probable outcome of this policy will be the emergence of a “state capitalist” model (though the term must be used with some caution) with specific features that include more widespread state entrepreneurial activity, the creation of a favorable environment for a narrow circle of loyal companies, some demonstratively repressive measures,

an asymmetry of goals and methods and a decoupling of the notions of Russia’s national interest and that of the inviolability of private property⁴⁶.

Of special significance is the extra-economic factor of ‘institutional construction’. As examples of this activity we have the attempt (abandoned) during 2004 – 2005 to merge the oil assets of Gazprom and Rosneft’ (this Yuganskneftegaz share deal would have been part of this), and also, arguably, the formation of relatively autonomous state-owned ‘centers of power’ in certain strategic sectors (e.g., the increase by Gazprom of its ‘oil component’ through the swallowing of Sibneft’ together with its share in power engineering, and the acquisition by Rosneft’ of Yuganskneftegaz and other assets formerly belonging to Yukos).

In the final analysis, the following three considerations seem to have motivated the choice of targets: the need to increase the shareholding of the state in the Open-ended Joint-Stock Company Gazprom to the point where the state had a controlling block; protection from judicial risks of the principal participants (on the buyer’s side) in the affair involving Yuganskneftegaz; the balance of influences and interests within state institutions and the insertion of these influences into the affairs of Gazprom and Rosneft’. This balance was evidently what influenced the key decisions in these specific matters and in our view this is where the essence of the problem resides. The preponderance of extra-economic considerations in deals of this magnitude places corporate interests at significant risk (those of the Open-end Joint-Stock Company Gazprom and those of Rosneft’) by introducing incompetence which finds expression not so much in the legal framework created as in the assessment of economic consequences and risks and in a propensity for making important decisions (the cost of which is estimated in billions of dollars as well as in reputation) in ‘emergency mode’. Serious strategic decisions that in normal international practice take years to prepare are adopted and then rejected within the space of a few hours depending on the current political situation and a very unstable balance of administrative influences.

The essence of this problem – which derives from the specific features of ownership relations in a transition economy – consists in the operation of double standards and different ‘rules of the market game’ for different classes of participants. The cultivation of these double standards (as demonstrated at both federal and regional levels throughout the 1990s and 2000s) has resulted in the emergence of insurmountable obstacles to the formation of a favorable institutional environment (within the framework described earlier) and to the implementation of institutional changes locally in the spheres of protection of ownership rights, corporate governance, financial markets and budget constraints. In other words, the existence of double

standards produces a situation in which market mechanisms can effectively function only within a limited space, which space, given the ongoing emergence in Russia of state capitalism, is tending to shrink further and further. In our view, whilst the long-term goal of creating a stable and adaptable institutional environment (to support the market system) has not lost its relevance, the priority of the moment is to create some basic preconditions for the operation of market mechanisms as such— that is, to construct a legislative, procedural, judicial and regulatory support that will support a uniform application of market rules. The only really effective way of combating the application of different rules in a system of double standards is to establish an independent instance of judicial procedure that would apply the rules uniformly to all market players. Of course, the prospects for the development of institutions conducive to economic growth are largely determined by the quality of political institutions and by the proficiency with which they function.

**Plans and contradictions**

Given that Russia has experienced a high rate of economic growth for nearly a decade (since 1999), it is quite natural that there has been a increasing interest in the country’s long-term development prospects and socio-economic problems. In 2007 – 2008, the most frequently discussed documents were the drafts of the *Concept (Strategy) of Socioeconomic (Long-Term) Development of the Russian Federation until 2020*. The *Concept* primarily addresses the prospects for creating an innovative institutional environment in the course of transition from a model of economic growth characterized by inertia and reliance on raw materials to a new, innovations-based model. Over and above changes in social policy and taxation, the strategy envisages development in the key areas of protection of ownership rights, corporate governance, competition, financial markets and the performance of the public sector.47

In our opinion, the *Concept* has three positive features (that will probably survive in the final version): the uncontroversial nature of all the priorities adopted (even if not all possible priorities are included); the replacement of medium-term by long-term goals; and the endorsement at official level of the notion of *institutional environment*. This last objective deserves special comment.

During the last few years, the role of the institutional factor in post-Communist transformation has been a subject of active discussion in academic literature, but hitherto the concept had not figured in official thinking. So, the very fact that of this question is embedded in the *Concept of Long-Term Development of the Russian Federation until 2020* marks a qualitative step forward, at least at the level of official intent and in this regard the new

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document differs from two other recent declarations - the *Programs of Medium-Term Socioeconomic Development* for 2002 – 2004 and for 2006 – 2008. Of course, Russia’s experience of institutional reform in the first decade of the 21st century does not inspire confidence that all necessary measures will be taken when it comes to implementation.

In our opinion, the dilemma consists in the following: the measures that need to be taken to optimize the institutional environment (with or without ‘innovation’), whilst they are not controversial in themselves, are predominantly *functional*. However, the *systemic* parameters of the institutional environment that emerged during the 2000s have remained intact48. These parameters are:

- the asymmetry of (differently vectored) developments in the market sector of the economy and of the political factors (political and legal institutions – primarily the State) that have been shaping the development of the economy;

- the hypertrophy of political institutions and, more broadly, of civil society institutions capable of effectively constraining arbitrary acts on the part of the authorities, including the abuse of official posts for personal benefit at all levels of state authority;

- ‘corruption-based loyalty’49 as the practice making for the corruption of the system as a whole;

- the chronic failure of legislation to catch up with existing economic realities (a lag of 4 to 10 years) and the constant expansion of an ‘uncertainty zone’. This result is an inadequate legal basis and inadequate enforcement and regulation of the development of economic institutions;

- the emergence of double standards and the application of different ‘rules of the market game’ to different classes of participants. This places insurmountable obstacles in the way of creating a generally favorable institutional environment and prevents implementation of institutional change at the local level;

- the negative mutual interaction of some key institutions (for example, the system for protecting ownership rights and the financial system). This reflects, first of all, of a lack of interest on the part of the State in establishing transparent rules and secondly, the impossibility of effective regulation in particular areas;

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48 Some of the aforementioned problems, owing to the frequency of references to them in public speeches, scientific literature and the mass media, have undoubtedly become commonplaces, but this has by no means diminished their real importance. See Radygin A. D. *Stabil’nost ili stagnatsia? Dolgosrochnye institutsional’nye problemy razvitia Rossiiskoi ekonomiki*.[Stability or stagnation? Long-term institutional problems of the development of Russia’s economy]. – Ekonomicheskaia politika [The Economic Policy], 2007, No 1 (5), pp. 23 - 47

49 This term was introduced by K. Rogov: ‘It is senseless to apply to the Russian economic and political system the “toothless” term corruption. It can add little to any real understanding of this country. One should speak of a mechanism operating on the basis of the principles of corruption-based loyalty’ (Rogov K. Mekhanism loial’nosti. [The mechanism of loyalty.]] // Kommersant [The Businessman], 2006, 13 November).
- the consolidation of a state capitalist economic model during the 2000s.

This last development is, in our opinion, the most significant and it can provide a useful conceptual framework for understanding the formation of an institutional environment in Russia. The formation of a Russian model of ‘state capitalism’ has been examined more than once by the present authors\(^ {50} \) and by others as well, but the topic merits further discussion here.

Quantitatively, the development of the state sector of the Russian national economy displayed the same dynamics during 2007-2008 as in preceding years: a formal reduction in the number of unitary enterprises, a continuing incorporation of state-owned assets into holding companies, an ongoing expansion of the business activity of those ‘holding companies with state participation’ that already existed, diversification of the sector through takeovers and mergers and vertical and horizontal integration. In 2007–for the first time since the late 1990s–the aggregate share of joint-stock companies in which the State was capable of exercising full corporate control through its ownership of either a controlling stake or a 100 % shareholding exceeded one half of the total number of all economic societies that had state participation.

According to available estimates, the proportion of Russian companies owned by the State in 2006 was 29.6 %, and in early 2007 –35.1 %.\(^ {51} \) By early 2008, the ‘extent of property concentration’ in the hands of the State, according to the database of Expert-400, was 40 – 45 %. Whereas in 2004 the State controlled 81 companies out of the largest 400 (these had aggregate asset value of $ 145 billion), in 2006 the number had increased to 103 (with aggregate proceeds of $283 billion)\(^ {52} \). If, in 2004 the State controlled 34.7 % of the aggregate proceeds of Russia’s 400 biggest companies, by the results of the year 2007 it had extended its control to 40 % of the aggregate proceeds\(^ {53} \). According to the data published by the Federal Antimonopoly Service (FAS) and Rosstat, in 2003 one-tenth of GDP was accounted for by 52 companies, but in 2006 by only 11 corporations.

An essentially new phenomenon was the simultaneous emergence, in 2007–2008, of a number of state corporations – Rosnanotekh, the Housing and Utilities Reform Foundation, Olimpstroy, Rostekhnologii, Rosatom and others. These structures differ from each other in terms of their objectives: Olimpstroy and the Housing and Utilities Reform Foundation will

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\(^ {51} \) The data published by Alfa-Bank (B. Grozovskii. Glavnyi sobstvennik strany. [The country’s principal property owner.] Vedomosti [The News], 13 February 2007)

\(^ {52} \) A stake no less than a blocking packet of shares, or the final stage of establishing state control.

implement a number of specific projects with fixed time limits, Rosnanotekh will become one of the instruments for promoting innovation activities, while the Bank for Development and Foreign Economic Activity will promote the export of goods of the processing industry and launch capital-intensive infrastructure projects. Rosatom is essentially a branch-based entity. Rostekhnologii is evidently a conglomerate designed to absorb the assets (after its transformation into a joint-stock company) of FSUE (Federal State Unitary Enterprise) Rosoboronexport, and it has also targeted hundreds of other enterprises.\(^{54}\)

These trends notwithstanding, the then First Deputy Prime Minister Dmitrii Medvedev formally stated in January 2008 that the creation of state corporations did not imply any change in the general course of Russia’s development or a departure from its market orientation and that state capitalism represented a dead end\(^{55}\). Explaining the reasons for creating such structures with State participation he pointed to the need to support priority areas where Russia had begun to lose its former leading position (nuclear power, shipbuilding and aircraft construction). At the same time, the limits to ‘invasion’ by private businesses were clearly set: in the majority of sectors they could occupy a significant position, but in the national defense industries there was no alternative to absolute control by the State.

The policy of the years 2007 and 2008 of creating state corporations (the trend is also manifest at a regional level) has noticeably increased pre-existing economic and financial risks. The “state corporations” (the terminology is somewhat absurd) are situated outside of the framework of the norms prescribed in legislation for each organizational-legal form (in the special laws designed to regulate joint-stock companies, unitary enterprises, or non-commercial organizations). It is also unclear what mechanisms will be employed to control the activity of these corporations, and in what detail these mechanisms will be described in documents relating to law enforcement in the safeguarding of state property and of financial resources. How will the targeted use of these resources be ensured and how will transparency and compliance of the corporation with the goals contained in its statutes be guaranteed?

Some recent research has suggested that the expansion of the State is reaching a quantitative limit. In our opinion, the quantitative estimates for 2004 – 2007 that we have cited above (even when rather arbitrary), and observable trends in the property activities of state-

\(^{54}\) From this point of view, the activity of Rostekhnologii provides an ideal example of a merger between authority and business as a characteristic feature of Russian state capitalism. When the contribution of the Russian Federation property to the state corporation was determined (it consisted of SUEs and stakes in open-ended joint-stock companies) it was found that the list of contributed objects had increased from the initial 250 to 500 – 600 entities in the spring of 2008, including enterprises belonging to ‘civil’ sectors, whilst, as usual, no economic or administrative justification was provided.

owned economic structures for the period 2007 – 2008, do not suggest that there is any slowdown in property acquisition by the State.

At the same time (all other conditions being equal, including considerations of politics and corruption (payoffs)), there is evidently a qualitative threshold to such expansion: the larger the state sector, the more difficult it is to manage and control. This was demonstrated, in particular, by the introduction (or attempted introduction) during the late 1990s and 2000s of a variety of new governance and control mechanisms for unitary enterprises and joint-stock companies with state shareholding. As with the evolution of private Russian business groups during the second half of the 1990s and the early 2000s, one can anticipate, in the medium term, a proliferation of measures aimed at optimizing the structure of acquired assets and the organizational and administrative functioning of state companies (or groups). Only time will tell how effective such measures will be when applied to state companies, and what the motives underlying this type of reorganization will be after March 2008. Certainly, a qualitative increase in direct state participation in the economy, or a continuous high degree of participation, is by no means unusual in the world of today. What is important, from our point of view, is to acquire an adequate understanding of the qualitative consequences of such a consolidation of the state capitalism model.

There is no single theory of ‘state capitalism’ – there is a range of models of economic development models (totalitarian, authoritarian or traditional), in which the State becomes the ‘basic’ subject of the economic process. Whilst state capitalism in Russia has not yet emerged in its mature form, by many of its parameters it corresponds to the authoritarian type – despite the existence of some generally accepted (“civilized”) norms in the legal framework and the existence of the key institutions of a market economy. Among the specific features of the Russian model, over and above increasing direct state interference in the economy, we note a general tendency for the State to substitutes itself for market mechanisms in the distribution of incomes and resources; the growth of corruption within state structures; and a merger between the state bureaucracy and the ‘business community’ in constructing an administrative “vertical” and in centralizing the political structure. All of this makes for increasingly obvious indicators of

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57 Perhaps, without any claim to originality, one may speak not only of the failure of the policy (declared in the early 2000s) of distancing authority from business but – on the contrary – of a process of transformation of the ‘oligarchic capitalism’ of the 1990s, which entered a qualitatively new phase and turned into the ‘state oligarchic capitalism’ of the 2000s.
poor performance and in the longer term can only limit opportunities for sustainable economic growth.58

The interactive structure - ‘the State (authority) – property’ that has been created during the 2000s envisages a merger of state property with the vertical of power. In such a model, the principal long-term problem consists not only – and not so much – in the fact that the ‘business community’ (the market and private property) is subordinated to the State (authority). It is no less important that the interaction between the state and private forms of ownership, instead of being horizontal (when there are market-based preconditions for competition), becomes vertical. This absence of market-based competition, in its turn, results in the suppression of one of the forms, in the destruction of market mechanisms and ultimately in the loss of the efficiency potential in both the state and private sectors.

As early as 2007 – 2008, during the debate over long-term plans for developing an ‘innovative institutional environment’, the State began to pay much more attention to the financial and regulatory (dirigiste) aspects of economic growth than it did to the institutional framework.59 Noteworthy in 2007 was the transition in budgetary policy to large-scale budgetary expansion, manifest primarily in the pumping of money into ‘development institutions’ and in the creation of state corporations. This policy was understandable given the massive inflow of ‘cheap money’ that the country had been experiencing for several years. But the only direct results of this policy so far has been an increase in inflation and a further slowdown of institutional reform. As to the need to modernize the political system (or politico-legal institutions) as an absolute priority (if all the other goals of socio-economic modernization are to be achieved), this issue, remains a matter of debate for political scientists and economists, but is absent from all practical proposals for Russia’s long-term development.