Governance and the Russian Economy

PHILIP HANSON

In his article on fragmentation of authority, Vladimir Brovkin reviews the general character of government and property relations in contemporary Russia and draws some strong conclusions. If his conclusions are correct, the prospects for the Russian economy are poor. In this note, I shall review some of the governance issues that bear on Russian economic prospects and offer not a Panglossian view that all will be well, but an assessment of what developments in the practice of government, corporate governance, and property rights would improve economic prospects. These developments are in my judgment possible, but they are by no means certain to occur in the next few years. The main point I want to make is that national and corporate governance are indeed weak in Russia, and property rights still are dangerously blurred, but the situation is not static. Changes are going on, many of them favorable to future economic growth.

The Bleak View of Government and Governance in Russia

After reviewing a wide range of developments in Yeltsin's Russia, Brovkin arrives at the following conclusions (which I paraphrase):

1. The process of government in Russia is little more than a power struggle among "criminal-corporatist clans." State agencies are in reality the fiefdoms of particular clans.
2. The agencies responsible for law, order, and tax collection are ill-paid and corrupt.
3. The property rights that firms have over assets are not secure, in part because they are conditional on protection from particular allies who hold political office. Changes in government could strip "owners" of particular assets overnight.

Philip Hanson is professor of the political economy of Russia and Eastern Europe at the University of Birmingham, UK. He is the author of books and articles on Soviet, Russian, and Central-East European economies and is currently working on regional differences in economic adjustment in Russia. Some of the work described here was supported by the UK Economic and Social Research Council, grant no. R000236398.

4. The above is true at the provincial level, as well as at the national level. In addition, provincial elites can and do set the rules of the economic game in their own regions.
5. The fact that Russia now has private property is no guarantee that the polity will be properly democratic.
6. The current political and social cleavage in Russia is not between reformers and traditionalists but between those who succeeded in grabbing assets when the old system broke up and those who did not.

This depiction of the state of affairs in Russia near the end of the second millennium is recognizable. It is one with which many people, not only those in the Russian intelligentsia, seem to agree. The grounds I have given elsewhere for being doubtful about a "coming Russian boom" pertain quite clearly to a country that could be described in this way.[1] Nonetheless, the list of conclusions given above is in my view unsatisfactory, for two reasons.

First, several of these statements do not tell us much about Russia unless comparisons with other countries are brought into the picture. For example, the most that has been claimed by Hayek, Friedman, and others in the liberal tradition is that capitalism is a necessary condition of democracy—not that it is a sufficient condition. In the face of the evidence, it would in any case have been foolish to claim any more. Market economies and authoritarian polities have coexisted in a number of countries: Salazar's Portugal, Franco's Spain, South Korea for much of the postwar period, and so on. Public service is generally worse paid than work in the private sector in almost all countries; the evidence is that such income disparities are not a guarantee of corruption.[2] And it is perhaps universally the case that politicians in office are beholden to some interest or business group to which they will tailor legislation: in Britain, the current government's disinclination to apply strong limits on media ownership to the Murdoch group seems to be an example. What's new about Russia?

In common with many other countries, including all of the other members of the Commonwealth of Independent States (CIS), Russia has a high level of corruption and ineffective state regulation. Its citizens' property rights, along with the property rights of nonresidents who invest in Russia, are in too many respects unclear or, when clear, not reliably defensible. But these characteristics are not immutable.

This brings us to the second ground for resisting this list of very strong conclusions: The situation is not static. The institutionalization and predictability of government are probably increasing. The institutional arrangements for corporate governance lately have been strengthened, and that entails some strengthening of property rights. The changes may or may not be proceeding fast enough to facilitate strong economic recovery and growth over the next ten to twenty years.[3] That is extremely hard to assess. But there are changes going on that are worth examining.

In this spirit, I shall look briefly and selectively at some changes in two areas, linked to conclusions 3 and 4 above: property rights and corporate governance, and the power of regional leaders to set local rules of the economic game, and thus to impede the reestablishment of a single economic space in Russia.[4]

Property Rights and Corporate Governance

One of the simplest indications of the unsatisfactory state of property rights in Russia has been the outflow of capital that has been observed from at least 1991 through 1996. It is often suggested that this is an outflow of illegally acquired wealth, and the illegal acquisition of that wealth is enough to account for the scale and duration of capital flight. But the basis of many, perhaps most, Russian fortunes was laid during 1990–93, when economic controls were still partly in place, the legality of many transactions was unclear, and opportunities for siphoning state assets into private hands and arbitraging between controlled and free prices were great. There could be little realistic prospect, in any country, of a public investigation that sought to unravel all of those deals and return wealth to some identifiable "rightful" owner.

What is probably more to the point is that successful Russian businesspeople (some of them from the old nomenklatura, some not) have had little reason to believe that personal and company assets were safe in Russia; their claims on property might be arbitrarily overturned by a new political regime or by the fall of one particular political protector. Bank accounts, real estate, and stakes in businesses were safer offshore. The methods by which much of the capital is transferred are often (not always) illegal; but that is another matter. It is the insecurity of property rights in Russia that has probably driven the gross outflow of capital.

For the same reasons, there has been a reluctance on the part of foreigners to invest in Russia. Public funds (International Monetary Fund, World Bank, European Bank of Reconstruction and Development loans, bilateral credits from Western governments, and so forth) came in in quite large quantities and were indeed augmented by modest amounts of private sector investment; but there was a net outflow of capital for much of the 1990s.[5]

If this interpretation of capital flight is broadly correct, then the evidence that net capital flows went into reverse in 1997 is encouraging. It suggests that political and institutional hindrances to the exercise of property rights may have been reduced. In the first three quarters of 1997 it appears that there was a net capital inflow (of the order of $4.4 billion) for the first time over any substantial period in the 1990s.[6] Advocates of market reform must, if they are consistent, believe that by and large and most of the time, active participants in markets make the best use possible of the available information that is relevant to their activities. Therefore, a shift from a net outflow to a net inflow of capital should be greeted by liberals as a better indication of the direction of change in property rights in Russia than any observations by academic onlookers like me.

This is not to argue that property rights are becoming well defined in Russia. That depends on both legislation and the implementation of that legislation. Neither is satisfactory, but it is probably now implementation that is the main problem.

Even on paper, however, there are still some large problems, two of which concern property rights in land and the rights of the creditors of insolvent entities.

Notoriously, the legislation needed to allow a functioning land market is still lacking. That is a major inhibitor of bank lending to the real economy. New legislation on bankruptcy (effective from 1 March 1998) may give more protection to creditors and inhibit asset-stripping by managers, but it still allows for a great deal of discretionary intervention by regional or local government to prevent "city-forming" enterprises from being closed down outright and their assets sold off to reimburse at least some creditors. It is characteristic of the contemporary political economy of Russia that some protection (under external management) is provided for locally important enterprises.[7]

In many other areas, however, it is implementation of legislation that has been most worrying. Major deterrents to investment—not only by foreigners but by anyone—have been the lack of transparency in financial reporting by publicly quoted companies, the lack of an accessible public record of shareholdings and of properly maintained shareholder registers, and the frequent disregard of the rights of minority shareholders. These may seem merely narrow, technical concerns. In fact, a great deal flows from them.

In the absence of effective regulation of capital markets, opaque arrangements, such as those under which the management of Gazprom (for example) uses the government's 35 percent stake to exercise *de facto* control of the company, are damaging to the long-run development of the Russian economy. There appears to be an implicit deal under which Gazprom props up a large chunk of (probably, mostly) nonviable Russian industry that would be better closed down. This works (for want of a better word) as follows: Gazprom fails, for long stretches of time, to pay its taxes; its alleged inability to pay its taxes is blamed on the fact that it receives only a small fraction of its "revenue" in so-called "live money" (ruble cash and bank payments);[8] that, in turn, is said to be because most of its Russian customers, especially in electricity generation, are receiving very little of *their* revenue in live money. The main reason for that is that many industrial enterprises are insolvent, producing little or nothing, but still open and using electricity. The government is not, therefore, upsetting the International Monetary Fund by subsidizing failing enterprises; Gazprom is doing it for them. Since Gazprom has large export revenues in thoroughly live money (deliveries to Ukraine and other CIS states apart), it is still able to raise money on international markets and to be regarded as a blue chip investment by portfolio investors.

The consequences of these strange arrangements are that political pain is avoided in the short run and economic recovery and sustained growth in the long run are impeded. Energy is used wastefully. Workers in insolvent enterprises are unpaid for long periods but still have a workplace and perhaps some fringe benefits in kind. Premises that could house viable new firms are not available. The federal and regional budgets do not receive revenue that might have been used for social and infrastructure support. Barter becomes, according to Sergei Aukutsionek's *Russian Economic Barometer* surveys, more widely used in industry even as inflation is being reduced.[9] The use of money surrogates (*veksels* and other IOUs) is widespread.[10] Dollarization remains high. Arrears of government payment to public sector employees, pensioners, and suppliers are a recurrent problem; so are arrears between producers. John-Paul Smith of Morgan Stanley Dean Witter Emerging Markets Research, puts late-1997 overdue payables at 30 percent of GDP.[11]

In these circumstances, there are good reasons for banks not to lend much to the real sector, given the difficulty of using real estate as collateral and of creditors' being treated reasonably in the event of a borrower's insolvency. The money mess, combined with the lack of financial transparency and of defense of shareholders' rights, deters both portfolio and direct investment. The continuation of government borrowing raises the possibility, notwithstanding Russia's debt-restructuring deals with international creditors, of an accumulation of public debt that could cast doubt on Russia's financial stability in the medium term, even if inflation stays low.[12]

"Property rights and corporate governance are not yet clear and growth-friendly in Russia. But they look better in early 1998 than they did in early 1997."

So far, this gloomy picture accords closely with the one in Brovkin's essay. The point to be made is that there have been some developments that tend to alleviate some of these problems. It is only by looking closely at the details of all these impediments to healthy growth in the Russian economy that one can see whether there are or are not institutional changes under way that are helping.

The Sviazinvest and Norilsk Nickel share auctions in summer 1997, notwithstanding all the political flak that followed them, were a move toward more open and competitive auctions of government-owned assets. Indeed, the bitter political fighting that followed was stimulated precisely by the fact that the auctions were not cozily sewn-up, insider deals. It is true that Boris Nemtsov's attempt to get more transparency and a better representation of the government interest in the running of Gazprom was unsuccessful, but at least there is to be seen in these struggles a conflict between market reform and entrenched interests. That the same struggles can also be represented as struggles between clans or alliances does not mean that the issue of competition versus monopoly could not also be involved.[13]

Meanwhile, the development of neutrally held share registers and efficient share registration and settlement schemes continues, partly as an institutional development from below and partly because of legislation. And more of the largest companies seek to have accounts audited to international standards because their management perceives the advantages of greater transparency when it comes to raising money.

The Federal Securities Commission (FKTsB), much criticized by opponents of Anatoly Chubais and of Harvard advisers, has contributed greatly to legislative and regulatory improvements. In February, the FKTsB intervened to annul three actions by over-mighty insiders because they infringed the rights of minority shareholders. These involved a convertible bond issue by Sidanko and transfers of assets to Yukos by Yuganskneftegaz and Samaraneftegaz.[14] The FKTsB rulings must be assumed to have gone against the wishes of the bosses of Oneksimbank and Menatep, respectively. The rulings should encourage investment. They also seem to be hard to construe as purely the product of a clan squabble.

In general, property rights and corporate governance are not yet clear and growth-friendly in Russia. But they look better in early 1998 than they did in early 1997. Writing the situation off as irredeemably distorted and corrupt is premature.[15]

Regional Policymakers and Economic Disorder

There are several considerations that might lead one to expect that regional (republic, oblast', krai) leaders might be particularly strong distorters of market development in Russia.

The continuity of elites from Soviet to capitalist times in Russia seems to have been strongest in the case of regional political elites.[16] There must therefore be a presumption—although it is only a presumption—that regional leaders will be more disposed than other elite groups (at the federal level and in business) to adhere to the old ways of doing things. They are, more strikingly than other elites, members of the old nomenklatura and might be expected to keep politics and production closely intertwined on their particular patches of turf. Whether they do in fact exhibit this tendency, and how much it matters, are separate questions.

Also of concern are the Russian constitution and legal and constitutional practice as they affect the working of the federation. The delimitation of powers between national and subnational levels is unclear, and the propensity of the center to establish special deals ad hoc with different subnational units—deals whose details are often not made public—does not make for a well-functioning federation. These characteristics of center-regional relations are not helpful to the development of a competitive economy in which no regional administrative barriers hinder the free movement of goods, services, capital, and labor.[17] The weakness of the courts—and especially their susceptibility to local political management—makes regional disregard for federal laws and policies hard to correct through the judicial system.[18]

On top of all this, the federal government has been weak and internally divided for much of the Yeltsin presidency, as well as being at odds with the federal legislature. The scope for regions to go their own way might be expected to be rather large. It is, therefore, not implausible to expect that we would see regional political elites cutting deals with local business to keep out competition from other regions, to siphon assets off by illegal means into personal wealth, and to buy local political peace in the short run by penalizing potentially successful economic activity to finance consumer price controls and prop up dying enterprises—all to the detriment of economic restructuring and long-term economic growth.

To a considerable extent, this is what we have indeed seen. But the market-distorting activity of regional elites has been mitigated by other factors. In particular, the economic intervention that could be practiced at regional levels has been limited by two things: the constraints imposed in most regions by the economic structure inherited from Soviet times, and the strength of the aggregate of market driven decisions made by households and firms.[19]

This is not the place to go into these issues in detail. The ways in which a lack of funds in poor regions forces a regional leadership to pursue *laissez faire* policies, whether or not they are inclined to do so, are nicely described by economic geographer Andrei Treyvish, for the case of Kostroma.[20] Regions that did have the means to operate price controls and block the cross-regional "export" of food for a time have tended to lose that ability as their capacity to subsidize has been eroded. The best-known example is Ulyanovsk, where price controls were largely abandoned in 1996.[21] The leaders of regions where there were initially high hopes of rescue by federal spending have had to face the fact that Moscow is not able to be of much help, even when the federal government sets up special development programs for particular regions. Consequently, they become more disposed to welcome the "invasion" of their regions by Moscow banks—a process that tends to strengthen cross-regional flows of capital.[22]

Meanwhile, "from below" firms and households have persisted in doing things that work against the market distortions attempted by many regional governments. For instance, small traders moved goods across the Samara-Ulyanovsk border in pursuit of profit when the Ulyanovsk authorities were trying to prevent it. As a result of such activities, prices have tended to converge more than traditionalist regional policymakers intended, at least within macro-regions. People have voted with their feet to leave regions where problems of economic adjustment are especially severe—especially in the far North and Far East. Small firms have developed rather less sluggishly in regions where demand and labor-cost conditions (and perhaps also regulation) were most encouraging. There has been some (slow and belated) convergence of interest rates and credit conditions across regions.[23]

At the same time, the pattern of net transfers between federal and regional budgets (taxes remitted "upward" to Moscow less transfers back to the regions), if it ever was politically driven, appears by the mid-1990s to have become at least weakly equalizing; in other words, the patterns in the mid-1990s are best explained statistically by the real income levels of different regions, rather than by political fore-fighting, or "oiling the wheel that squeaks loudest."[24]

These developments seem to have had their effect on what regional elites try to do. As regional business and political elites have had to deal with the new circumstances of life in Russia in the 1990s, their expectations, their networking patterns, and their concerns appear to have been modified. That, at least, is the tentative conclusion I would draw from a questionnaire survey conducted in seven regions in 1996 and 1997.[25]

The questions were addressed to close to 100 members of both political and business elites (though not in all regions in both years). Some increase in skepticism about state bailouts is detectable in the responses. And the two groups of respondents, political and business, though similar in general attitudes (about the desirability of more state help to industry, for example) show a clear, statistically significant difference in their patterns of networking: while the respondents from the political elite continue to network more with Moscow than within their region or with other regions, respondents from the business elite are substantially more inclined to network within their region. This is not a statistically representative sample of these two regional elites, but the respondents are not obviously unrepresentative. The implication is that thinking of regional elites as *nomenklaturshchiki*, whose business and political activities are so interwoven as to make each regional elite a single group, may now be misleading.

In short, stereotypes of Russian distributional coalitions in the provinces may need to be revised. A single elite in each region, able to block market entry, impede competition, and pursue their own interests to the detriment of the local population, is probably a misleading picture of the way things are in most Russian regions.

Conclusion

The arguments presented here are not meant to suggest that the dreams of market liberals are being realized in Russia. There have been seven years of officially recorded falls in output (1990–96 inclusive) and a preliminary estimate of an increase in 1997 that is within the margin of error for the change in GDP. It would be absurd, even with the known weaknesses of Russian statistics, to present this as any kind of success story. Economic reform in Russia has evidently encountered impediments far greater than in, say, Poland or Estonia. It is equally clear that what might very loosely be called institutional weaknesses have much to do with this. There is no strong ground, given those institutional problems and the low levels of saving and investment in Russia, to predict even that success (a strong and sustained improvement in average prosperity) is just around the corner.

At the same time, it is necessary to look closely at the blockages and see whether they are for some reason immovable—as many critics of Russian reforms claim—or whether they are perhaps susceptible to change and perhaps even being eroded. The contention put forward here is that some important institutional impediments are, in fact, being eroded. Whether that erosion is proceeding fast enough to permit a rapid trend rate of growth over the next twenty years or so is open to doubt. But that is not the same as saying that the situation is hopeless.

NOTES

1. P. Hanson, "What Sort of Capitalism is Developing in Russia?" *Communist Economies and Economic Transformation* 9 (1997): 27–43.

2. See World Bank, *World Development Report 1997* (Washington, DC: World Bank, 1997).

3. This is not meant to suggest that corruption and fuzzy property rights are the only constraint on Russia's prospective growth. A low rate of saving and underdeveloped financial institutions also constitute barriers. See Pekka Sutela, "The Strategic Role of Banks in Financing Russian Economic Growth," paper presented at the AAASS annual convention, Seattle, November 1997.

4. "Re-establishment," because the old, centrally administered economy, though inefficient (including about location and transport), was on any reckoning a single economic space. For better or (usually) worse, decisions made in Moscow about prices, outputs, and

investment held throughout the USSR.

5. Estimated at about 3 percent of GDP in 1996. *Russian Economic Trends* (February 1997).

6. Calculated from balance of payments figures in *Finansovye Izvestiya*, 19 February 1998, III–IV, treating the negative "errors and omissions" item of $7.8 billion as part of the outflow. The gross outflow remained very large—on the order of $40 billion at an annual rate. And funds flowing in to the Russian private sector remained less than the funds the Russian private sector was pumping out, but there was a substantial increase in private-origin funds going into Russia.

7. Oxford Analytica, *East European Daily Brief*, 24 February 1998, II.

8. In some recent, unspecified period, the share was said by the government's Mezhvedomstvennaya balansovaya kommissiya to be 9 percent. *Finansovye Izvestiya,* 13 January 1998, 3.

9. See *Russian Economic Barometer* 3, 4 (1997). The share of barter in the receipts of the 500 companies surveyed for the *REB* was 47 percent in December 1997 (personal communication from Dr Aukutsionek).

10. The stock of *veksels* in spring 1997 has been put at approximately 13 percent of 1997 GDP (derived from OECD, *OECD Economic Surveys. The Russian Federation 1997* [Paris: OECD, Annex II]. That ratio (of quasi-money to GDP) is almost equal to the end-year ratio of ruble broad money supply (M2) to GDP, of about 15 percent (derived from Institut ekonomicheskikh problem perkhodnogo perioda, *Belaya kniga. Ekonomika I politika Rossii v 1997 godu* (Moscow: IEPPP, 1998).

11. Address at Harvard, 10 January 1998.

12. For alternative debt scenarios through 2010, see Iikka Korhonen, "The Sustainability of Russian Fiscal System," *Review of Economies in Transition* (1998): 5–13.

13. To take a classic example: the repeal of the British corn laws in 1846 was a victory for one interest group over another, and it was also a victory for competition over protectionism.

14. *Moscow Times*, 19 February 1998, 10.

15. All the more so as the role of strategic outside investors in the control of Russian manufacturing enterprises, even in mid-1994, seems to have been larger than has generally been believed. That conclusion comes from a careful analysis of the concentration of share ownership in July 1994 in 439 enterprises. See J.S. Earle and S. Estrin, "After Voucher Privatization: The Structure of Corporate Ownership in Russian Manufacturing," draft, June 1997.

16. Olga Kryshtanovskaya and Stephen White, "From Soviet Nomenklatura to Russian Elite," *Europe-Asia Studies* 47 (1996). Their analysis of elites comes up to 1995. If the gubernatorial elections of 1996–97 are any indication, the situation will not have changed much since then. When incumbents were defeated, the winners were often from the same Soviet elite background.

17. See Darrell Slider, "Russia's Market-Distorting Federalism," *Post-Soviet Geography and Economics* 38 (October 1997): 489–504.

18. However, a study by legal scholar Brynjulf Risnes suggests that the "second" constitutional court has been acting in a constructive way in matters of conflicting jurisdiction. "Can Law Keep Russia Together?" Paper delivered at the NUPI-Fridtjof Nansen Institute conference, Oslo, January 1998.

19. On the interaction of regional elites' interests and the inherited economic structures of particular regions, see V. Mau and V. Stoupin, "The Political Economy of Russian Regionalism," *Communist Economies and Economic Transformation* 9 (March 1997): 5–27.

20. Andrei Treyvish, "Kostroma Oblast': An Average-Russian, Averagely-Depressed Region," forthcoming in *Communist Economies and Economic Transformation*, 1998.

21. See Arbakhan Magomedov in the Jamestown Foundation's electronic review, *Prism* 4 (February 1998).

22. See Arbakhan Magomedov, “Krasnodar Krai: A ‘Growth Pole’ in the Transitional Economy of Russia?” forthcoming in *Communist Economies and Economic Transformation*, 1998.

23. See D. Berkowitz, “Russia: Market Integration Against the Odds,” National Council for Soviet and East European Research, Washington, DC, 1994; D. Sutherland, “Regional Economic Structure and the Process of Economic Transformation in the Russian Federation,” PhD thesis, University of Birmingham, 1997; P. Hanson, “Regional Income Differences,” in *The Russian Economy in the 1990s,* Brigitte Granville and Peter Oppenheimer, eds., forthcoming.

24. The most up-to-date and comprehensive statistical analysis is by Kitty Stewart, “Are Intergovernmental Transfers in Russia Equalizing?” Innocenti occasional papers no. EPS 59, UNICEF, Florence1997. For an authoritative account of the underlying issues, see Aleksei Lavrov, *Mify I rify rossiiiskogo byudzhetnogo federalizma* (Moscow: Magistr, 1997).

25. Peter Kirkow, Philip Hanson, and Andrei Treyvish, “Networks, Linkages and Legacies: Evidence from an Elite Survey in Seven Russian Provinces in 1996–7,” forthcoming in *Communist Economies and Economic Transformation,* 1998.