The “Other” Russian Economy:

How Everyday Firms View the Rules of the Game in Russia

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Introduction

A new narrative has come to dominate visions of business state relations in Putin's Russia. This view depicts the rise of Russia as a natural resource state bent on using its oil, gas, and mineral riches to restore Russia's place in the world and to ensure high levels of economic growth for the population at large. Indeed, scholars and policymakers have devoted great attention to the impact of the boom in natural resources on the Russian economy in recent years. This attention is well-placed as the energy sector has fueled economic growth in Russia since 2000. Oil and gas exports alone account for more than two-thirds of Russia's export revenue and more than 15 percent of GDP. Of course, energy's importance for economic growth is not the only reason for the great attention to this sector. The oligarchs running these mammoth companies, whether they were high-flying private citizens in the 1990s or spies turned businessman in the last decade, make good copy for the press.

However, far less attention has been paid to the "other" Russian economy, in particular the manufacturing and service sectors. This is unfortunate because these sectors are also critical for Russia's future, particularly given the recognition by the Russian government of the importance of diversifying the economy. This imperative is not universally shared within the government and there has been much debate about the benefits of diversification, but the global financial crisis and the collapse of the price of oil has changed the terms of the debate and focused attention on other sectors as well.

The importance of the manufacturing and service sectors are also readily apparent in employment data. Most Russians work outside the natural resource sectors and

whether manufacturing and service sector firms are able to pay good wages on time will go a long way toward determining the prospects for social peace in this suddenly more turbulent period.

In addition, the oligarch-dominated businesses in the energy and natural resource sectors are atypical due to their large share of state ownership, high levels of geographic concentration, and international prominence. The problems of *Gazprom* are not the problems of *Voronezhtransstroi*, a construction company in Voronezh. To understand the full diversity of business state relations in Russia, it is important to draw from a broader sample and look beyond the oligarchic companies.

Finally, from a policy perspective, the Russian government has more control over the business environment for manufacturing and service sector firms than it does for natural resource firms that operate in a global market with fluctuating prices that are largely beyond the control of the Kremlin. In contrast, the business and service sectors are much more dependent on municipal, regional, and federal officials to create a business environment that allows them to prosper.

To throw light on the "other" Russian economy, we report results from two original surveys of 500 firms conducted in 2000 and 2007 in eight regions in Russia that explore the business environment for manufacturing and service sectors. We find that the formal and informal rules of the game for everyday firms in Russia have changed dramatically in the Putin years. Most importantly, while the informal and formal rules of the game in 2000 were quite similar for firms that were investing and those that were not, in 2007 regional governments had come to favor the former through a variety of informal and formal means. This shift in the rules of the game in favor of firms that invest suggests

that a core group of firms in the regions under study have managed to cooperate with the regional government to temper the weak institutional environment in Russia.

It would be certainly be preferable to have more neutral rules that provide a level playing field for all firms in Russia and the arrangement we document is a "second-best" option for economic development (Rodrik 2008). But it is also an improvement over a "third-best" option that involves the state using its power to punish successful firms to reward less successful firms. More generally, this change in informal institutions in a relatively short time suggests that informal institutions are mutable than many accounts suggest.

Background

One of the central tasks of the transition from a command to a market economy is the creation of set of formal and informal institutions that protect property rights and support market exchange. New state agencies needed to be constructed to perform functions that did not exist under a command economy such as regulating monopolies, governing stock markets and banks, collecting taxes, and privatizing state assets. In addition, state agencies that were powerful under the command economy, such as the State Planning Agency, needed to be reformed or abolished to make way for economic liberalization.

This novel experiment in the postcommunist world dovetailed nicely with a theoretical turn in economics and political science towards the study of the emergence, evolution, and impact of formal and institutional arrangements. Scholars began to analyze more precisely how the quality of governance, levels of corruption, and the constitutional arrangements of state power influenced economic performance. A new

consensus emerged which emphasized that to promote economic development and transition it was not sufficient to "get the prices right" as suggested by neoclassical models of economic growth, but countries also needed to "get the institutions right." Without informal and formal institutions that reduced the costs of engaging in exchange and protected property rights, economic development was difficult to achieve. In addition, capable state institutions that created a level playing field and promoted the entry of new firms to challenge old firms were an important component of the new recipe for development. As a result of these two cross-currents, studies of business state relations have been among the most fertile areas of research in postcommunist studies.

Research on business state relations in Russia have undergone at least two periods. In the 1990s, analysts examined whether relations between business and the state were better characterized by a "grabbing hand" model or by a "helping hand" model. The former envisioned state officials who provided few public goods, failed to coordinate their governance strategies leading to high levels of corruption, remained above the reach of legal institutions, and imposed heavy regulatory burdens on firms. This model depicted states largely as predators on economic activity. The latter model depicted state officials as intimately involved in the promotion of economic activity, as providing favorable policies to some firms, but not others, and as having a coordinated governance strategy that lead to lower overall corruption. The helping hand model looked to the East Asian developmental states as a reference point (Frye and Shleifer 1997).

Evidence from Russia in the 1990s found stronger support for the "grabbing hand" model. The disorganization and fragmentation of the Russian state allowed

individual bureaucrats and politicians to use the power of the state to extract considerable rents from businesses. Governments at all level were especially likely to prey on more successful firms to redistribute rents to less successful firms and to political allies. This line of research had special relevance for small and medium-sized firms that lacked political power to defend themselves against public officials.

Another line of research in the 1990s emphasized the role of oligarch-dominated firms that earned tremendous rents from distortions early in the reform process and managed to parlay their economic gains into political power (Hellman 1998). On this view, it was the bureaucrats turned businesspeople who managed to capture the state, enrich themselves, and undermine economic development. This argument fit well for the oligarch dominated firms, but there is debate about how well it accounts for relationships between non-oligarch firms and the state (Frye 2002; Yakovlev and Zhuravskaya 2004; Iwasaki 2007). Taken together the grabbing hand and the state capture models emphasized the pathologies of business state relations in Russia in the 1990s.

By contrast, in the Putin years, studies have turned the state capture argument on its head and have instead emphasized that the state has captured private business (Yakovlev 2006). Rather than oligarch dominated firms dictating policy to the state, it is the federal government that defines which firms will be favored. The turning point in this relationship occurred with the arrest of Mikhail Khodokorsky, the principal owner of YUKOS on charges of underpaying taxes and abusing privatization in the fall of 2003. At the time of Khodorkovsky's arrest, YUKOS was the largest private oil company in Russia, had grand plans to expand its sphere of operations, and little inclination to work closely with the Putin administration. The federal government bankrupted YUKOS and

auctioned off its main oil producing entities which eventually ended up in the hands of the state-owned *Rosneft*. The creeping renationalization of firms in other sectors, from automobile production to aviation, drove home the point that the rules of the game between the largest firms and the federal government in Russia had changed.

Whether business has captured the state at the regional level is an open question. Using data from 2000-03, Yakovlev and Zhuravskaya (2004) find that large firms continued to exert influence over regional policy as evidenced by "earmarks" in regional legislation that mention benefits for specific firms. This research project is an important contribution, but captures the types of informal benefits that regional governments may deliver to influential firms somewhat less well. In contrast, Yakovlev (2006) argues that the very strong position of the federal government viz-a-viz private business and recent personnel changes in regional elites have lead to the development of cooperative strategies between business and state actors in some regions in Russia. In a similar vein Brown et al. (2008) find that the privatization of industrial firms in Russia is more effective with regions with larger bureaucracies. Thus, there is some evidence that regional governments and at least some types of firms have found a common language despite Russia's generally hostile business environment.

In both periods scholars have emphasized the importance of informal relations between business owners and public officials (c. f., Ledeneva 1998; 2006). Indeed, in many instances the boundaries between the two were blurred beyond recognition. This line of research has sought to demonstrate the importance of informal institutions relative to formal institutions for defining relations between business and the state and to unravel precisely how these informal institutions function. This is no mean feat given that the

beneficiaries from these informal rules of the game seek to obscure their existence and leave few paper trails.

Thus, each of these models paints a quite different picture of relations between business and the state, but there is little consensus about the current state of affairs. This may be due to the facts that many studies focus on the 1990s and the early years of the Putin presidency, but few address the second half of his term. This is important because many scholars see a sharp break in business state relations between President Putin's first and second terms. Moreover, much existing work focuses on relations between oligarchs and the federal government rather than on non-oligarch firms and regional governments, but it is unclear if the two types of firms have similar relations with public officials. Finally, few works make an effort to capture change over time in the business environment.

We aim to address these three points in the literature. First, we explore the relevance of different models of business state relations for contemporary Russia by examining the formal and informal institutional environment in 8 regions. Second, we focus on the interaction of the regional government and non-oligarchic firms rather than on oligarch firms. In addition, we explore both formal and informal institutions. Finally, we can capture the evolution of the business environment better than most studies because we have survey data from two points in time. Using the year 2000 as a baseline, we hope to identify the extent to which there have been significant changes in the formal and informal institutions in the years of the Putin presidency.

Manufacturing and Service Sectors in the Putin Years

It is hardly a secret that manufacturing and service sector firms in Russia face a host of difficulties. The historic underdevelopment of the service sector and the grave distortions in the manufacturing sector under the command economy left them ill-suited to make the transition to a more market oriented economy. In addition, managers in these sectors must contend with Russia's notoriously difficult business environment with all its corruption, favoritism and red tape. Moreover, they are in a difficult position in relation to global competitors. Squeezed between hi-tech Europe and low-wage Asia, Russian manufacturing and service sector firms face stiff competition in terms of product quality and market price in the pursuit of export markets.

So have how manufacturing and service sectors fared in recent years? Relatively well. Since 2000 the manufacturing and service sectors have generally shared in the strong performance of the Russian economy as a whole. It is surprising to note that even as the natural resource sector has ridden record high prices, the share of industry and the service sector in gross domestic product has been remarkably steady. For example, as oil prices surged beginning in 1999, the share of GDP growth in Russia coming from the manufacturing sector barely fluctuated between 1998 and 2006, ranging from 19 percent in 1999 to 19.4 percent in 2006. Similarly, industrial employment hovered around 21 percent of total employment through the Putin years.

Moreover, the relatively strong performance of the manufacturing and service sectors is rather broadly based (De Souza 2008: 26). Whereas the energy sectors alone contributed about 30 to 40 percent of the growth in the Russian economy from 2000-05; this figure fell to about 10 percent in 2006. The rest of the economic growth came from outside the energy sectors. These estimates are imprecise for a variety of reasons, but

still leave considerable room for the manufacturing and service sectors to contribute to Russia's rapid economic growth in recent years. In particular, machine-building construction and the service sector experienced considerable growth in the last decade.

The manufacturing and service sectors have seen impressive productivity gains since 1998. De Souza (2008: 84) estimates that industrial productivity increased on average by more than 7 percent per year from 1999-2006. Much of the rebound in the manufacturing and service sectors can be attributed to the devaluation of the ruble following the economic crash of 1998, the improved macroeconomic environment that followed, and the low starting point for comparison. Indeed, the steep economic decline of the 1990s that was accelerated by the financial crash of 1998, left little room to go but up.

It is also interesting to note the heterogeneity of the performance of firms within economic sectors. Firm-level studies have found that successful firms are not necessarily defined by sector (Golikova et al. 2008). Successful firms have managed to innovate in all sectors and firm performance varies widely within sectors. Thus, while it is helpful to report average performance across sectors, it is also important to differentiate between successful and unsuccessful firms within sectors.

Other evidence also suggests that the much of the economic growth in recent years has come from non-oligarchic firms and that there is substantial heterogeneity in the performance of non-oligarchic firms. Drawing from a sample of firms provided by the Russian State Statistical Agency, one study finds that from 2000-2006 medium sized firms (annual sales between USD $10m and 350m) experienced quite strong performance (*Ekspert'* 2008). Within this group, about 20 percent of firms experienced a drop in

average annual sales in constant dollars, but 39 percent saw average annual increases of more than 20 percent in sales. Thus, beyond the oligarchic firms a second tier of middle-sized companies appears to have emerged during the Putin years that saw rapid expansion.

It is important not to make too much of the performance of the manufacturing and service sectors in recent years given the global financial crisis. Even the best performing firms will go untouched by the crisis, and more likely, many firms that have performed well in recent years will see their gains erased as credit tightens, inflation increases, and global trade contracts. Nonetheless, firms that have prospered even in the harsh business environment of Russia in recent years will go a long way toward determining how well Russia adapts to the current economic crises. Firms that have already restructured will be in a better position to respond to changes in the market environment than those that have not. In the next section, we begin to explore the evolution of the formal and informal rules of the game for firms in Russia for successful and unsuccessful firms in Russia.

Our Approach

To better understood the behavior of firms and the evolution of business state relations in Russia, we commissioned the Levada Center to conduct two large-scale surveys conducted in the autumn of 2000 and the spring of 2007 in eight regions in the European part of the Russian Federation, including Moscow, Bashkortostan, Voronezh, Nizhny Novgorod, Novgorod, Sverdlovsk, Smolensk and Tula. The range of regions was selected in 2000 to have different types of units of the Federation presented in the sample: donors and recipients of the federal budget, regions with statist and liberal economic policies; and those that had and had not changed their governors since the start

of economic reforms. These regions capture roughly 20 percent of the population of Russia, about one-third of GDP in 2006 and include one-third of all enterprises registered in Russia.

We stratified the sample by the number of employees and sector, and then chose firms randomly within each strata. Five hundred respondents took part in each survey and represented enterprises and organizations in all industrial sectors except agriculture and social services (public health, education etc.). The samples were designed to be representative of the economies of the regions in question with a correction for a somewhat larger share of industrial enterprises and a somewhat lower share of commercial trade than in the structure of the general set. So, in contrast to many studies of big business and "the oligarchs", our surveys reflect the views of the rank and file of Russian business.

Interviewers spoke with top managers of the enterprise, including the chief financial officer, the chief executive officer or chief legal officer. The survey instrument had more than 150 questions about a range of topics, including the condition and efficiency of public institutions, influence of the firm on economic policy, and the different ways in which the government influence their business.

Our sample represented industrial and service firms in almost equal shares. Numerically, they were mostly small-scale ones. For example, 50 percent of the industrial firms had less that 200 employees, another 18 percent had between 200 to 500 employees. In the service sector, a third of all firms employed less than 50 workers and another third, from 50 to 150 workers.

About 60 percent of the industrial firms in the sample were established before 1991. In services, the share of such firms was much lower – only 32 percent. It is also worth mentioning that one fifth of all enterprises in our sample were established after 1998 (in industry, their share was 10 percent, and in the services, it reached 28 percent).

The absolute majority of firms (about 70 percent) had a dominant owner who maintained control over the enterprise. The share of state-owned (state and municipal unitary enterprises) was 6 percent of the sample, while foreign juridical and physical persons had only 2.5 percent of all firms under their control.

Our data suggests that enterprise performance has been relatively steady. For instance, 39 percent of industrial and 64 percent of service firms described their financial and economic condition as "good" or "very good". Similarly, the share of firms that doubled their sales between 2000 and 2006 was 38 percent in industry and 55 percent in the services.

Our sample of firms is designed to be representative of the regions that we study in terms of employment by sector, but it is close to a national sample in terms of employment by sector in the energy, finance, construction and transport/communications sectors. For example in 2007, we have a higher percentage of manufacturing firms by employment in the sample than the national average (46 versus 30) and somewhat lower percentage of service and trade sector firms (18 versus 29). Given manufacturing's importance for output and the difficulty of categorizing "service" sector firms, this imbalance is less troubling than it might seem, but these differences between our sample and the national sample should be kept in mind.

Survey data have strengths and weaknesses. Surveys can help paint a more general picture of business-state relations than can case studies by capturing the experiences of a broader swath of firms. Case studies have the great advantage of being able to provide a rich, detailed account of specific firms in specific circumstances, but it is often difficult to extrapolate from the experience of specific firms in specific sectors because their views may be driven by idiosyncratic factors. Surveys also allow us to gather information on a broad range of factors that may be influencing firm performance, and when surveys are repeated over time, they provide clear benchmarks for measuring change over time.

But this approach also has some drawbacks that should be kept in mind. Surveys can provide a useful snapshot, but we should be aware that responses can often be unduly influenced by current events. We also recognize that respondents are unlikely to respond truthfully to questions about sensitive financial data and we avoid these.

Two more stubborn difficulties arise from "survivor bias" and the "anchoring problem." First, we are only able to gather data from firms that have "survived" by adapting to the business environment and therefore we miss data from firms that have become extinct. This is usually a greater problem for samples dominated by small firms rather than large firms. Nonetheless, it is likely that our results may be biased in favor of positive evaluations of state authorities in part because those potential respondents that have a bad relationship with public officials may have been less likely to survive.

In addition, survey questions that seek to capture the perceptions of respondents often suffer from anchoring problems. For example, interviewers may ask respondents to rate the performance of different agencies on a scale, but it is difficult to know whether

each respondent is using the same scale. In other words, is one person's "5" the same as another person's "5". One hopes that these types of measurement errors cancel each other out, but it is difficult to divine this ex-post. Similarly, the "halo effect" may bias responses in favor of more positive evaluations of the business environment. Russia's rapid rate of economic growth may induce respondents to give better ratings of the business environment than is warranted. Given the complexity of the environment, respondents may falsely attribute the improved performance of their firm to improvements in the business environment. Where respondents give higher scores to all aspects of the business environment, one might suspect that the halo effect is at work. However, where respondents discriminate across policy issues and individual elements of the business environment, one might conclude that they are less influenced by the halo effect.

This problem is more relevant for questions that tap perceptions of the business environment rather than the behavior of respondent. For example, anchoring problems may lead respondents to inflate ratings of the performance of government agencies, but are less likely to cause them to say that they used the courts to resolve a dispute than when they did not. For the most part, we find that anchoring problems are not a major obstacle, but we are nonetheless cautious in interpreting responses that capture the perceptions of respondents to similar questions across time. All methodologies have strengths and weaknesses that lead to bias. At least we can better understand the direction of the bias given the nature of our data.

While the halo effect complicates comparisons of responses across surveys over time even if the survey design and questionnaire are held constant, this problem should

not have much of an effect on comparisons by respondents to similar questions within each survey. For example, we can compare the responses of successful and unsuccessful firms in 2000 and 2007 and see if the difference between these two groups of firms has increased, decreased or stayed the same. By comparing the responses of groups of business managers within each survey, we can trace important changes in the formal and informal business environment in Russia.

Changes in the General Business Climate

To begin, we make simple comparisons in responses to similar questions about the business climate in 2000 and 2007. For example, we asked firm managers whether or not their firm "planned to make a major investment in their firm (such as a new construction or reconstruction project, a major building renovation, the purchase of new capital stock or equipment etc) in the next 12 months." While only 33 percent of firms in our sample in 2000 responded positively, this figure increased to 49 percent in 2007, reflecting the improved economic fortunes of the country in 2000. To capture the level of corruption in 2000 and 2007, we asked firm managers to rate on a scale of 1-5 (where 1 equals no problem and 5 is an extremely severe problem), "how intense is the problem of bribery for firms in your line business among bureaucrats at the federal level." We then repeated the question, but asked about bribery among bureaucrats at the regional and municipal levels. Average ratings of the intensity of bribery as a problem were somewhat lower at all levels of government in 2000 compared to 2007. Thus, on average there seems to have been an increase in the perception of bribery as a problem between 2000 and 2007 at the municipal and the regional levels.

We also asked respondents to rate the performance of several state agencies on a scale of 1-5, (where 1 is low and 5 is high) including the state arbitration courts, the police, and the regional bureaucracy.[1] Respondents gave higher marks to state arbitration courts than to the police or the bureaucracy and we some very small increases in the ratings between 2000 and 2007 for all three agencies. However, for the reasons noted above, we are reluctant to draw strong conclusions from estimations of the level of bribery and the rating of performance of government institutions given the difficulty of anchoring problems in surveys over time. Indeed, give the dramatic improvement in the Russian economy between 2000 and 2007 one might have expected responses in the latter survey to be somewhat more inflated. In other words, it is surprising that that increases in the ratings of the performance of state agencies over time are so small.

We asked firms in both surveys whether they had "managed to influence legislation on matters of importance to their firm in the last two years." In both surveys 17 percent of firms reported that they had done so. Finally, we asked firms whether or not they had experienced a violation of their property rights in the last two years. In 2000, 70 percent of respondents said yes, while in 2007 this figure fell to only 50 percent. This indicates a substantial drop in the number of firms reporting violations of their property rights between 2000 and 2007.

Table 1. The General Business Environment 2000 and 2007

	2000	2007
Firms planning to invest (%)	33	49
Regional Bribery as an obstacle (1 not an obstacle-5 a severe obstacle)	2.0	2.3
Municipal Bribery as an obstacle (1 not an obstacle-5 a severe obstacle)	2.1	2.3
Ratings of State Arbitration Courts (1 low -5 high)	3.2	3.3
Ratings of Police (1 low -5 high)	2.6	2.8
Ratings of Bureaucracy (1 low -5 high)	2.8	2.9
Firms reporting lobbying success at regional level (%)	17	17
Firms experiencing a property rights violation in last two years (%)	70	50

Investor and Non-Investor Firms

To examine the differences in responses among firms that had successfully adapted to the market and the rest of the population, we considered several criteria. Our survey included a host of questions on sales, profit, and subjective ratings of the financial position of the firm. These responses provide valuable insights, but may not tap successful adaptation to the market very well. Firm performance may be driven by sectoral considerations, price fluctuations, or other market-wide factors rather than the

specific behavior of the firm. Thus, a profitable firm that is increasing sales may not have adjusted to the market, but simply be benefiting from good market conditions.

Instead, we focus on firm investment. More specifically we examine a response to a question about whether firms were planning to make a major investment in their firm in the next 12 months as a useful starting point for identifying successful firms. These types of major investments require up-front costs for only the prospect of future gains and therefore indicate that the firm has confidence in the security of its property rights over time. Moreover, investment itself is a useful indicator of firm performance. Of course, one objection to using the question as an indicator of success is that it refers to plans rather than to behavior. However, it is highly correlated with other measures of past restructuring in the survey. In addition, it is forward looking and therefore captures future intentions and may be a better guide to future behavior.

Thus, to drill deeper into relations between business and the regional government, we divided the sample in each survey in two groups: investor firms, including those that planned to make a major investment in the coming 12 months; and non-investor firms including those that did not. Investor firms in 2007 tended to be headed by managers who were slightly younger (45 versus 48 years old) and to have more employees, but were no more likely to belong to business organizations or to be members of large financial industrial groups that play an important role in the Russian economy.

We explore the extent to which relations between the government and investor firms changed between 2000 and 2007 with a focus on the degree to which formal and informal institutions are biased in favor or against investor firms. We also want to identify the extent to which the degree of bias in formal and informal institutions changed

over time. For example, we divided the responses to the question about bribery at the regional and municipal level into those given by “investor” firms and “non-investor” to determine whether there were differences in the answers between these two types of firms.

The responses are intriguing. In 2000, there is no statistically significant difference in the responses between investor and non-investor firms. At the regional and the municipal level, investor and non-investor firms report experiencing bribery at about the same levels. But in 2007, the picture is quite different. Investor firms perceive bribery to be a significantly less important obstacle than do non-investor firms. Non-investor firms rated bribery by regional government officials to be a 2.40 on a scale of 1 - 5, whereas investor-firms rated it is only a 2.09. These differences are not large in magnitude, but this is to be expected given that the scale of 1-5 is rather limited. Nonetheless, that we find statistical significant differences between these two groups despite the crudeness of the measure and the narrow scale is revealing. More importantly, the differential treatment of investor and non-investor firms in 2007, but not in 2000, repeats itself throughout the data which gives us greater confidence in the results.

Table 2. The Changing Rules of the Game

	2000		2007	
	Non-Investors	**Investors**	**Non-investors**	**Investors**
Regional Bribery (1-5)	1.99	1.79	**2.40**	**2.09**
Municipal Bribery as Obstacle (1 no obstacle -5 severe obstacle)	2.16	1.96	**2.51**	**2.13**
Competition as Obstacle (1 no obstacle -5 severe obstacle)	2.87	2.91	**3.37**	**3.09**
Regional Government Help for Firms (%)	26	30	**10**	**31**
Rating of Arbitration Courts (1 low - 5 high)	3.16	3.26	**3.40**	**3.10**
Expect to Win vs. Regional Government in Court (%)	37	44	**44**	**58**
Expect to Enforce vs. Regional Government (%)	37	39	**45**	**60**
Resolved Dispute Without Using the Courts (%)	--	--	**53**	**79**
Successful Lobbyist at Regional Level (%)	**12**	**26**	**14**	**21**
Firms experiencing a property rights dispute (%)	**66**	**76**	**43**	**57**

Bold indicates significant differences in the responses of investors and non-investors within each survey at the .05 level.

We also asked respondents in 2000 and 2007 to rate how big of an obstacle for their firms was the current level of market competition. On average, competition was a less severe problem for firms in 2000 than in 2007, which indicates some improvement in the business environment from the early Putin years to the late Putin years. More importantly from our perspective, investors and non-investors in 2000 found competition to be an equally big problem in 2000, but the responses of investor and non-investor firms diverged significantly in 2007. Non-investor firms reported that competition was a 3.37, while investor firms reported that it was only a 3.09. This difference is statistically significant in a simple comparison of means at the 95 percent level. Moreover, regional governments were more likely to discriminate between investor and non-investor firms in granting aid to firms in 2007 than in 2000. In 2007, 31 percent of investor firms reported receiving some form of aid from the regional government while only 11 percent of non-investors did so, but in 2000 there was little difference in the responses between these two groups (30 versus 26 percent).

In addition, investor firms expected much greater protection of their property rights compared to non-investor firms in 2007. Investor firms in 2007, but not 2000, gave significantly higher scores to the performance of the state arbitration than did non-investor firms. In addition, we asked firms whether they believed that the courts could protect their rights in a dispute with the regional government. In 2000, investor firms and non-investor gave relatively similar answers. Thirty-seven percent of non-investors said "yes" or "more or less yes," while 44 percent of investor firms did so. This difference falls just shy of statistical significance. However, the gap between the responses of investor and non-investor firms in 2007 was much greater. Investors were 14 percentage

points more likely to believe that they could use the courts to protect their rights in a dispute with the regional government. In addition, investor firms were significantly more likely to believe that their property rights could be enforced in a dispute with the regional government compared to non-investor firms in 2007, but not in 2001. Finally, data from 2007 indicate that 53 percent of non-investor firms expected that could resolve a dispute with another firms without turning to the courts, while 79 percent of investors believed that they could do so.[3] These results suggest that investor firms benefitted disproportionately from both formal and informal means of protecting property in 2007, but not 2000.

These changes do not appear to stem from an increased ability of investor firms to lobby the regional government relative to non-investor firms. In both 2000 and 2007 investor firms are significantly more likely to report being able to influence legislation on matters of importance for their firm at the regional level. Indeed, if anything, investor firms experienced greater lobbying success in the regional government relative to non-investor firms in 2000 than in 2007. Twenty six percent of investor firms reported being able to influence legislation at the regional level in 2000 versus 21 percent in 2007. It also does not seem to be the case that investor and non-investors differed in the frequency with which they experienced property rights violations. In both 2000 and 2007, investor firms were more likely to report a violation of their property rights within the last two years. In some respects this is not surprising. Investor firms were likely engaged in more extensive business activities which may have made them more likely to experience a dispute. Thus, the change in the business environment is not due to investor firms

becoming more successful lobbyists or less likely to experience property rights violations.

The change in business state relations was not a one-way street in which regional government showered investor-firms with formal and informal benefits without receiving anything in return. In 2007, investor firms were significantly more likely to report that they had offered various forms of aid to the regional government than did non-investor firms. Sixty-six percent of non-investor firms reported delivering some form of assistance to the regional government, but a whopping 90 percent of investor reported doing so. These figures may be inflated by managers seeking to exaggerate their sense of good citizenship. But both investor firms and non-investor firms have similar incentives to dissemble. Thus, the difference in responses between investor and non-investors should not be affected by this bias.[2]

In sum, our findings depart from the literature in two respects. While the fingerprints of the grabbing hand are still present, we also find evidence in support of some aspects of the helping hand model. Data from 2007 indicate that regional governments have tended to bias the formal and informal institution toward a select group of firms that exhibit an intention to invest. In return, these firms are more likely to provide aid and assistance to the regional government than are other firms. If in the 1990s, state officials primarily preyed up on successful firms, in recent years, regional governments have begun to bias policy in their favor.

Second, whereas much of the literature on informal institutions emphasizes their resistance to change, here we find evidence in support of their mutability. If in 2000 informal institutions underpinning business state relations were similar for investor and

non-investor firms, by 2007 the rules of the game had changed dramatically. Investor firms benefitted considerably more than non-investor firms from changes to informal institutions.

These differences in the treatment of investor and non-investor firms indicate that a tangible change has taken place in business-state relations at the regional level in the Putin era as formal and informal institutions appear to reward investor firms far more than non-investor firms. Determining whether these patterns hold across the country as a whole requires more research, but the relationship is consistent in the data. One recent study does make a similar point. Using data from 77 regions for 1993-2004, Ahrend (2008) found that more reform-oriented policies and better regional leadership are positively related to economic development during the period 1998-2004, but not before.

It is important not to overstate the changes in the business environment in the Putin years. Russia remains a very difficult business environment for investor and non-investor firms alike and investor and non-investor share many of the same grievances. Moreover, whether the differential treatment of investor and non-investor firms survives the global financial crisis is very much an open question.

Implications

This shift in the formal and informal rules of the game under President and now Prime Minister Putin's rule will likely have considerable implications for how firms respond to the global financial crisis, but it is difficult to identify precisely which effects will dominate. On one hand, it is likely better for economic efficiency that regional governments are giving favorable treatment to firms that are willing to invest. As an alternative, they could be using a "leveling" rule that redistributes resources away from

successful firms to unsuccessful firms, a practice for which there is some evidence in the 1990s (Frye and Zhuravskaya 2000). In a second-best scenario, it could be that regional governments are trying to substitute for the lack of capable and neutral institutions by favoring firms that have better adjusted to the market (Rodrik 2008). This more positive view of the evolution of relations between firms and the regional government has echoes in studies of business relations with local governments in China, Brazil and Southern Italy (Qian 1999; Locke 2001).

On the other hand, it could be that only those firms that are on good relations with the regional government receive favorable treatment and are therefore willing to invest. To the extent that these firms are not more economically efficient than other firms in the region, the regional government may be blunting incentives for the majority of firms in the region to use their capital, effort, and time productively. In sum, political favoritism rather than economic developments determines to whom the regional government provides benefits. If this is the case, then the consequences for economic efficiency are likely quite negative.

We tried to distinguish between these two views by comparing whether investor and non-investor firms rated the performance of the governor differently. Neither in 2000 nor in 2007 did investors and non-investors give significantly different responses to the question. This gives mild support to the former interpretation, but it hardly conclusive.

From Crisis to Crisis

As this work goes to press the elephant in the room is the financial crash that continues to roil markets, upset governments, and destroy savings in Russia and around

the globe. Indeed, the financial crash of 1998 and global financial collapse of 2009 provide rough bookends for the surveys in our study. It is difficult to determine how business state relations may evolve as the crises unfolds and the consequences of the current financial crisis will be felt for some time to come in Russia and elsewhere. Precise predictions about the future of the Russian economy are foolhardy.

On one hand, firms in Russia are likely in better condition to weather the financial storm of 2009 than the crash of August 1998. Most industrial firms in Russia are now dominated by a single owner or small group of owners which gives stronger incentives for current owners to restructure their firms for the long-haul rather than to strip assets for the short-run (Berglöf and Pajuste 2003; Yakovlev 2004; Iwasaki 2007). If the 1998 financial crash led to a host of conflicts within enterprises over ownership rights that had a destructive effect on performance, this scenario is less likely in 2009. In addition, the quality of management is likely higher today than it was a decade ago. Indeed, the experience of surviving the last crisis may have prepared to managers and regional governments to better handle the current extraordinary levels of financial and economic instability. Moreover, while the declining value of the ruble makes it harder for borrower firms to repay loans, it will ultimately make Russian exports more competitive than they are today. Of course, demand for Russian exports will depend to a large extent on exporting countries rebounding from the current crisis and when that will happen is anybody's guess. Finally, Russia began the crisis with a large financial cushion – a roughly 500 billion dollar stabilization fund.

On the other hand, the current financial crisis is likely to be much more profound than the August 1998 crisis due to its global nature. Demand for Russia's main export -

energy - will not likely rebound until the economies of large importers begin to recover. In addition, the crisis is hitting Russia especially hard. Industrial output fell by 20 percent and manufacturing output fell by 30 percent in January 2009 as compared to December 2008. Manufacturing output fell by more than 25 percent compared to January 2008 (*Moscow Times*, February 17, 2009). Growth for the year is likely to be negative. Few companies in Russia are likely to go unscathed and, in certain respects, the more successful firms are more exposed to the global crash because they are more likely to rely on export markets that are experiencing slow growth and are more likely to have borrowed abroad to invest at home. As the ruble weakens relative to the dollar and euro as many expect it will, these loans will become more difficult to repay.

Conclusion

Our study seeks to make three general contributions. First, our research points to the value of looking beyond the oligarchs in the natural resource sectors of the Russia economy. The non-energy and non-natural resource sectors continue to play a key role, and in the short-run, the importance of these sectors is likely to grow due to the depression of oil prices. Indeed, over the longer term, if Russia's attempts to diversify its economy are to have any hopes of success the manufacturing and services sectors will have to find new sources of efficiency and growth.

In addition, there appear to be important differences between the business environment for oligarchic and non-oligarchic firms in Russia. Despite the increasing encroachment of the state in the natural resource sector which has likely produced greater uncertainty over future business opportunities, there appears to be greater stability in the business environment for more typical firms in the manufacturing and service sectors.

The rule of the game between manufacturing and service sector firms and regional government appear to have solidified, although they now appear to be more biased in favor of investor-firms.

Second, our work contributes to the study of formal and informal institutions. In recent years scholars of economic development have paid increasing attention to the importance of formal and informal institutions for shaping economic outcomes. This interest has dovetailed nicely with the postcommunist cases. We find that over the last eight years, that there has been substantial change in the relationship between firms and regional governments. Firms were much more likely to invest in 2007 than in 2000, but investor and non-investors have come to inhabit increasingly different business climates within the same regions in Russia. That is, regional governments were much more likely to give favorable treatment to investor firms than non-investor firms in 2007 than in 2000. While much of the existing work stresses the difficulty of changing the informal rules of the game, our study depicts considerable change over a relatively short period of time.

Finally, our work provides a temporal baseline against which we can measure future changes in formal and informal institutions in Russia. The financial crisis which is currently battering all sectors of the Russia has the potential to reshape fundamentally relations between business and the state. Whether the informal and formal institutions that emerged between 2000 and 2007 survive the financial crash, will be a topic for future research.

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Endnotes.

1. The state arbitration courts are the main forum for resolving disputes between firms and between firms and the state. They are located in each of Russia's regions.

2. Here we have reported these changes by simply comparing differences in mean responses between investor and non-investor firms within each survey. However, these results also hold in many instances if we run more sophisticated statistical analyses or use measures of firm restructuring rather than investment.

3. This question was not included in the survey in 2000.