

Ivanenko, Vlad

Working Paper

Markets and democracy in Russia

BOFIT Discussion Papers, No. 16/2005

Provided in Cooperation with:

Bank of Finland, Helsinki

Suggested Citation: Ivanenko, Vlad (2005) : Markets and democracy in Russia, BOFIT Discussion Papers, No. 16/2005, ISBN 952-462-799-X, Bank of Finland, Institute for Economics in Transition (BOFIT), Helsinki,
<https://nbn-resolving.de/urn:nbn:fi:bof-201408072114>

This Version is available at:

<https://hdl.handle.net/10419/212568>

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.

BOFIT Discussion Papers
16 • 2005

Vlad Ivanenko

Markets and democracy in Russia



EUROJÄRJESTELMÄ
EUROSYSTEMET

Bank of Finland, BOFIT
Institute for Economies in Transition

BOFIT Personnel 2005

Economists

Mr Pekka Sutela, head

Russian economy and economic policy
Russia's international economic relations
China in the world economy
Pekka.Sutela@bof.fi

Ms Tuuli Juurikkala, economist

Russian economy and economic policy
Private sector development
Tuuli.Juurikkala@bof.fi

Mr Juuso Kaaresvirta, economist

Chinese economy and economic policy
Juuso.Kaaresvirta@bof.fi

Ms Tuuli Koivu, economist

Chinese economy and economic policy
Editor-in-Chief of *BOFIT China Review*
Tuuli.Koivu@bof.fi

Mr Iikka Korhonen, research supervisor

Exchange rate policies in transition economies
Monetary policy in transition economies
Editor-in-Chief of *BOFIT Discussion Papers*
Iikka.Korhonen@bof.fi

Mr Vesa Korhonen, economist

Russia's international economic relations
Russia's banking system
Vesa.Korhonen@bof.fi

Mr Aaron Mehrotra, economist

Chinese economy and economic policy
Monetary policy in transition economies
Aaron.Mehrotra@bof.fi

Mr Simon Ollus, economist

Russian economy and economic policy
Simon.Ollus@bof.fi

Mr Jouko Rautava, economist

Russian and Chinese economies and economic policies
Editor-in-Chief of *BOFIT Russia Review*
Editor-in-Chief of *BOFIT Online*
Jouko.Rautava@bof.fi

Ms Laura Solanko, economist

Russian regional issues
Public economics
Laura.Solanko@bof.fi

Ms Merja Tekoniemi, economist

Russian regional issues
Merja.Tekoniemi@bof.fi

On leave of absence

Ms **Seija Lainela**, email: Seija.Lainela@formin.fi

Mr **Jian-Guang Shen**, email: Jian-Guang.Shen@ecb.int

Information Services

Mr Timo Harell, editor

Press monitoring
Editor-in-Chief of *BOFIT Weekly*
Timo.Harell@bof.fi

Ms Liisa Mannila, department secretary

Department coordinator
Publications traffic
Liisa.Mannila@bof.fi

Ms Päivi Määttä, information specialist

Information services
Paivi.Maatta@bof.fi

Ms Tiina Saajasto, information specialist

Information services
Tiina.Saajasto@bof.fi

Ms Liisa Sipola, information specialist

Information services
Liisa.Sipola@bof.fi

Contact us

Bank of Finland
BOFIT – Institute for Economies in Transition
PO Box 160

Phone: +358 10 831 2268
Fax: +358 10 831 2294
E-mail: bofit@bof.fi

BOFIT Discussion Papers
16 • 2005

Vlad Ivanenko

Markets and democracy in Russia



EUROJÄRJESTELMÄ
EUROSYSTEMET

Bank of Finland, BOFIT
Institute for Economies in Transition

BOFIT Discussion Papers
Editor-in-Chief Iikka Korhonen

BOFIT Discussion Papers 16/2005
30.12.2005

Vlad Ivanenko: Markets and democracy in Russia

ISBN 952-462-798-1
ISSN 1456-4564
(print)

ISBN 952-462-799-X
ISSN 1456-5889
(online)

Multiprint Oy
Helsinki 2005

Contents

Tiivistelmä.....	5
Abstract	6
1 Introduction: Are Russian institutions and markets converging?	7
2 What is normalcy?	9
2.1 Defining the concept	9
2.2 Components of like-mindedness	10
2.2.1 Economic principles	10
2.2.2 Democratic principles.....	11
3 Empirical evidence on Russia’s institutions	12
3.1 Market structure	14
3.2 Corporate practices	17
3.3 Democracy indicators.....	20
3.4 Results summary	26
4 Russia’s great challenge: Dealing with corruption.....	26
4.1 Private interests of public agencies	27
4.2 Coalition building and breaking: Russia’s policy options	29
5 Conclusions	35
References	37

All opinions expressed are those of the author and do not necessarily reflect the views of the Bank of Finland.

Vlad Ivanenko*

Markets and democracy in Russia

Tiivistelmä

Tässä työssä tutkitaan, miten venäläiset taloudelliset ja poliittiset instituutiot ovat lähentyneet muiden demokraattisten markkinatalousmaiden vastaavia instituutioita. Lisäksi työssä selvitetään erilaisia markkinatalouden, demokratian ja julkisen sektorin tehokkuuden kattavia normaaliuden käsitteitä. Työssä selvitetään Venäjän instituutioiden konvergoitumista kohti G7-maiden sekä "B5-maiden" institutionaalisia kehitystasoja. B5-maat ovat suuria keskituloisia maita, kuten Brasilia, Kiina ja Intia. Joillakin lohkoilla Venäjän kehitys on ollut parempaa kuin B5-maissa, mutta toisilla sektoreilla Venäjä on jäänyt selvästi jälkeen. Presidentti Putinin hallinnon reformisuunnitelmia analysoidaan siitä näkökulmasta, miten ne vaikuttavat yleisön epäluottamukseen, korruptioon ja hallinnon tehotuuteen.

Asiasanat: markkinatalous, demokratia, instituutiot, Venäjä

* Visiting Researcher, Bank of Finland, Institute for Economies in Transition (BOFIT), Helsinki, Finland and University of Western Ontario, London, Canada. Email: ivanenko60@yahoo.com The author expresses his gratitude to Pekka Sutela, Simon Ollus and Anna Mahlamäki (BOFIT), Konstantin Sonin (NES) and William Tompson (OECD) for perceptive comments. Iikka Korhonen (BOFIT) has contributed significantly to the final shaping of this paper. The remaining errors and omissions are the sole responsibility of the author.

Vlad Ivanenko

Markets and democracy in Russia

Abstract

The paper looks into convergence of Russian institutions with those of other democratic, free-market-oriented states, and considers definitions of "normalcy" that incorporate the concepts of free market, democracy, and government efficiency. The author provides an estimate of Russia's institutional convergence to the standards of the G7 and the "Big Five" group of large, middle-income countries that includes Brazil, China, and India. In some areas Russia outperforms "Big Five" countries, in others it trails behind. Finally, public mistrust, corruption, and inefficient governance in Russia are discussed in light of the Putin administration's current reform policies.

JEL: O57, P30, P52

Keywords: Free market, democracy, institutions, Russia

1 Introduction: Are Russian institutions and markets converging?

In this section we discuss the potential convergence of Russian institutions and market practices with those found in two comparison groups, G7 and so-called "Big Five" countries (Brazil, China, India, Indonesia, and South Africa). The issue is interesting in itself, but it also extremely important for Russia's future integration with the rest of the world, both in the sphere of economic activities and in the political arena. We utilize a number of objective indicators to assess the degree of convergence in market structures, corporate practices and quality of public institutions.

As we use a large number of objective indicators, we can sidestep some of the problems associated with the debate over whether Russia has become "normal," i.e. a typical middle-income capitalist democracy. Proponents such as Shleifer and Treisman (2004), argue that Russia is normal and already adheres to democratic principles and free market philosophies found in Brazil, India and elsewhere in the Third World. Opponents such as Rosefielde (2004:5) declare that Russia remains "an abnormal political economy unlikely to democratize, westernize or embrace free enterprise any time soon."

Part of the problem is semantic. Shleifer and Treisman assume implicitly that Russia has never been a developed country, so they find it appropriate to compare Russia with countries in the developing world. This view somewhat discounts the political weight Russia continues to wield in international circles.

So what is normal? Western policymakers partly form their position *vis-à-vis* Russia based on assumptions about normalcy. It is quite reasonable for them to ask, for example, whether Russia is a reliable partner, whether they should place their confidence in the integrity of Russia's leadership, and if Russia plans to continue its current policies.

In addition to calling for a well-defined yardstick for normalcy, it also seems appropriate to judge Russian institutional strengths and weaknesses beyond the context of the G7 countries to the major emerging economies. Broader comparison helps tease out the dynamics of Russia's institutional trajectory relative to its main competitors – the potential heavyweights of the twenty-first century. Comparison can reveal Russia's attainment in areas such as market infrastructure that help determine foreign direct investment (FDI) levels. Western firms considering organizing production in Russia likely compare costs of doing business in Russia with other countries, say, Brazil or India. All other things equal, we

would expect Russia to attract more FDI from the G7 countries when its utilities provide superior services and its transportation network affords greater compatibility with theirs. The siting of production in Russia, in turn, brings technology transfer that elevates Russia's status within global production chains and boosts domestic prosperity. Commonality of corporate practices (e.g. accounting standards, attitudes to property rights and labor training) also increases opportunities for Russian firms to establish international alliances with consequent expansion abroad and promotes economic diversification, especially into high-tech industries where success is critically dependent on market size.

From the political standpoint, Russian adherence to democratic principles facilitates the defense of its national interests; the government finds it easier to establish good rapport with leading industrial nations. The EU, for example, implicitly conditions Russian access to its markets on the compatibility of Russian institutional norms to the EU standards.

Determining Russia's relative strengths and weakness helps guide assessment of the current political processes in Russia. Although Mr. Putin is routinely accused of trying to build an authoritarian state, some indicators suggest his administration's policy agenda is actually fairly nuanced. A more accurate assessment might be that Russia is dealing with serious institutional challenges by resorting to methods inappropriate for a mature democratic country.

The substantive part of this paper starts with a discussion of Western perspectives on normalcy, especially the notion of "like-mindedness" that the OECD uses to evaluate potential members. We propose normalcy determinations that include three natural criteria – free market infrastructure, corporate practices, and democratic principles – and link them to cross-country data from the World Economic Forum (WEF, 2005), World Bank (2005a), and others research groups. The following section provides data analysis to distinguish Russia from the "Big Five" group of middle-income economies. While the Soviet legacy has conferred a number of relative strengths (e.g. physical infrastructure and labor market), Russian institutions are generally weak. It has been slow in developing good corporate practices and internalizing democratic principles. Although Russia's free-market indicators have improved over time, the dynamics of its democratic parameters have stayed flat or deteriorated. The paper concludes with a discussion of the Putin administration's current administrative reform. We suggest this reform has better chances of success if trust-building measures complement efforts to stem corruption through centralization and greater state-control of selected enterprises.

2 What is normalcy?

2.1 Defining the concept

The term “normalcy” has two closely related meanings. The first definition is pragmatic; normalcy is expectedness, an absence of novelty. “Normal” human interactions are routine and predictable. Routine behavior, in turn, has practical importance in commerce and politics as it determines the norms individuals apply in dealing with one another. In the absence of norms, people must explicitly anticipate their response to various contingencies (e.g. by making a written contract). Working outside the comfortable confines of normalcy can be costly, burdensome, or even impossible.

The second meaning of “normalcy” is the state of affairs that prevails within certain bounds, e.g. within a territory. This definition connotes the existence of a cultural commonality for those within a defined area. In this context, normal means behaving like the majority of people.

These two meanings often blur in public debate, so it may help this discussion to specify the concept of “normalcy.” The first, more pragmatic, interpretation has the advantage over the cultural alternative in that it precludes the need to decide whether Russia is a “civilized” country. Moreover, the pragmatic interpretation drastically limits the set of features that determine normalcy.

Moreover, it is necessary to make clear distinctions about actors and their objectives. For example, technological standards may be more demanding at the international level than at the domestic level, or corporate norms may vary regarding dealings with partners or public agencies (e.g. a private-sector business arrangement may validly include side payments, while such practices are inappropriate with officials). In Russia’s case, three common situations arise. First, differences between market structures add costs for the Western company doing business in Russia and may force it to adjust its technological processes. Second, the international company interacting with its Russian partner must learn to accommodate differences in ownership rules, accounting and labor practices, and patterns of collaboration with suppliers and customers. Third, Western residents and governments may find it difficult to adapt to Russian governance practices.

The variants of normalcy defined above correspond closely to the standards used by the OECD (2004) when inviting new members. The OECD applies the admittedly vague notions of “like-mindedness” and “significant player.” The OECD (2004: 16) says it as-

sesses like-mindedness from two perspectives: free-market economy and democratic principles. The concept of significant player implies that current members can learn from the invited country's policies or approaches.

2.2 Components of like-mindedness

2.2.1 Economic principles

The minimal tests for a free-market economy are whether the state guarantees private property rights and private agents are free to produce and trade.¹ Proponents of a free-market economy make two arguments to justify the view that actions of private agents deserve supremacy over state action. First, under the condition of informational asymmetry, individuals seen as better suited to detect and realize socially valuable opportunities in production and exchange than a vertically organized state. This proposition appeals to the concept of efficiency because it implies that the free market is better at raising the standard of living than state planning. Second, there is concern that democracy becomes hollow if citizens depend on the state for their living. In this case, a market-based economy is a means to achieving “freedom,” a notion unrelated to economics.

The OECD countries universally share the belief in free markets. The basic tenets of this belief include letting private individuals command productive facilities and financial funds, own assets privately or rent from other agents, and accumulate resources through long-term investment. The government, in turn, acts as guarantor and impartial arbitrator in protecting private property and enforcing private contracts.

Of course, free-market economies seldom live up to this ideal, because certain forces militate for expanding the role of the state beyond mediating conflicts and guaranteeing private rights. First, unfettered markets ignore social conventions that embody values of non-economic significance. Using a *reductio ad absurdum* argument, Aune (2001) suggests that an unfettered market implies organs donors should be free to sell their body parts to reduce transplant waiting lists and parents should be free to sell their children to childless couples to minimize search costs. Second, unregulated markets ignore the problem of externalities. For example, a profit-maximizing firm does not consider the costs of environmental degradation or health hazards that the society pays for its activities as a

¹ Compare with the definition of the Heritage Foundation (2005, Ch. 5): “economic freedom is ... the absence of government coercion or constraint on the production, distribution, or consumption of goods and services

whole. In such cases, the OECD members agree that the state has the authority to intervene. It may prohibit some operations within national borders (e.g. prostitution or drug trade) or order firms to pay for public hazards (e.g. medical treatment of smokers). However, to limit power abuses, the state must be subject to the popular vote. This final observation suggests that the West values democratic principles matter at least as much as free-market standards.

2.2.2 Democratic principles

If taken alone, the principle of economic efficiency may render democracy irrelevant. Indeed, some economists argue that an authoritarian regime can generate superior results to a democracy under certain conditions.² Nevertheless, one can say with certainty that democratic values are widely recognized as important in the modern world.³ Historical reasons may explain why developed countries attach high value to democratic traditions. The twentieth century evidenced horrible instances of human suffering, particularly during the last world war. In its aftermath, Western countries grew convinced that democracy safeguards against destructive conflict. In this respect, the creation of the OECD is the part of a broader process to promote democracy internationally. This OECD was superseded in 1961 the Organization for European Economic Cooperation (OEEC), created in 1948 as an extension of the Marshall Plan for reconstruction and development. Its objective was “the revival of a working economy in the world so as to permit the emergence of political and social conditions in which free institutions can exist.”⁴ Predictably, the OECD statutes embed the goal of upholding democratic credentials, a standard of normalcy in the Western sense.

A good starting point for defining democracy, therefore, is its modern liberal variant. Democracy is a system of governance that includes periodic change of leadership defined and legitimized by elections. Liberal democracy further incorporates protection of certain indi-

beyond the extent necessary for citizens to protect and maintain liberty itself. In other words, people are free to work, produce, consume, and invest in the ways they feel are most productive.”

² See e.g. Barro (1996) or Besley and Coate (1998).

³ Sen (1999), reflecting on major events of the twentieth century, concludes that the rise of democracy is the key recent development. He continues that in the twentieth century the focus clearly shifted from a discussion of “whether one country or another was ‘fit for democracy’” to discussing whether “it has to become fit through democracy” (*italics in original*).

vidual rights. These two features – elections and protection of rights – characterize democracy as the political system where majority rules and minorities have rights.⁵ The first feature is that citizens have the right to vote and that the majority of voters elect state authorities through open process. This arrangement is efficient under the condition that voters have well defined social interests and can choose among alternative policies that promote their interests. The second feature is that the public authority is not free to pursue every agenda that majority approves. A liberal democratic government operates within the limits set constitutionally and citizens can bring a claim against government actions in independent courts. The two features have inherently contradictory purposes. Democracy based on majority rule must provide the means for peaceful resolution of conflicts. At the same time, it must protect the rights of the minority against rules that are unnecessarily unfair or intolerable. For example, even where sacrificing a life may save many more lives, the right to life needs to be treated as part of a set of inalienable rights.

To specify essential conditions for a democratically normal country, one needs to define the list of such rights. The concept of social contract of Rousseau and transcendental rights of Kant form its logical foundations. For our purposes, the list stipulated in the Universal Declaration of Human Rights suffices.⁶

3 Empirical evidence on Russia's institutions

The concept of normalcy implies an overall absence of substantial deviations. In this section, we present an extended account of our free-market and democracy indicators. The account is definitely partial if only for the sake of unmanageability. The choice of indicators is also subjective. Some indicators (e.g. banking development) were not included because their comparison does not elicit any new information. The bulk of data comes from two closely related studies. One is the index of business competitiveness developed by the

⁴ From a speech given by United States Secretary of State, George C. Marshall at Harvard University on June 5, 1947.

⁵ See <http://en.wikipedia.org/wiki/Democracy>

⁶ Rousseau and Kant built on the work of Hobbes and Locke. Among modern works, the concept of the “veil of ignorance” advanced by Rawls (1971) is a sensible, albeit imperfect, guide. It posits that when citizens do not know in advance how their position will differ from the position taken by majority, they will unanimously support a certain set of rights. The Universal Declaration of Human Rights was adopted by the General Assembly of the United Nations on December 10, 1948 and has been ratified by 189 countries, including the OECD members.

World Economic Forum (WEF). The second is the World Bank (WB) economic surveys that estimate the ease of doing business nationally. Because the goals of both projects are limited and underrate the importance of democratic institutions, this study complements the WB and WEF sets with democratic indicators constructed by Polity IV, Amnesty International, and other organizations that monitor democratic institutions worldwide.

A short description of main datasets illustrates their relevance to the current study. The World Bank became interested in the issues of governance in 1990s as the previous emphasis of aid programs aimed at enhancing the productivity of capital and labor in developing countries had delivered meager results. Numerous stories about the embezzlement of assistance funds, local corruption and dire inefficiency of projects' management attracted attention to governance issues. Consequently, the World Bank has developed a program aimed at identification of key components of good governance and working out a systematic approach to their monitoring. It maintains an extensive inventory of governance indicators collected through business surveys.⁷ The WEF has set a similar objective of measuring the quality of business environment, while taking a wider perspective on necessary components of growth. The WEF considers some democratic parameters such as the freedom of press in constructing its competitiveness index. Again, executive surveys represent the main source of information for the WEF. We will see that reliance on survey information is potentially troubling as a "halo effect" tends to bias results. On the other hand, analyzing this effect, which evidences respondents' misperception of issues, provides interesting additional information. For example, Russian respondents show unwarranted pessimism, a finding that supports our inference about high incidence of mistrust in this country. For other datasets, we make extensive use of democratic indicators monitored by Polity IV. These contain detailed information about replacement rules for authorities and levels of public oversight.⁸

We compare Russia with two reference groups. The first group, the G7, is an obvious candidate as Russia struggles to establish its reputation as a full member of this prestigious club. However, the difference in parameters is so stark that such comparison becomes uninformative. Comparison with the other group, the "Big Five" (B5) group of large middle-income countries (Brazil, China, India, Indonesia and South Africa) is more instructive. It allows assessing the validity of Shleifer and Treisman (2004) claim that Russia

⁷ The WB dataset can be searched and downloaded at <http://rui.worldbank.org/>

⁸ See <http://www.cidcm.umd.edu/inscr/polity/>

is a “normal” middle-income capitalist economy. Furthermore, the choice of countries follows the OECD list of “strategic non-members” the organization considers future international heavyweights. An analytical “horse race” provides an opportunity to assess which candidates are most and least likely to increase their political influence in the near future.

3.1 Market structure

The presence of essential physical infrastructure is essential for a favorable market environment. Modern firms rely heavily on physical infrastructure such as transportation facilities, communication networks, and electrical utilities. In this respect, Russians perceive their domestic infrastructure much like people in the B5 countries. Figure 1 shows that the Russians are especially critical about the reliability of electricity supply and telephone services. Transportation networks get higher grades in this country with the quality of railroad services getting the highest relative rank.

The availability of a well-educated, healthy workforce is indispensable for the functioning of most economic sectors. Well-educated, professionally trained workers can produce sophisticated goods with high value-added content. Moreover, the international division of labor rewards countries capable of innovative research and development. In a free market environment, firms fill vacancies through open market and subcontract research projects to scholarly establishments. Figure 2 shows that Russian managers consider the labor market and prospects for research in this country to be relatively good. Other surveys corroborate this result. For example, finding qualified personnel is less of a problem in Russia than in the B5 states.⁹ Russia’s health situation, however, is unsettling, particularly with respect to the disparity in health treatment between the rich and poor. Given that the rich can afford similar treatment in every country, this parameter reveals the relative quality of health services. Other indicators corroborate the poor state of Russian health care.¹⁰ On the other hand, Russia boasts a level of tertiary enrollment comparable with the G7 standard.

⁹ As reported by the World Bank Group in Investment Climate Surveys. Unfortunately, the survey does not cover the G7 countries. See <http://iresearch.worldbank.org/ics/jsp/index.jsp>.

¹⁰ The World Bank (2005b) life expectancy indicator puts Russia (65.7 years) in the middle of the B5 group.

Figure 1. Physical infrastructure. Sources: WEF (2005, all but water and roads) and WBES (2000, water and roads).

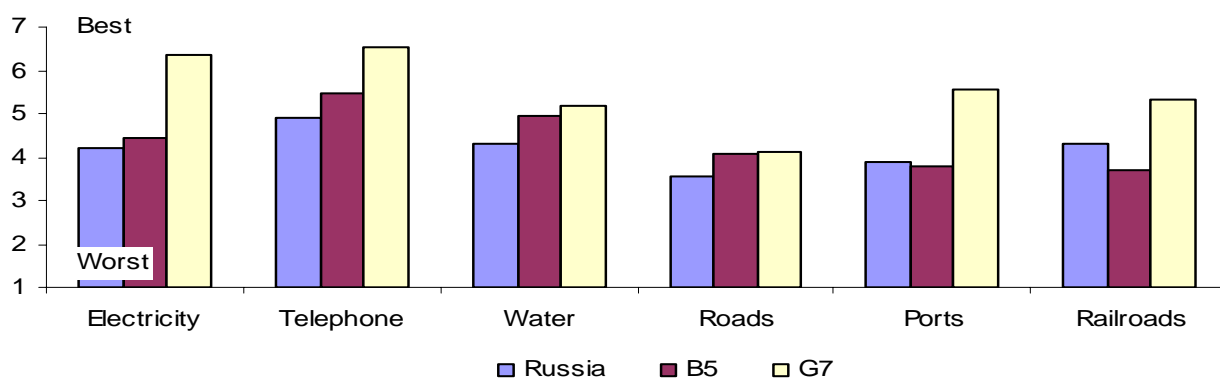
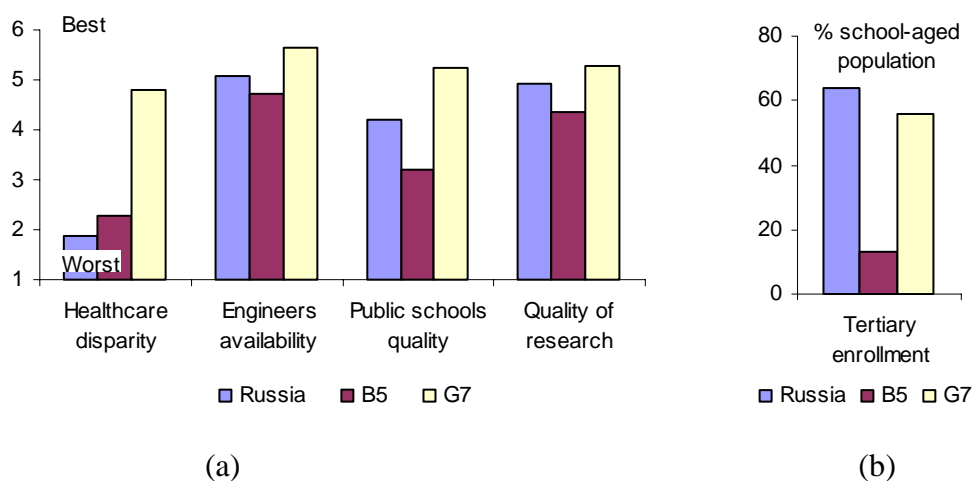


Figure 2. Labor market. Source: WEF (2005).



Robust competition among suppliers and consumer dominance at the marketplace is the third parameter of favorable market environment. Figure 3 shows how companies estimate the price and market power environment in various countries. Russia slightly beats out the B5 countries, but underperforms by the standards of G7 countries.

Figure 3. Market competitiveness. Sources: WEF (2005, monopolism) and WBES (2000, the rest).

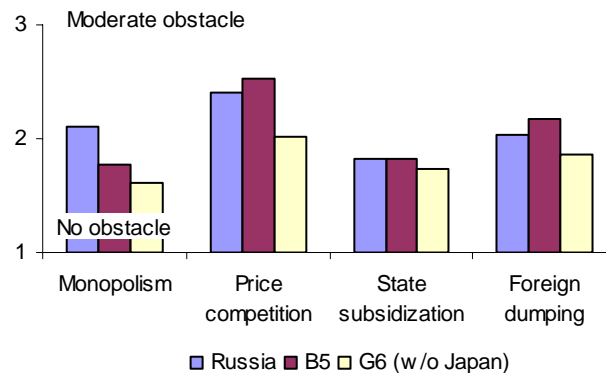


Table 1. Market structure. Equality of means test. The sign of coefficient indicates the direction of the difference. Values in bold are significant at 1%, values in italics – at 5%. Author's calculations.

Area	Subject	Student t-test	Mann-Whitney test	Comparison with the B5
Quality of infrastructure	Electricity	-1.95		somewhat below average
	Telephone	-6.96		
	Water		-8.51	
	Roads		-4.13	
	Ports	<i>2.14</i>		
	Railroads	5.50		
Quality of labor and research	Health care disparity	-3.96		above average
	Research	6.87		
	Public schools	8.22		
	Scientists	5.56		
Market competitiveness	Monopolism	-6.79		somewhat above average
	Price competition		1.20	
	State subsidization		0.74	
	Foreign dumping		0.54	

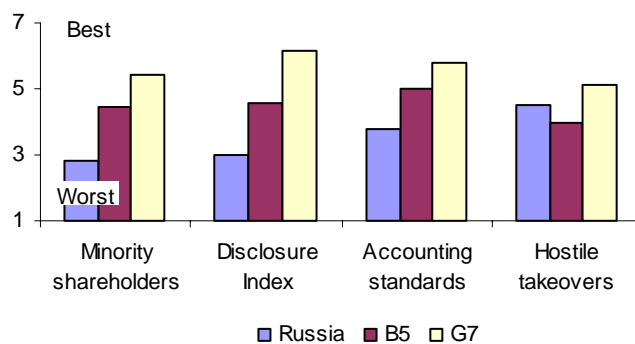
Table 1 summarizes the main findings of this subsection. It contains the results of two tests of the equality of means. First is the Student t-test that assumes the normality of distribution. The other is non-parametric Mann-Whitney rank test that does not require this assumption. The first test applies to aggregate data (WEF, 2005); the second to datasets that contain individual values (WBES, 2000). In general, the evidence presented here suggests that Russia's physical infrastructure is in relatively good shape, the labor market is appealing and competition is present. Because these factors have particular significance for firms contemplating direct investment in Russia, our analysis suggests Russia is an appealing destination for investments from the G7 countries.

3.2 Corporate practices

The compatibility of business practices is another component of market environment. Companies differ in how they protect ownership rights, in their attitudes toward worker training and designing incentive schemes for managers, as well as how they organize technological chains, compete in markets, and retain customers.

Figure 4 shows that Russian firms jealously guard corporate secrets. This leads to an informational scarcity that makes minority shareholders reluctant to invest and banks reluctant to grant credit. With Russian firms' access to external finance restricted, most corporate investment is financed with internal sources of funds. Even so, it would be unfair to assume Russian companies hide information deliberately to cheat hapless investors and bankers. Secrecy is a protective device in a country where property rights are hard to maintain. Indeed, data suggest that Russian firms are more susceptible to hostile takeovers than companies in the B5 group.

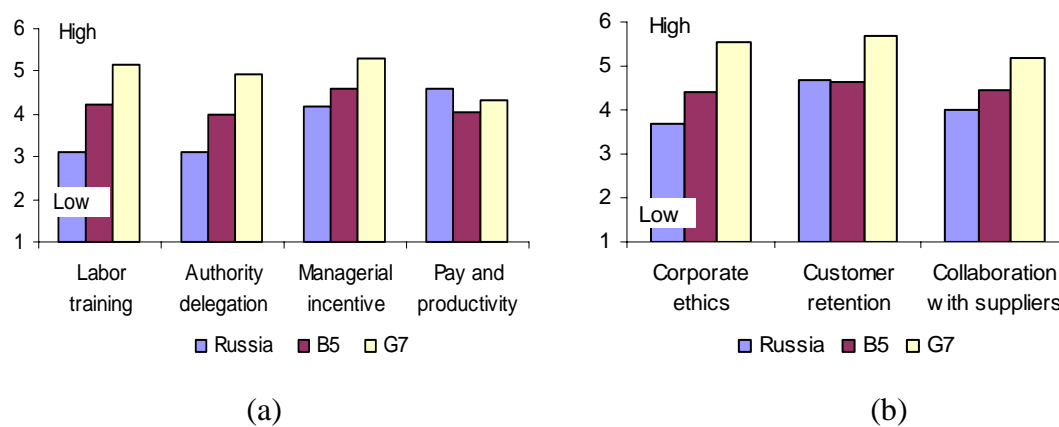
Figure 4. Disclosure and property rights. Source: WEF (2005, all but disclosure index) and World Bank (2005a, disclosure index).



Corporate labor practices determine policies on training and retaining employees, the degree of decentralization expressed in the level of supervision, and the incidence of performance-based compensation. Figure 5a shows that Russian managers prefer closer supervision of workers than their colleagues in other countries. This finding suggests the pattern of mistrust. Similar to the attitude that corporate insiders demonstrate toward outsiders, the high estimate for the pay-and-productivity link implies workers assume part of market risk. Indeed, Russian firms generally face lower firing costs than firms in the B5 group. The lack of attention to labor training borders on open conflict between Russian

managers and workers. The former find that workers get what they deserve, while the latter believe that better performance will not affect their wages.¹¹ Ironically, managers also complain that pay is poorly related to *their* productivity, because compensation of management does not include significant bonuses and stock options in Russia. Thus, the workers' view appears closer to reality.

Figure 5. Corporate (a) labor and (b) client practices.. Source: WEF (2005).



Russian firms' assessment of their cooperativeness, shown in Figure 5b, is in line with their evaluation of market price competitiveness. Data on corporate attitudes toward suppliers and customers indicate that companies in this country opt for limited cooperation. The Russians believe that Russian corporate ethical standards are low, a view that is hardly conducive to cooperative behavior.

Regardless of relative Russian strength in labor, research and physical infrastructure (see Figures 1 and 2), Russia trails behind the B5 group in terms of global penetration. The apparent difficulty that Russian firms experience looking for foreign partners can explain their poor international performance. Russian companies are wary of partners that might renege on contracts or cheat them outright, so long-term connections develop quite slowly. As a result, Russian participation in the global division of labor is limited. This has detrimental effects domestically as suppliers know their customers' dependence and are slow to adapt new technologies.

¹¹ The result of the FOM survey conducted in 2002, 1500 respondents. See http://bd.fom.ru/report/cat/societas/problem_soc/rich_poor/before-tax_contributions_/of023904

Figure 6. Market penetration. Sources: WEF (2005).

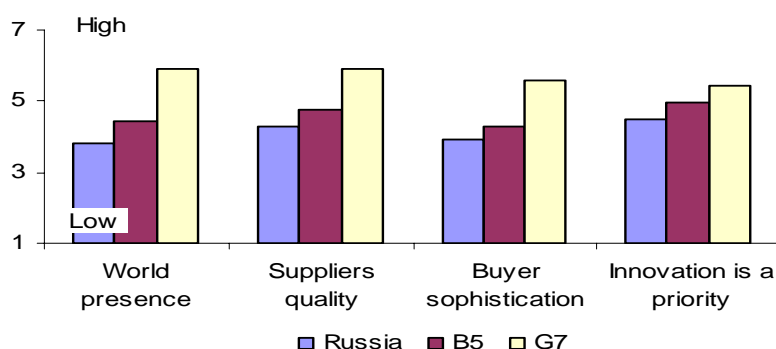


Table 2. Corporate practices. Equality of means test. The sign of coefficient indicates the direction of the difference. Values in bold are significant at 1%. Author's calculations.

Area	Subject	Student t-test	Comparison with the B5
Transparency and ownership rights	Minority shareholders	-13.48	somewhat below average
	Accounting standards	-11.68	
	Hostile takeovers	6.57	
Labor practices	Labor training	-11.00	somewhat below average
	Authority delegation	-7.05	
	Managerial incentive	-1.47	
	Pay and productivity	2.85	
Market practices	Customer retention	0.19	somewhat below average
	Corporate ethics	-7.47	
	Collaboration with suppliers	-6.60	
	Innovation a priority	-6.20	
Market breadth	World presence	-5.62	below average
	Buyer sophistication	-2.97	
	Suppliers' quality	-3.42	

Data in Table 2 confirm that situation with corporate practices is generally bleak in Russia. The differences are particularly stark in the areas of transparency and respect for ownership rights. As we argue in the next section, weak delineation of property rights and corresponding low trust in partners, clients and employees are serious weak points for Russian institutional structures.

3.3 Democracy indicators

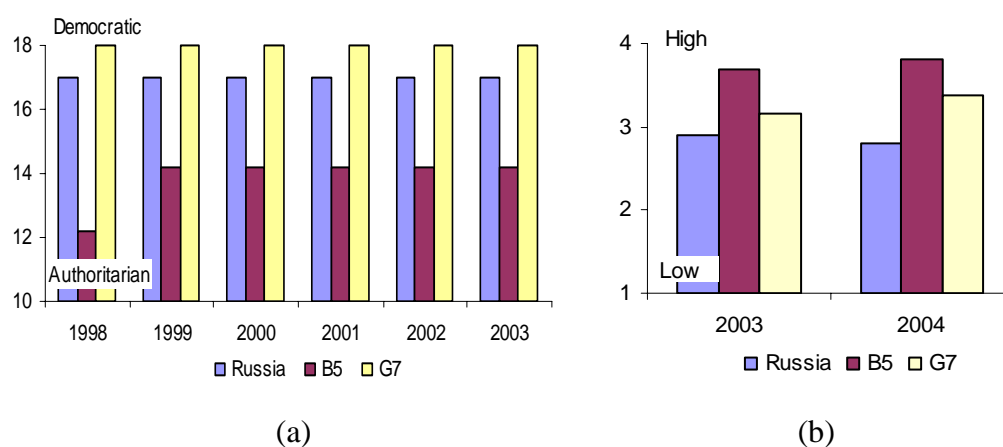
Democratic values represent the third distinct set of standards we consider. The Polity IV Project, which that evaluates democracy as the process of power change and political innovation, divides democratic institutions into three broad categories.¹² The first comprises formal procedures through which citizens exercise their right to choose leaders and express their policy preferences. The second category includes institutionalized constraints that monitoring authorities use to limit executive power. The third combines working mechanisms that guarantee civil liberties. This depiction describes concisely the main elements of democracy. It establishes the existence of such common democratic principles as popular vote, the mechanism of checks and balances used by legislative and judiciary authorities and freedom of the press. In essence, it maps the definition of democracy as a state where the “majority rules and minorities have rights” into a space of measurable concepts. Given that constraints on executive power are not systemically different from defence of civil liberties, the list of parameters collapses to two sets of indicators.

Polity IV defines a democratic process that follows well-established rules, where any citizen can compete for the top position, and where the winner is determined through competition (normally in the form of free elections). The composite of three factors – the existence of rules, competition, and openness of participation – comprises the indicator of executive recruitment presented on Figure 7a. It shows that Russia has similar democratic rules as the G7 average and outperforms the average of B5 group (albeit the gap has been closing in recent years). This indicator does not capture, however, an important aspect of the selection of executive authority. How candidates appear on the ballot matters and the right to file a candidacy does not imply that everyone has equal chances of winning the race. It is reasonable to expect that the chances are higher for candidates with some form of public support. This is the area where Polity IV detects a gap between Russia and the G7 group. Its data suggest that Russian candidates get endorsement from groups organized around regional, not national, interests. This situation is conducive to political fragmentation and discontinuity of political power elite. Consequently, because politicians have to satisfy supporting groups, fragmentation creates favorable conditions for corruption. As a side effect, discontinuity breeds political apathy among citizens. The latter bodes badly for

¹² The project is administered by the Center for International Development and Conflict Management, University of Maryland at College Park (Polity IV, 2002).

the quality of political candidates. The Russians appear to believe that participating in public affairs is not everyone's business. For example, the *Fund Obshchestvennoye Mnenie* (FOM) reports that only 10% of Russians believe they are eligible for elected office and 21% claim that they could not be elected under any circumstances.¹³ Data in Figure 7b further supports the view that Russians are politically passive. Corporate support of volunteerism is weak in Russia. This is important because volunteering is a part of political activism, and leadership in an informal organization is often the first step in a political career.

Figure 7. Electoral process. (a) Index of electoral rules; (b) corporate support of volunteerism.

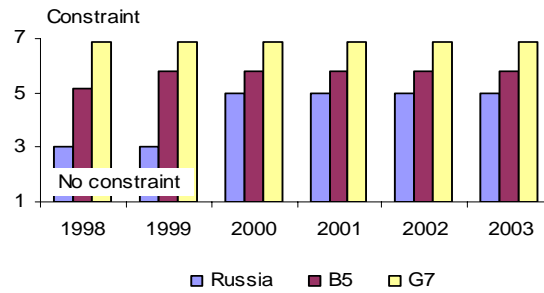


Source: Polity IV (2002, index) and WEF (2004-2005, volunteerism).

The second set of democratic elements deals with the effectiveness of constraints that executive authorities face in their day-to-day operations. There are two reasons for their existence. First, unconstrained leaders are free to substitute agenda entrusted by voters with their personal priorities. Second, an unconstrained majority can instruct executive authorities to mistreat minorities.

¹³ See http://bd.fom.ru/report/cat/societas/problem_soc/chelovek_i_zakon/tb051213. The poll took place on March 19-20, 2005.

Figure 8. Legislative constraint on executive power.

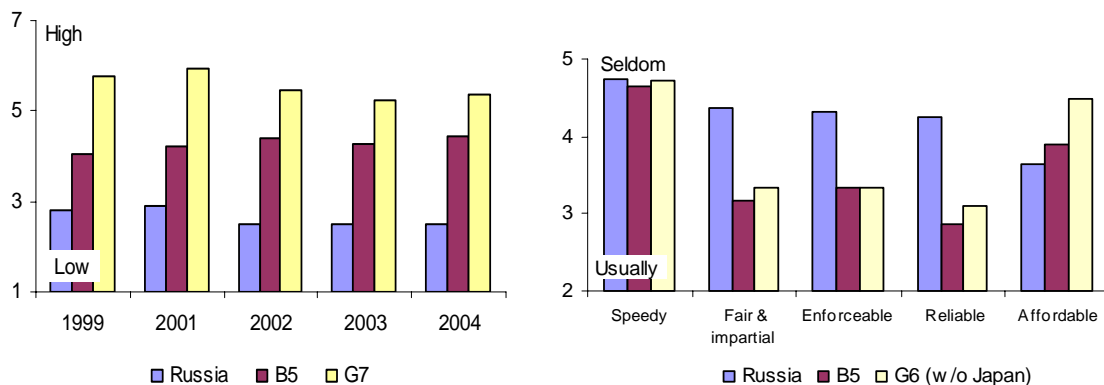


Source: Polity IV (2002)

To prevent abuses of power, democratic nations limit the degree of executive deviation from its mandate through regular audits by the legislative authority. Polity IV estimates the power of accountability groups, such as legislatures, can exercise in dealing with executive power. Figure 8 suggests that the Russian parliament (Duma) has less power than legislatures in other surveyed countries but its authority has increased as President Yeltsin, who often overturned legislative initiatives by the power of decree, stepped down in 1999.

Judicial power can also play a role in promoting executive branch compliance with the law. However, to exercise power, courts have to be independent from political interference. Figure 9a shows that Russian courts are more vulnerable to interference by powerful interests, both public and private, than courts are in the other countries. The FOM survey mentioned above corroborates this finding: 25% of respondents doubted that domestic courts could challenge state officials and only 9% believed they could obtain justice through the Russian legal system. Similarly, Figure 9b shows that Russian courts have the reputation for being unfair, unreliable, and lacking authority.

Figure 9. Judiciary: (a) independence; (b) quality.



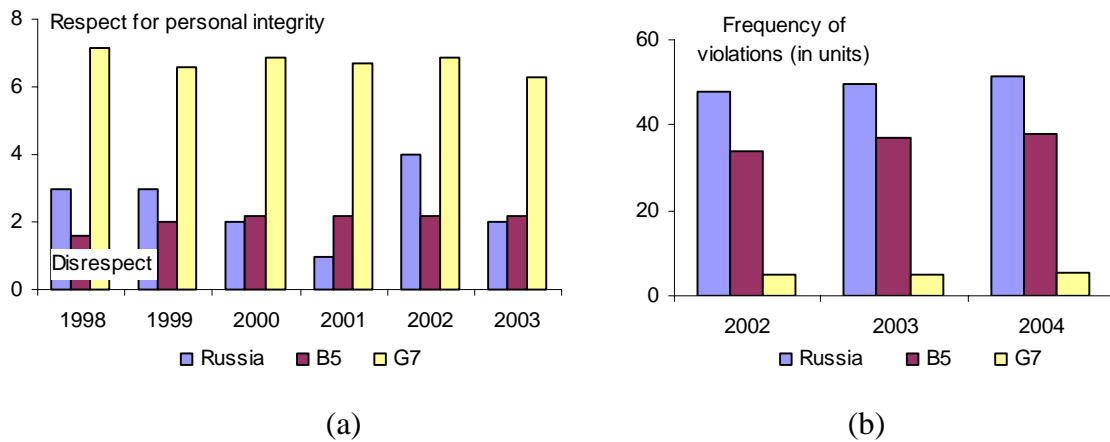
Sources: WEF (2000-2005, variables 8.05 (2000), 6.01 (2002-5)) and WBES (2000, variables FI_CRT, Q_CRT, AFF_CRT, ENF_CRT, CF_CRT).

Apart from indirect evaluation of legal constraints that the executive authorities face, one can evaluate their capacity for being 'liberal' by looking at observance of human rights. Amnesty International (2004) monitors the observance of the Universal Declaration of Human Rights worldwide. Figure 10a shows its evaluation of state protection of the right to life and personal dignity. Consistent with the previous indicators, Russia underperforms relative to other countries. However, the interpretation of this result requires caution. Amnesty International predominantly uses news reports to build its case. Such sampling is unrepresentative, because highly publicized stories affect strongly its estimates. Amnesty International reports e.g. that Russia performs badly in the areas of religious freedom and the freedom of movement. This contradicts several national survey findings.¹⁴ Indeed, closer inspection of the Amnesty International findings reveals much of reported abuse of religious freedom and freedom of movement has to do with events in Chechnya. Public polls on the other hand use countrywide samples. The index of press freedom – constructed by the Reporters without Borders, a non-governmental organization that records presumed acts of state-related intimidation of journalists – is another indicator. It counts cases of violence and impediments to media operations by public agencies. Given that freedom of press makes abusive state policies less likely, this indicator gauges if the executive authorities stay within the limits of their mandate. Figure 10b suggests journalists face greater state intimidation in Russia than elsewhere. Unfortunately, Reporters without Borders use a rather broad interpretation as to what constitutes state intimidation.¹⁵ Its indicator may also be biased in another respect. Reporters without Borders rely on publicized cases – thus presuming some degree of informational openness – and discount cases of self-censorship that media outlets may introduce because of implicit state pressure.

¹⁴ About 32% of respondents consider that they have the right of religious freedom. Another 26% believe they have the right to settle anywhere in the country, while 9% do not believe that they have such right. The poll was taken on June 1, 2004. See <http://bd.fom.ru/report/cat/man/valuable/of042503>.

¹⁵ For example, Reporters without Borders find it suspicious that Russian police assumed the death of a camera operator collecting information about illegal drag racing on May 21, 2005 was the victim of a hit-and-run accident. They suggest the authorities may have been involved in the homicide.

Figure 10. Human rights. (a) Indicator of state respect for human life and personal dignity; (b) Freedom of press index.



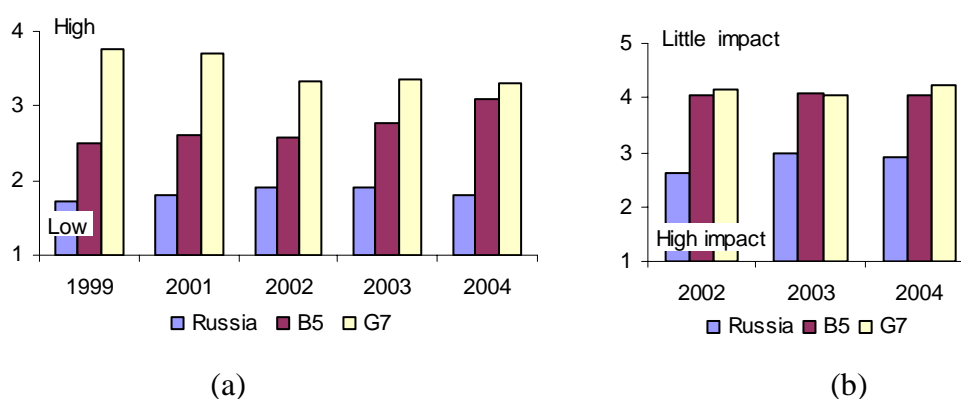
Sources: Amnesty International (2004) and Reporters without Borders (2005).

The perception of personal integrity of politicians is a measure of the moral restraint a society believes its authorities possess. Figure 11 shows that the Russians are more cynical about their leaders than citizens in the B5 and G7 groups. Many Russians believe that the abuse of position for financial gain is rampant. Evidence suggests that politicians gain predominantly for serving private interests. For example, Russian state officials granting contracts and amending regulations in response to requests of well-connected companies is more common in Russia than in other countries.¹⁶ Moreover, the consequences of political donations have had a profound effect in Russia. Notably, the stable dynamics suggest powerful private interests have captured public agencies. A recent Levada Center poll finds that 83% of respondents think that a small group of individuals whom voters cannot control (oligarchy) holds power in Russia.¹⁷

¹⁶ See WEF (2005) data on government favoritism and prevalence of illegal political donations.

¹⁷ See http://www.chslovo.com/include/output_articles.asp?Id=31701. The poll took place on May 13-17, 2005.

Figure 11. Political respect (a) financial honesty of politicians; (b) policy consequences of political donations.



Source: WEF (2000-2005).

Test statistics in Table 3 confirms that Russia performs significantly worse in democratic terms than the average B5 country. Russia appears to be particularly poor at preventing potential abuses of power by the executive authority. The weak performances of judicial and legislature branches of government branches offer little comfort. Interestingly, many Russians believe that big businesses actually wield power, while politicians and public agencies are simply corrupt.

Table 3. Democratic indicators. Test of the equality of means; sign indicates the direction of the difference. Values in bold are significant at 1%. Author's calculations.

Area	Subject	Student t-test	Mann-Whitney test	Comparison with B5
Democratic control	Volunteerism	-11.14		below average
	Judiciary independence	-15.79		
	Freedom of press	-0.27		
	Honesty of politicians	-16.53		
	Effect of political donations	-12.80		
Quality of judiciary	Fair & impartial		-13.86	below average
	Speedy		-1.45	
	Affordable		3.94	
	Enforceable		-11.60	
	Reliable		-15.88	

3.4 Results summary

In section 3, we evaluated Russia's standing using three groups of free-market and democracy indicators. We saw that Russia has a relatively good market infrastructure, indicating that the country should be an attractive destination for FDI compared with other middle-income large countries. On the other hand, Russia fared poorly in other areas. Russian companies employ practices significantly different from G7 standards, implying that Russian firms will experience difficulties searching for foreign partners and attempting to integrate in the world economy, which, in fact, they do. Moreover, poor corporate practices frustrate Russian attempts at economic diversification. Symptomatically, Ahrend and Tompson (2005) find that the current institutional structure preserves the situation, whereby Russia remains reliant on the export of natural resources. Ahrend and Tompson predict this natural-resource dependence will lock it at the bottom of global value-added chain. Particularly troubling is the finding that Russia gets consistently low marks on the issues of democratic control and respect for human rights. The combination of unconstrained bureaucrats and widespread violations creates the impression of an authoritarian state, which, among other things, tarnishes Russia's image.

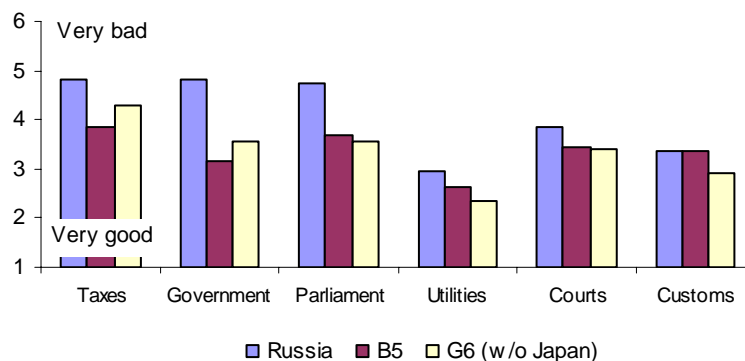
4 Russia's great challenge: Dealing with corruption

The evidence presented provides a rather somber assessment of Russian institutional development. The combination of potentially unethical businesses and executive branch with little outside control is especially alarming. This combination appears to nurture corruption, one of the most severe institutional challenges facing Russia. To suggest policies to confront this problem, we need to understand the driving forces of corruption in Russia. This section provides evidence on its causes and evaluates the prospect that the Putin administration's current policies will lower corruption.

4.1 Private interests of public agencies

Given the previous findings, it comes as no surprise that Russian public agencies operate poorly (see Figure 12). State inefficiency appears to fit well with the pattern of weak democratic oversight mentioned earlier. Arguably, if bureaucrats are free to act arbitrarily, they behave irresponsibly with impunity. Because authorities are not accountable, they pressure businesses to pay bribes. A natural conclusion follows that the Putin administration should curb the discretionary power that bureaucrats exercise over firms in order to contain corruption.¹⁸

Figure 12. Government efficiency.



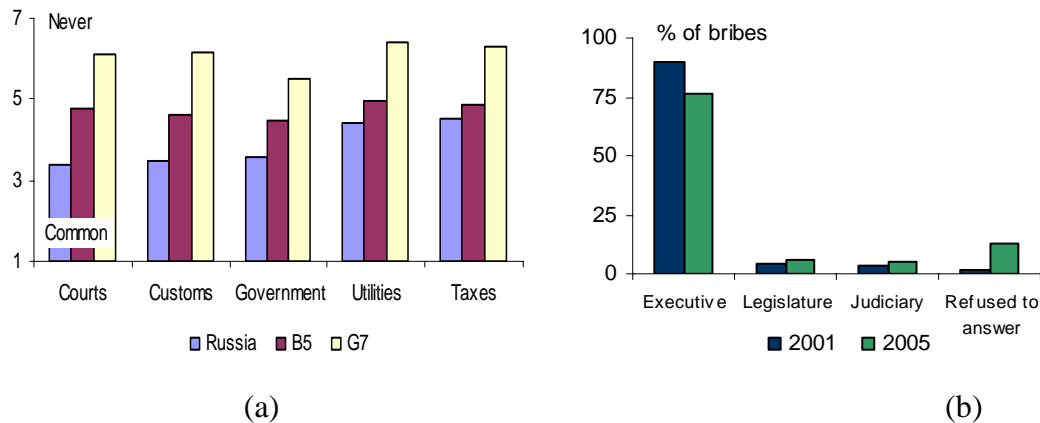
Source: WBES (2000).

As Figure 13a attests, corruption is a common phenomenon in Russia. Its incidence is concentrated with the executive branch of power (see Figure 13b), a result consistent with our earlier finding that the legislature and judiciary have little authority in Russia compared to other democracies. On the other hand, two facts contradict the view that an unrestricted bureaucracy harasses business in Russia. First, data on the ease of regulatory compliance (Figure 14a) suggest that regulatory costs are relatively low. As ease of compliance appears to color evaluation of efficiency, a “halo” effect may be present. Comparison of Figures 12 and 14a shows that firms claim the tax agency is the least efficient and hardest agency to comply with, while the relatively efficient customs agency gets a good score on

¹⁸ Compare this to the OECD’s comments. “Russia ... is a weak state with strong officials. The patronage dispensed by individual officials – particularly those charged with managing state property or large financial flows – can be enormous, while the weakness of the administrative machinery makes it easy for officials to

the ease of compliance. This finding suggests that businesses equate efficiency with the ease of compliance.

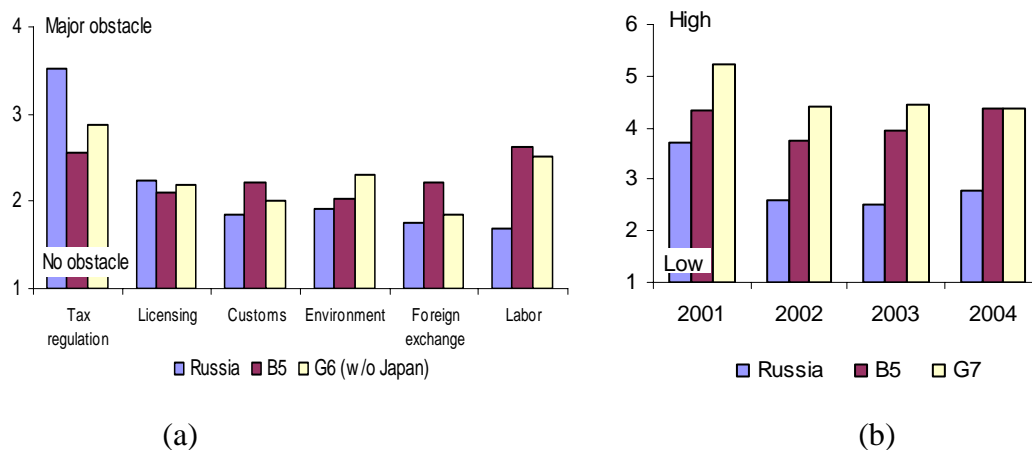
Figure 13. Corruption. (a) Undocumented payments to public agencies; (b) Distribution of payments in bribes.



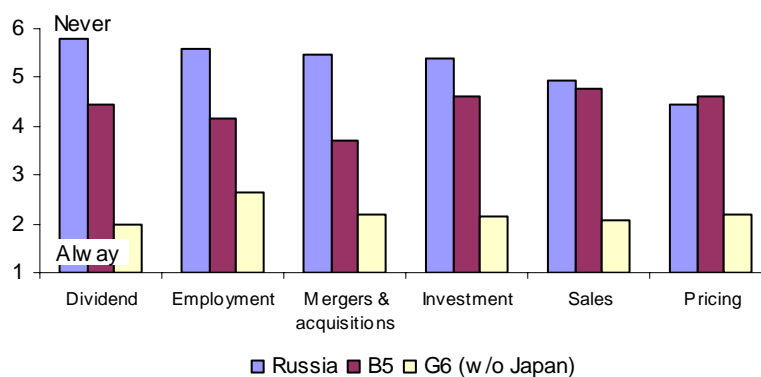
Sources: WEF (2005, public agencies) and INDEM (2005, distribution).

The next finding is quite striking. Data on the level of corruption and ease of compliance (Figures 13 and 14a) show that the highly corrupt customs agency is seen the easiest to deal with. Russian firms are evidently active participants in corruption, not its mere victims.

Figure 14. Government-business relationship. (a) Ease of compliance; (b) Transparency of regulatory changes; (c) Government interference in commercial decisions



use that power to pursue narrow private or political ends.” From *Russia: Building rules for the market* (OECD, 2005:46).



(c)

Sources: WBES (2000) and WEF (2002 – 2005, variable 6.07).

Russian companies are also more assertive in making sure they get what they paid their bribes for than firms elsewhere.¹⁹ Given that corporate ethics are low anyway, it appears many firms see corruption as a convenient tool for circumventing regulations. Paradoxically, numerous complaints about regulatory uncertainty (Figure 14b) do not imply that Russian public agencies are highly intrusive in business affairs. On the contrary, the level of state interference is minimal in Russia (Figure 14c). These observations suggest that bureaucrats are not as powerful as they appear. In fact, they may simply be in the business of selling public interests to the highest private bidder.

4.2 Coalition building and breaking: Russia's policy options

In devising policy for curbing corruption in Russia, it is necessary to understand the emergence of private groups with links to public agencies. Three causes are obvious. First, following the collapse of collectivist ideals Russians had lost moral guidance. Many plunged in the abyss of abject poverty but few had found tremendous opportunities for enrichment by preying on the state. The explosive combination of great opportunities, survival mode of living and weak moral constraints created the impression that dirty tricks – reneging on contracts or cheating customers and partners – were justifiable if not outright respectable as “true” capitalist practices. Consequently, the number of conflicts surged but legal adjudication did not take place because of underdeveloped institute of independent courts that

¹⁹ See WBES (2000). Things appear to be changing as Russians are now less convinced that bribery delivers the desired results (WEF, 2003, variable 7.09).

was absent in the Soviet system of power. As a result, many conflicts were left unresolved or resolved by extra-legal means. Poor conflict resolution increased caution with which Russian residents started to deal with strangers. Organizing coalitions was a method to get an upper hand over rivals in treacherous post-Soviet environment.

Second, the diminishing authority of vertical administration corrupted institutions of power. Bureaucrats realized that serving the state was less advantageous than working for private interests. Many switched sides, becoming “servants of the state” in name only. Mature democracies resolve this problem of potential power abuse, common in decentralized states, by maintaining delicate systems of checks and balances. Young democracies often lack such systems and suffer corruption as a result (see, e.g. Keefer, 2005).

Third, Russia’s approach to privatization provided substance to the “get-rich-quick” formula that for many became associated with the notion of capitalism. It entailed a massive redistribution of state property that gave rise to private entities with strong ties to public agencies. Recall that privatization in Russia consisted of two distinct phases. In the first, insiders (managers and workers) realized the option of acquiring small and medium-sized enterprises. Many of such firms were major employers that formed the basis of social life in their cities. Because regional authorities depended on tax revenue generated by large local taxpayers, they were eager to accommodate their interests. Regional bureaucrats are under weaker public oversight and can better pursue their private interests coalescing with owners of local firms. The second phase involved the divestiture of Russia’s most valuable companies, particularly in the natural resource sectors, through rigged privatization deals. The “loans-for-shares” privatization scheme is the prime example of how a small group (oligarchs) managed to get hold of Russia’s blue-chip assets. The oligarchs acquired control over large cash flows and formed alliances with top bureaucrats. The bureaucrats, in turn, sided with private interests responding to the changes in money flows that moved outside of state budget. The lobbying of rival coalitions for regulatory changes has now given rise to regulatory uncertainty.

Thus, breaking the link between private interests and public agencies would appear to be the first logical step that the Putin administration needs to take to diminish corruption. Interestingly, market forces already seem to be causing a cleanup of corporate practices (see Table 4). Nevertheless, the stability of corruption indicators suggests that Russia may have settled at a suboptimal institutional equilibrium in its bureaucratic preferences. Therefore, the Putin administration needs to provide incentive to bureaucracy to switch

sides and start serving the state again. One potential policy would be to increase state centralization and bring money flows under state control through re-nationalization of the corporations run by oligarchs.

Table 4. Historical changes in the quality of Russian institutions.

Parameter	2001	2002	2003	2004
Positive trends				
<i>Quality of market: World presence</i>	3.6	3.2	3.4	3.8
<i>Corporate practices: Minority shareholders</i>			2.6	2.8
<i>Corporate practices: Accounting standards</i>		3.4	3.6	3.8
<i>Corporate practices: Managerial incentive</i>	3.3	3.3	3.6	4.2
<i>Market practices: Customer retention</i>	4.2	4.3	4.4	4.7
<i>Market practices: Corporate ethics</i>		3.2	3.4	3.7
Negative trends				
<i>Corruption: Courts</i>		3.6	3.4	3.4
<i>Corruption: Customs</i>	3.8	3.8	3.5	3.5
<i>Corruption: Procurement</i>	4.6	3.8	3.4	3.4
<i>Government efficiency: Favoritism</i>	3.7	2.6	2.5	2.5

Source: WEF (2000-5).

Indeed, the Putin administration appears to be exploring this policy in all but name with a two-prong strategy. First, at the regional level, where privatization has contributed to the development of local groups that interfere in regional public affairs pursuing private interests, the Putin administration has succeeded in establishing central control over regional governors by changing the rules of their selection. By making regional bureaucracy accountable to the center, Moscow has effectively broken local coalitions. Second, it has used partial re-nationalization of large corporations (the Yukos case, and more recently Sibneft) to increase state control over the cash-rich oil sector. These actions are likely to decrease the incidence of corruption. When local branches of power are accountable to the center, they are less likely to grant favors to regional economic heavyweights. Greater state control over cash-rich corporations increases the bureaucratic payoff for serving the state. It secures the financial position of bureaucrats who perceive greater income stability and, consequently, are less likely to risk losing it for a bribe.²⁰

There is a real danger that the current process of centralization and partial re-nationalization will not break current private-public coalitions, but merely rearrange coalitions.

²⁰ The risk premium on bribery may increase. INDEM (2005), for example, finds that while firms are less likely to offer a bribe today than four years ago, the average bribe size has grown thirteen times. Respondents were also more cautious about answering questions.

tion rankings. Using the re-nationalizing of corporations as a means limit corruption may give politicians incentive to expand the list of companies for various private reasons.²¹ Second, greater state power could fuel the tendency to authoritarianism. On the other hand, incumbents facing disenfranchisement could be motivated to influence the voting process to protect themselves.²²

Consider now this list of negative consequences in light of the general mistrust of Russian voters toward their leaders. Most Russians believe power resides with a small clique beyond their control. Voters need first to trust executive authority before the state attempts centralization and re-nationalization.

Indeed, the data suggest Russians are more mistrusting than people are in other surveyed countries. It suffices to look at costs strangers pay to obtain credit. Russian banks set high collateral requirements. It costs as much as 11.6 % of income per capita to create collateral in Russia compared with 7.5 % in the B5 group. Predictably, G7 banks charge the least for collateral, 1 % (see World Bank, 2005a).

Evidence of distrust abounds. Figure 5a brought out the reluctance of Russian managers to trust workers, even when they otherwise have a high opinion of their expertise. Russian firms also disclose less information about their performance (Figure 4), which indicates a, perhaps well-founded, mistrust towards outsiders. Company contacts are limited to “trusted” suppliers.²³

Two conditions are especially troubling. First, the process of democratization languishes amid the widely held perception that politicians lack financial honesty (Figure 11a); there are no political dividends to pushing one’s image as an honest politician.²⁴ Sec-

²¹ The travails of the bill listing “strategic sector” (a euphemism for re-nationalization) companies that has been stalled in the Duma is indicative of such dynamics. A potential solution to the problem of power struggle for economic control is to limit the list to companies controlled by Russian *nouveau riches* that were involved in “loans-for-shares” privatization deals. According to Klebnikov’s (2004) account, a Russian oligarch is typically a man who has accrued his wealth through natural resource companies and banking. This wealth came largely as the fruit of rigged privatization deals and financing of government deficits in 1990s. The link between private fortunes and poor state management suggests a close association between private firms and the personal interests of public servants.

²² This problem may be mitigated by the fact that non-elected bureaucracy will resist electoral fraud if they feel social stability is needed to maintain the level of state spending.

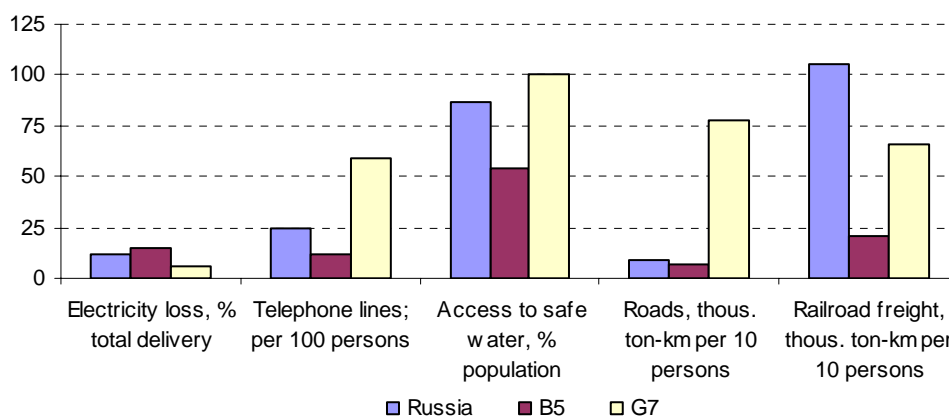
²³ For example, Johnson et al (1999, Table 2) report that only 1.4% of Russian firms were ready to replace their suppliers, compared to over 40% of firms in Slovakia, Poland, and Romania when new suppliers offer better prices.

²⁴ Distrust of the political process may not be as bad as many Russians believe. An FOM survey (conducted July 14, 2005), for example, reports that while 51% of respondents thought that the results of parliamentary elections in 2007 would not reflect popular choice, only 20% felt they should boycott the elections. The Russian tendency to strong expression does not necessarily result in action.

ond, lack of trust in the ability of Russia’s judicial system to deliver cognitively fair, consistent judgments (see Figure 9b) hinders development of the legal system.

The above-mentioned negative “halo effect” can be seen, for example, in the gloomy assessments Russians make of their country’s physical infrastructure (Figure 1). They simply do not match the data on comparative infrastructure development (Figure 15). Russian excess pessimism is further manifest in evaluating electrical power system reliability, availability of telephone lines, and access to safe water. While Russia beats out the B5 group in all these categories, respondents discounted reality on the expectation that something would go wrong anyway. Perceptions also did not match actual data on the efficiency of public agencies. Finally, while Russian firms strongly condemned regulatory practices and the judicial system (Figures 12 and 9b), the outrage did not appear to match the data on business time and money actually spent on complying with regulations or adjudicating conflicts (Table 5). It would appear a basic mistrust colors the views of Russian respondents.

Figure 15. Data on electric power transmission and distribution losses, goods hauled by railways and roads, telephone mainlines, improved water access.



Sources: World Bank (2005b).

Table 5. Costs of doing business, in time and money.

	Starting a business (days)	Registering property (days)	Enforcing contracts (days)	Cost of enforcing contracts (% of debt)	Recovery rate in bankruptcy (% of debt)
Russia	36.0	37.0	330	20.3	48.4
B5	94.2	38.8	416	44.4	18.1
G7	17.6	45.4	370	11.9	68.0

Sources: World Bank (2005a).

To raise the legitimacy of the political process in Russia, trust-building measures must complement the current centralization policy and politicians need to stay committed to set policies. Recall that politicians in young democracies lack incentive to build reputations for honesty as it brings no political dividends. Party membership provides a certain level of commitment, however, because it serves as a “trademark” of assured continuity. The Putin administration appears to understand this. It has introduced political reform to raise the profile of parties in elected bodies, while divorcing parties from corporate sponsorship. The new system of proportional representation in the Duma favors party membership. Independent candidates, often with shadowy financial backing, now face diminished chances of getting elected. Their only resort may be to submit to party discipline. While corporations currently provide the bulk of party funds, the political reform envisages public sponsorship of successful parties as is common in developed democracies. Dependence on corporate donations has eroded the political credibility of parties because business donors are quick to solicit favors. Figure 14c attests to the significant impact of political donations on Russian policymaking. Change the source of financing from private to public sponsorship frees parties from obligations to corporate sponsors.

The Putin administration appears to understand the pitfalls of public mistrust as it experiments with ways to increase public oversight. The creation of the Public Chamber is a case in point. Although there is little evidence the idea will work, it is an attempt in principle to replicate the work of the Duma in a different form. The same applies to public financing of non-governmental organizations (NGOs). NGOs are widely seen as incubators of future political leaders and their public support gives prospective politicians a welcome opportunity to develop management qualities. Funding NGOs, therefore, could increase the level of trust that Russian citizens have toward the political structure. Of course, without much of a track record, it can very well be that the current political activism of the Putin administration will backfire. The active use of political technologies can be abusive and the executive authorities that oversee disbursement of public funds can easily corrupt and discredit such non-representative bodies. In the end, the Putin administration seems to see no better option than attempting to promote public trust through administrative measures.

5 Conclusions

The current paper had three overarching goals. First, it provided an assessment of the level of Russian institutional development relative to the G7 countries, i.e. countries that exemplify “normalcy” in the Western sense. Second, we compared the attractiveness of Russia to Western firms relative to the market conditions found in the large middle-income countries (Brazil, China, India, Indonesia, and South Africa). Third, we analyzed a list of Russian institutional weaknesses and considered how and whether current government policies can improve the situation.

Our findings showed Russia underperforming relative to G7 standards in virtually every category. This result underscores the weakness of Russia’s claim to full membership in a club of the world’s economic elite. Perhaps more surprisingly, Russia seems to compare poorly with the B5 group. This finding appears to explain why Russia attracts less of foreign direct investment and has been less successful in penetrating world economy than, say, China or India. Russia also received poor grades on its democratic institutions – a particularly worrisome sign that bodes for a reversion to authoritarianism. However, it should be noted that lack of democratic institutions has not deterred investment e.g. into China.

On the other hand, current policies provide grounds for optimism. The Putin administration appears to have correctly identified corruption and mistrust as major institutional problems. While the government’s policy options are limited, it appears the level of corruption has stabilized in the face of the government’s proactive stance. Nevertheless, the current centralization attempt, intended in part to diminish regional corruption, risks increasing competition among powerful groups for central executive control. To prevent a power struggle from spilling beyond legal bounds, the Putin administration needs to create conditions conducive to civilized political competition through political reforms that increase the importance and financial independence of political parties. Apart from enhancing the status of parties, the government has introduced measures that may or may not raise public trust in domestic political process. These include the recent creation of the Public Chamber and public financing of non-governmental organizations. Most important perhaps is that such reforms ultimately increase the level of public oversight and the quality of political debate.

The paper offered three technical innovations. First, building on indicators listed in OECD (2004), we formalized the concept of free market economy and democracy, which

constitutes a contribution to the literature on cross-country comparison of institutions. Second, we presented a consistent review of institutional indicators, which, unlike earlier studies in the area, focused on comparing a subset of countries similar to Russia in terms of size and income per capita. Here, we followed the line of research advanced by Shleifer and Treisman (2004). Contrary to their findings, however, we must conclude that Russia is not a normal country by the standards of its peers. The use of different reference groups explains the distinction between two works. Third, the paper has shown that Russia performs worse in the areas that involve trust-building measures such as the judicial process, corporate practices and efficiency of public services. Touching briefly on the issue of causality, we note the hardly surprising finding that powerful private interests are the prime source of corruption in Russia.

References

- Ahrend, Rudiger and William Tompson (2005), "Russian Institutions and Possible Development Plans," manuscript.
- Amnesty International (2004), *The Cingranelli and Richards (CIRI) Human Rights Dataset*, <http://www.humanrightsdata.com>
- Aune, James (2001), *Selling the Free Market: The Rhetoric of Economic Correctness*, N.Y.: Guilford Press.
- Barro, Robert J. (1996), "Democracy and Growth," *Journal of Economic Growth* 1, 1:1-27 March
- Besley, Timothy and Stephen Coate (1998), "Sources of Inefficiency in a Representative Democracy: A Dynamic Analysis," *American Economic Review*, 88(1): 139-56, March
- Heritage Foundation (2005), *The Index of Economic Freedom*, Washington, D.C.
- INDEM (2005), *Biznes i korruptzija: Problemy vzaimodeystviya* (Business and corruption: The problems of interaction), Moscow, <http://www.anti-corr.ru/cipebc.shtm>
- Johnson, Simon, John McMillan, and Christopher Woodruff (1999), "Contract Enforcement in Transition," manuscript.
- Keefer, Philip (2005), "Democratization and clientelism: Why are young democracies badly governed?" *World Bank Working Paper WPS3594*, Washington, D.C., May
- Klebnikov, Paul (2004), "Special Report: The 100 Richest Russians," *Forbes*, July 23, <http://www.forbes.com/lists/2004/07/14/04russialand.html>
- OECD (2004), *OECD Strategy for Membership Enlargement, Report by the Chair of the Heads of Delegation Working Group on the Enlargement Strategy and Outreach*, Paris.
- Polity IV (2002), *Political Regime Characteristics and Transitions, 1800-2002 Dataset Users' Manual*, University of Maryland, College Park, <http://www.cidcm.umd.edu/inscr/polity>
- Rawls, John (1971), *Theory of Justice*, Cambridge, MA: Harvard Press.
- Reporters without Borders (2005), *Third Annual Worldwide Press Freedom Index*, http://www.rsf.org/article.php3?id_article=11715
- Rosefielde, Stephen (2004), "An abnormal country," *BOFIT Discussion Papers* 15, Finland.

-
- Sen, Amartya (1999), "Democracy as a Universal Value," *Journal of Democracy*, 10(3): 3-17
- Shleifer, Andrei and Daniel Treisman (2004), "A Normal Country," *Foreign Affairs*, 30 March
- The World Bank Group (2000), *The World Business Environment Survey*, <http://www.ifc.org/ifcext/economics.nsf/content/IC-WBESConditions>
- World Bank (2005a), *Private Sector Development: Doing Business and Investment Climate*, database with methodological notes, <http://rru.worldbank.org/DoingBusiness/>
- World Bank (2005b). *World Development Indicators*, Washington, D.C.
- World Economic Forum (2005), *The Global Competitiveness Report 2004-2005* (also previous issues for 2000, 2002, 2003 and 2004), Ne

- 2004**
- No 10 Yuko Kinoshita and Nauro F. Campos: Estimating the determinants of foreign direct investment inflows: How important are sampling and omitted variable biases?
 - No 11 Akram Esanov, Christian Merkl, Lúcio Vinhas de Souza: Monetary policy rules for Russia. *Published in: Journal of Comparative Economics vol 33, no 3 (2005) pp. 484-499. ISSN 0147-5967.*
 - No 12 Greetje M.M. Everaert: The political economy of restructuring and subsidisation: An international perspective
 - No 13 Igor Vetlov: The Lithuanian block of the ECSB multi-country model
 - No 14 Michael Funke and Jörgen Rahn: Just how undervalued is the Chinese renminbi. *Published in: World Economy vol. 28, no 4 (2005) pp. 465-489. ISSN: 0378-5920.*
 - No 15 Steven Rosefielde: An abnormal country. *Published in: The European Journal of Comparative Economics vol. 2, no 1 (2005) pp. 3-16. ISSN: 1824-2979.*
 - No 16 Juha-Pekka Koskinen, Tuuli Koivu and Abdur Chowdhury: Selecting inflation indicators under an inflation targeting regime: Evidence from the MCL method
 - No 17 Anna Dorbec: Liquidity provision in transition economy: the lessons from Russia
 - No 18 Iikka Korhonen: Does democracy cure a resource curse?
 - No 19 Bernadina Algieri: Trade specialisation patterns: The case of Russia
 - No 20 Jarko Fidrmuc and Iikka Korhonen: A meta-analysis of business cycle correlation between the euro area and CEECs: What do we know—and who cares?
 - No 21 Anatoly Peresetsky, Alexander Karminsky and Sergei Golovan: Probability of default models of Russian banks.
 - No 22 John Bonin and Paul Wachtel: Dealing with financial fragility in transition economies.
- 2005**
- No 1 Pertti Haaparanta and Jukka Pirttilä: Reforms and Confidence
 - No 2 Paul Wachtel and Iikka Korhonen: A note on exchange rate pass-through in CIS countries. *Published in: Research in International Business and Finance (2005), ISSN 0275-5319. (Forthcoming.)*
 - No 3 Balázs Égert: Equilibrium exchange rates in Southeastern Europe, Russia, Ukraine and Turkey: healthy or (Dutch) diseased? *Published in: Economic Systems vol. 29, no 2 (2005) pp. 123-282. ISSN: 0939-3625.*
 - No 4 Balázs Égert and László Halpern: Equilibrium exchange rates in Central and Eastern Europe: A meta-regression analysis
 - No 5 Pingfang Zhu, Lei Li and Nannan Lundin: S&T activities and firm performance- microeconomic evidence from manufacturing in Shanghai
 - No 6 Michael Funke: Inflation in mainland China – modelling a roller coaster ride
 - No 7 Sophie Claeys: Optimal regulatory design for the central bank of Russia
 - No 8 Balázs Égert and Amalia Morales-Zumaquero: Exchange rate regimes, foreign exchange volatility and export performance in Central and Eastern Europe: Just another blur project?
 - No 9 Stanislav Anatolyev: A ten-year retrospective of the behavior of Russian stock returns
 - No 10 Sophie Claeys, Gleb Lanine and Koen Schoors: Bank supervision Russian style: Rules versus enforcement and tacit objectives
 - No 11 Bruno Merlevede and Koen Schoors: On the speed of economic reform: Tale of the tortoise and the hare
 - No 12 Brian M. Lucey and Svitlana Voronkova: Russian equity market linkages before and after the 1998 crisis: Evidence from time-varying and stochastic cointegration tests
 - No 13 Eugenio Proto: Growth expectations and banking system fragility in developing economies.
 - No 14 Gang Ji: Cross listing and firm value- corporate governance or market segmentation? An empirical study of the chinese stock market.
 - No 15 Anna Dorbec: Choice of the substitution currency in Russia: How to explain the dollar's dominance?
 - No 16 Vlad Ivanenko: Markets and democracy in Russia.

Bank of Finland
BOFIT – Institute for Economies in Transition
PO Box 160
FIN-00101 Helsinki

 + 358 10 831 2268
bofit@bof.fi
<http://www.bof.fi/bofit>