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Doing Business in Russia. The Main Political Risks and Challenges for International Companies

105 - Risks in International Business. Considering the market while not neglecting the political dimension

Abstract

Over the last few decades, Russia has become the third most attractive country for foreign direct investment (FDI) worldwide after the US and China. Yet, at the same time it is one of the most corrupt countries in the world. Political corruption remains one of the main obstacles toward Russian political and economic development and the primary challenge to business activities there. The other key problem in the Russian economy is that it is based on a small number of large and super large enterprises in which the state holds a major share. State-owned enterprises dominate all the strategic sectors, such as energy, transport and banking, and account for about half of GDP. Taking this as a starting point, this article examines the informal [business] rules and practices that have developed in Russia. The paper first investigates the specific characteristics of these rules and practices. In particular, it focuses on systematic corruption, systemic favouritism and institutional ambiguity as the main political risks. Next, it gives an overview of the anti-corruption efforts and methods undertaken by the Russian leadership in 2008-2014 aimed at mitigating or minimizing the negative consequences of corruption, favouritism and institutional ambiguity. The paper concludes with an evaluation of the political risks for international companies in Russia.

Keywords:

Russia, business environment, corruption, institutional ambiguity, systemic favouritism

1. The country characteristics of political risk

The problems of Russian economic and business development have attracted the attention of a range of scholars for a long time. The conclusions that can be drawn from these analyses are that reforms have not worked as expected because the Russian economy is not transparent. The reasons for this include corruption (Ledeneva, 2006; Gorenburg, 2013; Orttung, 2014), state capture (Hellman, Kaufman, 2001), institutional ambiguity that arises out of incomplete institutional transformation and the incomplete implementation of reforms, alongside the lack of a functional legal framework and the high dependence of the Russian economy on unwritten rules and practices prescribing formal rules to only have a limited effect (Ledeneva 2006, van Zon 2013). Ledeneva explained the prevalence of informal practices in Russia as follows “We should consider two fundamental sets of factors [...]. One set derives from the future-oriented formal rules – that is, the legislation designed to improve the political and economic order in Russia, and the loopholes in its formulation and enforcement. The other is related to the nature of informal norms as well as legacies of the past that continue to shape today’s practices” (Ledeneva, 2006, p. 23). There are a number of works on informal rules and

practices in Russia that identify corruption as a major obstacle to economic development. Some studies indicated the ambiguity between formal and informal rules as one of the reasons for the spread of corruption in the country (Rozov, 2013, p. 92).

Several studies on Russian corruption indicate that for many ordinary Russians, paying bribes in no way represents somehow feeding the system of corruption, as, they have no concept of what an act of corruption actually means. This legitimizing logic of corruption has developed a specific type of behaviour in Russian society that justifies corrupt practices as a social norm (Tulaeva, 2011; Rozov, 2013). Corrupt mechanisms mitigate the transition costs from a planned economy to market relations and help a person survive in daily life. In some situations, the use of informal mechanisms is more efficient than the use of formal rules because they help to save money and time. Because official rules are constantly changing, informal mechanisms play the role of an insurance that serves to reduce the role of unpredictable risks. Moreover, they help businessmen or officials in some cases defend themselves against expulsion by other corrupt players on the markets (Tulaeva, 2011, p. 11).

Another key political risk is systematic favouritism. It strengthens informal practices in Russia due to the fact that domestic business is dominated by state-owned enterprises that are located in a number of strategic sectors such as energy, transport and banking (Radziwill, Vaziakova, 2010). Senior state officials at the federal and regional levels occupy the key positions in companies' structures, for example, by serving or chairing the boards of directors of the companies in which the state holds a controlling share. The government has explained that placing senior state officials on the boards of corporations is necessary to defending the state's interests and to improving the effectiveness of company management. Russian critics, however, have argued that by rewarding its most loyal officials, the political leadership has developed a lucrative patronage system that ensures its own necessary political support (Ortung, 2006). Their nominal presence on boards enables state officials to receive high bonuses, much more than they are paid for their work as senior state officials. As result, a new generation of oligarchs has surfaced that manages state-owned companies and uses government as a business tool. Consequently, the political and economic power in the country is shared between different groups, including 'old' oligarchs (people who bought assets from the state in the 1990s), the 'new oligarchs' (people who manage state companies), the 'siloviki' (i.e. people who made their careers in the Ministry of Internal Affairs (MVD), the Committee of State Security (KGB) or Ministry of Defence) and the 'nomenklatura oligarchs' (Schröder, 2010; Burger, Gitau 2010). An additional remarkable characteristic of these patronage relations is a strong network structure that is usually based on family relations or personal connections and friendships established at school or university. Patronage relations complicate market entry and impede competition. Entrepreneurs who are not able to buy administrative services, are forced out of the business by state officials. The global financial crisis in 2008 led to net capital outflows of US\$ 133.6 billion and had a hugely damaging effect on Russian economy. In response, the Russian government took a number of decisions to fight off financial implosion. They adopted a law, for example, that restricted foreign investment in 42

strategically significant economic sectors and implemented a number of regulations on protection mechanisms for domestic industries (Federal Law 57-FZ). This policy has strengthened the position of Russian hardliners, including representatives of the 'siloviki', who want more state control over the Russian economy.

2. Impact of anti-corruption measures on the business environment

Over the last decade, the Russian leadership has issued a number of normative regulations, rules and procedures to fight against corruption. Moreover, Russia has signed and ratified numerous international conventions, has become a member of several international anti-corruption structures and, finally, has implemented a range of initiatives introduced by the OECD and WTO (Pavlova, 2014; Shekshnia, Ledeneva, Denisova-Schmidt, 2014). In 2011, the Russian leadership set a target for Russia to reach 20th place in the World Bank's Doing Business rating by 2020. It has also undertaken implementing several of the World Bank's policy recommendations to improve its rating on the ease of doing business (Gruzinova, Sterkin 2013). This paper will outline some of the main measures implemented by the Russian government under the leadership of Dmitri Medvedev and Vladimir Putin during 2008-2014. Remarkably, both presidents declared corruption to be the main obstacle to economic development and proclaimed that combatting it was a priority of their presidencies (www.kremlin.ru). However, the initiatives implemented under their respective leaderships have not significantly improved the situation in Russia with regard to corruption but rather have *de facto* worsened it.

The fight against corruption has gained momentum during the third presidency of Vladimir Putin. In March 2012, the government introduced the National Anti-Corruption Plan for the upcoming years. This included several important regulations, for example amendments combatting corruption in the Criminal Code of Russia and the Code on Administrative Violations (Radzivill, Vaziakova, 2015, p. 7). As a result, for example, in 2012, Russian investigators prosecuted 889 state officials, including 244 city mayors and 1,159 law enforcement officials on corruption charges (RAPSI, 2013). Although there have been cases of successful anti-corruption campaigns, the anti-corruption legislation seems to be undergoing fragmented implementation. Some instances also indicated that the campaign was being primarily taken advantage of by state officials for the purpose of removing offenders at the lower level of the administrative hierarchy. Top politicians involved in corruption scandals however remained mostly untouched by state investigators.

Furthermore, in the opinion of some experts, the Kremlin's anti-corruption campaign can be interpreted as a means of counteracting initiatives from opposition activists and bloggers who have uncovered corruption cases in the state structures (Rogoža, 2013; Pavlova, 2014). State officials have remained mostly indifferent to the allegations and no criminal charges against state officials involved in the fraudulent schemes were filed on the basis of the accusations. Instead of this, state officials have mounted a number of criminal investigations of corruption against anti-corruption blogger and protest leader Alexei Navalny himself and his brother Oleg, accusing them of stealing and laundering money

in business deals between 2008 and 2011. Navalny described the cases against him and his brother as falsified and politically motivated (Kramer, 2012). For several years, he has been actively engaged in anti-corruption activities, including posting online documents about the fraudulent activities of the president's political allies involving public resources. Notably, the implementation of anti-corruption measures has increased Putin's popularity, yet the whole campaign has proceeded without any significant success. Some experts maintain that the ongoing anti-corruption discourse in Russia is in reality often unconnected to the practical fight against corruption (Ledeneva, Shekshnia, 2011).

Apart from this, the Russian government has taken steps to improve the FDI climate in the country. It has implemented a number of incentives for foreign investment, including financial support. Despite these measures, the regulatory regime for FDI in Russia remains one of the most restrictive among the OECD countries, particularly in the financial sectors, mining and transport (Radzivill, Vaziakova, 2015, p. 21). In addition to this array of contradictions, there is no consensus among leading foreign investors in Russia about the political risks of doing business there. In the opinion of some entrepreneurs who have been doing business with Russian national companies in strategic sectors such as oil and mining: 'it is very risky, but it is very profitable, especially if the Kremlin likes you' (The Economist, 2008). Yet, it would be foolhardy to believe that the alliance between Western companies and Russian national companies under the Kremlin's patronage can guarantee protection for those doing business there.

3. Conclusion

Over the last decade, the Russian government has done a lot to attract FDI. Yet, there is a huge gap between the regulations welcoming foreign investors and their practical implementation. For many foreign investors, Russia is still an authoritarian state with corrupt state officials, a weak judiciary and unclear economic strategy. The Russian government still has problems attaining strategic economic goals and diversifying or redirecting its resource-based economy towards a knowledge-based economy with free and fair competition. Russia needs to create a favourable business climate for small and midsize businesses, including simplifying regulatory procedures and instituting tax incentives. The package of measures implemented by the government has had little influence on the development of these businesses so far. The business operations of foreign companies, particularly in strategic sectors such as energy and telecommunication are still vulnerable to the government's intervention. The examples given in this chapter have shown a shift in the methods used by Russian officials towards foreign investors: from taking control over foreign assets in Russian businesses to changing legal regulations and foreign ownership rules.

Western sanctions imposed in 2014 against Russia over the Ukrainian crisis and Russia's reaction to them have shown that for Russian officials, geopolitics matters more than economic stability. Political strains have already considerably weakened the business environment in Russia and increased the exchange transfer risks. It is difficult to predict how the political situation will develop in the medium-

and long-term. Russia needs foreign investment, technology and knowledge to implement its large economic projects. The country is in fierce competition with dynamically developing emerging markets such as China and India for foreign investment. Foreign companies are also important political tools for the Russian government in developing Russian relations with Western countries. Therefore, Russia will remain dependent on the help of foreign investors. In cooperating with the Russian government and Russian companies, foreign companies need to find way to deal with this Russian willingness on the one hand, and political uncertainty, on the other. The further development will undoubtedly increase the financial and political costs of doing business in Russia.

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