

The Transition of Russian Business and the Potential for Economic Development

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Content

- Starting conditions of transition and realities of 1990s in Russia
- 1998 crisis and new trends in Russian business in 2000s
- 2008-2009 crisis, attempts to renew state-business dialogue and impact of 2011 political events
- Potential of Russian market and key problems for economic development

Starting conditions of 1990s

- Absence of key institutions important for market economy
- Lack of necessary skills and knowledge on the side of honest actors (both in business and bureaucracy)
- 'High stakes' in terms of structural distortions inherited from plan economy and huge opportunities for rent extraction (see Woodruf (2003) for comparison of Russia and Poland)
- Dominance of opportunistic incentives in the elite (as result of elite cynicism in late Soviet time)


Reality of 1990s in Russia

- Poor institutional environment
- Rent-seeking and vested interest lead to huge state capture (Hellman et al, 2003)
- Assets stripping and mass violation of property rights (Black et al, 2000)
- Barter, non-payments and tax arrears (Gaddy & Ickes, 1998)



Deep economic decline, capital flight and fiscal crisis

1998 crisis and its consequences

- Not only financial but also political crisis – Primakov’s government with prominent communists in leading positions
 - Challenge for new elite and start of dialog between main groups in the elite with search for more adequate economic policy
 - Liberal reforms of early 2000s (radical tax reform, lowering of custom tariffs, simplification of SME regulation) as ‘negotiated institutional change’.
 - Peak business associations – RSPP, DR, OPORA – as important actors in state-business negotiations
-  Lower political uncertainty as the precondition for investment and economic growth of 2000s

‘New business’ as social group

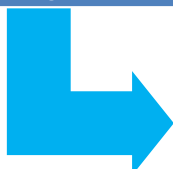
- Successful medium-size companies that managed to take advantage of the opportunities provided by the high growth in domestic demand. →
- Already in 2006 about 5,000 medium-size firms with an average annual turnover above \$10 million maintaining average annual rates of sales growth at the level of 20 percent and more (Vin’kov et al., 2008). Particularly active in construction and trade, but represented in all economic sectors.
- These companies were familiar with the Russian market as well as had resources and skilled management teams. Such companies could become the basis for the new model of economic growth. However, in order to succeed they should be sufficiently motivated to invest.

Crisis 2008-2009 as turning point

- **Margins vs. costs of doing business:** Before 2008 high demand in global & domestic market provided enough incentives for investment and growth in spite of poor conditions for doing business in Russia. After 2008 – high uncertainty and low confidence in economic policy
- **Policy response:** Short-term – huge increase in social spending in 2009 (resulted in budget deficit now). As a next step → search for new model of economic development: **dialogue with business & elaboration of Strategy-2020**
- Some steps already in 2009-2011 (liberalization of Criminal code, introduction of RIA procedures, creation of ASI). But as the most comprehensive part – **National entrepreneurial initiative** announced by Mr. Putin in February 2012 with idea to improve Russia's position in DB ranking: elaboration of relevant 'road maps', introduction of ombudsman for entrepreneurs, new criteria of governors performance evaluation, WTO accession etc.

But what about final outcomes?

	2011	2012	2013	2014
Real GDP, percent growth	4.3	3.4	1.3	0.3
Investments, percent growth	10.8	6.6	-0.3	-3.2
Net inflow/outflow of capital, billion dollars	-83.0	-55.8	-60.7	-152



Why there was no impact of new 'investment climate policy' on economic performance?

An other side of coin

Arab Spring + mass protests in Moscow in December 2011 → fear to lose the power → suppression of political opposition and search for 'external enemies'.

As the consequences:

- Law on 'foreign agents', pressure on NGOs, anti-US campaign
- 'Experts case': criminal investigation (by Investigative Committee) about the reasons for review of second criminal case against Khodorkvsky and Lebedev (provided on the request of Presidential Council of human rights in 2011) – with interrogation, search and seizure of documents → emigration of Sergei Guriev, well-known economist and one of economic advisers of Dmitry Medvedev
- Initiative to return to Investigative Committee the right to initiate criminal cases on tax evasion without any approval and confirmation from Federal Tax Service → strong opposition of leading business association and also from the government → long consultation between government and Kremlin → draft of Investigative Committee was supported by Mr. Putin with minimal changes
- Merger of Highest Arbitration Court (responsible for commercial disputes) with Supreme Court (criminal and civil justice) → strongly opposed by leading legal firms and by business but without any success

Center of decision-making: **Government → Kremlin → Security Council**

Different visions of future

- New version of Strategy 2020 was prepared in 2011 by a group of liberal reformers with involvement of hundreds experts coordinated by HSE and ANE on direct request of Mr. Putin.
- Many measures on investment climate improvement proposed in Strategy-2020 were implemented by the government
- But there is also another 'vision of the future' shared by some groups in Russian elite – with focus on mobilization for 'Major Breakthrough' → Izborsky Club – as think tank providing analytical support for this line of thinking. Sergei Glaziev, Dmitry Rogozin – as representatives in public domain
- And this strategy also is implementing → strong increase in military spending, law on 'foreign agents', anti-offshore measure, prohibition to have accounts in foreign banks for public officials, Crimea and support of separatists in East Ukraine

Potential of Russian market

According to IIMS project on foreign business associations:

- Availability of various natural resources (including, in addition to oil, also metals, timber, agricultural lands).
- Significant structural distortions in the economy (inherited from the Soviet plan system and not overcome during last 25 years) → market niches with opportunities for sales growth for many years to come.
- High qualification of labour force → opportunity for locating high-tech production facilities in Russia.
- High urbanization level combined with a high level of education and increased level of incomes → mass-scale demand for consumer goods of high and medium quality.

Conclusion

1. Russia (a big and very non-homogeneous market) has huge potential for economic development – long-term growth at 5-6% per year is possible
2. But: different understanding of strategic goals and priorities by different groups in political elite → deep contradictions in economic policy → high uncertainty for the business → declining investment and expectations of economic stagnation.
3. Need for comprehensive ‘vision of the future’ and relevant strategy shared and supported by main groups in elite and by broader social groups → but unfortunately no evidences to go to dialogue with these social groups on the side of top political elite after 2011.
4. Long-term stagnation as the most probable scenario – due to resources accumulated in 2000s and strong political support of Mr. Putin by population