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# The Russian Economy: Can Growth be Restored within the Economic System?

Cover: Protester at a rally downtown in St. Petersburg, Russia, 10 December 2011. Russian text: 'no voice/no vote'. AP, Dmitry Lovetsky.

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## Sammanfattning

Hur kan det ryska ekonomiska systemet beskrivas och kan det främja fortsatt tillväxt? Kan starkare marknadsorienterade institutioner öka tillväxten? Skulle en demokratisering resultera i att initiativ till reformer kommer underifrån och inte bara från regimen uppifrån? Syftet med rapporten är att analysera systemproblemen i den ryska ekonomin efter 2009 och bedöma om det ekonomiska systemet kan främja fortsatt tillväxt baserad på ökad produktivitet och innovationer. Rapporten undersöker i vilken grad som det ekonomiska systemet under president Putin kan underlätta resursallokeringen mellan sektorer, minska resursslöseriet, och öka produktiviteten och konkurrensen. Studien utvecklar en modell som är baserad på Gaddy and Ickes (2010) som analyserar ”ränteberoende” och det system för ”ränteomfördelning” som Putin har infört i den ryska ekonomin. Det teoretiska bidraget i rapporten utgörs av att modellen har utökats med en sektor för små och medelstora företag, ”den nya privata sektorn”. Därigenom är det möjligt att studera effekten av ränteberoendet och ränteomfördelningssystemet på den småskaliga privata delen av ekonomin. Rapporten visar att när en stor del av ekonomin styrs av ränteomfördelning till fördel för aktörer som stödjer regimen, har marknadsstödjande institutioner en begränsad inverkan då endast en begränsad del av ekonomin påverkas av dessa. Att institutionerna är svaga i Ryssland beror på det demokratiunderskott som utmärker det ryska samhället. Medborgare och organisationer saknar organiserade kanaler för att ge röst åt sina idéer. Rapporten analyserar effekten av de restriktioner som lagts på yttrytandefriheten och civilsamhället sedan 2012 och finner att systemet inte kommer att kunna reformeras underifrån. Den förtroendekris som har följt på Ukrainakrisen 2014 förstärker stagnationstendenserna i den ryska ekonomin.

Nyckelord: Ryssland, ekonomiskt system, ränteberoende, institutioner, civilsamhälle.

## Summary

What are the characteristics of the Russian economic system and what potential does it have to spur growth? Would strengthening of the institutions underpinning the market economy make a difference? And is there any chance for reform initiatives from below through democratization? The purpose of the report is to analyse the systemic characteristics of economic development in Russia after 2009 and to assess the potential of the present hybrid economic system to resolve the impediments to future growth based on the improvement of productivity and innovation. Fundamentally this is an investigation of the extent to which the economic system can facilitate a more efficient allocation of resources between sectors, reduce resource waste, increase productivity and strengthen competition by enabling entry of new actors into different markets. The study develops a model based on Gaddy and Ickes (2010) and analyses the effects of rent dependence and Putin's rent redistribution system on small and medium-sized enterprises, 'the new private sector', which has been added to the original model. It is argued that when a dominant part of the economy is ruled by the management of oil rents to secure the power of the regime, the role of market-oriented institutions becomes limited. Weak institutions have a background in the democracy shortage in Russia, which is reflected in weak channels of 'voice' for citizens and organisations to express their opinion. The report analyses the effects of the present restrictions on voice and civil society development and concludes that there is little hope for 'reform from below' of the system. The confidence crisis caused by the Ukrainian crisis of 2014 further aggravates Russia's problems of stagnating economic growth.

Keywords: Russia, economic system, rent dependence, rent management, institutions, civil society.

# Preface

Research for this report started in early 2012 when citizens in Moscow and other big cities in Russia voiced their discontent with the unfair Duma elections in December 2011 and the fact that Vladimir Putin would stand for president for a third time. Democracy and citizens' participation are not only a political question; they also affect the economy and most importantly its framework and institutions. Later the same year, however, it became clear that the third presidency of Vladimir Putin would not be characterized by more democracy but just the opposite. Therefore, this report analyses in depth the economic system of Russia under Putin and the difficulty it will have in meeting the challenges ahead without citizens' participation. The importance of democracy and of potential contributions to the economy by civil society is discussed in general terms as well as the effects of the present democracy shortage.

I have had the opportunity to present and discuss various versions and parts of the report at seminars and conferences, for which I am most grateful: 'The weak "voice" of civil society in Russia's modernization and its impact on economic development', at a panel on 'Modernization, Civil Society, and Corruption' at the Nordic Russian and East European Studies Conference, Helsinki University, Helsinki 24–25 May 2013; 'Institutions, Civil Society and Economic Development: Russia in a Comparative Perspective', at the international conference 'Beyond Transition', Lund University, Lund 2–4 October 2013; and 'Russia's economic decline. Are stronger institutions the remedy?' at the seminar 'Russia's Economic Decline. Is there a remedy?' at The Swedish Institute of International Affairs, Stockholm 19 February 2014.

I am indebted to Jan Leijonhielm who reviewed the draft version of the full report for his helpful corrections, comments and suggestions on how to improve its quality. In the revisions I have also profited from remarks by Carolina Vendil Pallin, Fredrik Westerlund, Tomas Malmlöf, Richard Langlais, and Gudrun Persson that were made at the final seminar on 10 April 2014.

Stockholm 5 May 2014

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## Abbreviations and acronyms

BEEPS	Business Environment and Enterprise Performance Survey
bn	billion
CIS	Commonwealth of Independent States
CPI	Corruption Perception Index
CSO	Civil society organisation
EBRD	European Bank of Reconstruction and Development
ECU	Eurasian Customs Union
EvrAzEs	Eurasian Economic Community
GDP	Gross domestic product
ILO	International Labour Organisation
MED	Ministry of Economic Development of the Russian Federation
Minfin	Ministry of Finance of the Russian Federation
MPC	European University Institute Migration Policy Centre
NGO	Non-governmental organisation
Rosstat	Russian Federal Statistical Agency
RUR	Russian roubles
TI	Transparency International
USD	American dollars
WGI	Worldwide Governance Indicators
WTO	World Trade Organization

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# 1 Introduction

After a strong recovery in 2010 after the 2008–09 economic crisis, in 2012–13 the Russian economy shows signs of declining growth, which is well below expectations in earlier official strategies and forecasts. Growth in 2012 was 3.4 per cent, and in 2013, 1.3 per cent. The stagnation of global demand for Russian commodities is part of the explanation and it is quite clear that the Russian growth model largely based on growth of foreign demand for Russian hydrocarbons is exhausted. Future growth requires that productivity increases through structural change, investment, organisational modernisation and technical innovation. The confidence crisis following the Ukrainian crisis in early 2014 has added to the systemic problems and makes the prospects for the Russian economy even more uncertain, as is manifested in capital flight and weak propensity to invest. Growth forecasts vary between a decline in GDP to growth of 1–2 per cent for 2014–15 (World Bank 2014b).

Is the present politicised economic system able to meet the challenges and restore growth? After the shift away from a command economy in the 1990s and the consolidation of the market reforms at the beginning of the 2000s, the Russian economy has experienced re-nationalisations and increasing political interference. As a result the Russian economic system, in early 2014, is a hybrid of the old Soviet heritage and state intervention, on the one hand, and a market economy, with private ownership, modern and sound budgetary rules, and WTO-accession, on the other. In addition, this economic model is seasoned with an increasing shadow economy and widespread corruption. Liberal economists in Russia argue for renewed market reform in order for Russia to be able to compete in the global environment, overcome capacity constraints and support innovation. They have also started to emphasise the need for real democracy to enable modernisation (Åslund 2012: 382).

To some degree the government supports the idea of modernising the economy and making it more competitive (Government RF 2013). However, at the same time, President Vladimir Putin sympathises with forces advocating a ‘Russian economic model’ including revitalising the economy by technological ‘leap-frogging’ through militarisation of the economy, an expansive fiscal policy and

an even stronger role for the state.<sup>1</sup> Uncertainty regarding Russia's economic policy road map makes it relevant to explore in more detail the characteristics of the Russian economic system and investigate its potential to stimulate growth.

The purpose of the report is to analyse the systemic characteristics of economic development in Russia after 2009 and to assess the potential of the present hybrid economic system to resolve the impediments to future growth based on improvement of productivity and innovation. Fundamentally this is an investigation into the extent to which the economic system can facilitate a more efficient allocation of resources between sectors, less resource waste, productivity increases and stronger competition by enabling entry of new actors into different areas. The study uses a model of the economic system under Vladimir Putin which is a development of the model of Gaddy and Ickes (2010) on 'rent addiction' and the 'rent management system' in the Russian economy. However, in this report the emphasis of the analysis lies not on rent addiction in itself but on the effects on other parts of the economy, especially the small and medium-sized enterprises, 'the new private sector', which has been added to the model. It is shown that when a dominant part of the economy is ruled by the management of oil rents to secure the power of the regime, the role of market-oriented institutions in economic growth becomes limited. Weak institutions have a background in the shortfall of democracy in Russia which is reflected in weak channels of 'voice' (Hirschman 1970) for citizens and organisations to express their opinion. The report analyses the effects of the present restrictions on voice and civil society development and concludes that there is little hope for 'reform from below' of the system.

The outline of the report is as follows. The second section starts with an analysis of the Russian economic system, highlighting the effects of Russia's dependency on commodity trade and the distribution of rents from the oil and gas trade to the non-competitive industry, which inhibits reform of the economy and its development. The third section discusses economic development after 2009 and analyses the government's economic policy and the main challenges, such as demographic developments and the business climate. This section touches briefly on Russia's international cooperation in the World Trade Organization and the Eurasian Customs Union and whether these external links can improve the performance of the economy. The fourth section investigates the situation of basic market-oriented institutions using the World Governance Indicators, which give comparative empirical evidence of the relative strength of institutions in different countries. The fifth section raises the importance of democracy and civil

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<sup>1</sup> The main champion of the 'Russian economic model' has been Sergey Glazyev, who became Putin's personal economic advisor in July 2012 (Åslund 2012: 380).

society for further economic development. Russia has a tradition of ‘reform from above’ but protests after the Duma elections in 2011 showed that the Russians want to voice their opinions and raised some short-term hope of ‘reform from below’. Civil society as a vehicle for organised voice in a society has since been severely restricted in Russia, but the efficiency challenges of the economy remain and are interlinked with the shortage of democracy. The final section draws the conclusions of the study.

The study takes its starting point in the existing literature on the situation in Russia during and after the economic crisis in 2009 – see e.g. Oxenstierna (2009; 2012); Åslund et al. (2010) – and recent contributions investigating in depth the nature of the Russian economy since the start of the economic reforms up to the mid-2010s. The handbook on the Russian economy edited by Alexeev and Weber (2013) provides a broad collection of analyses covering both systemic topics and analysis of the main sectors of the Russian economy as well as social and regional issues. Its starting point is the Soviet economic system and phenomena in transitional Russia are analysed with the Soviet heritage as a reference. Hare and Turley (2013) offer a handbook on the economics of transition organised by standard economic topics; the book is devoted to problems that are general in transition economies. It shows that the problems of weak institutions, a poor business climate and state versus private ownership are common to all these economies and to various degrees remain problem areas. The monograph on Russia’s political economy by Sutela (2012) analyses the Russian economy up to the crisis in 2009 with a stress on developments in energy, the financial sector and welfare.

As to theoretical approach, the study is inspired by Gaddy and Ickes (2010),<sup>2</sup> an article on the ‘rent addicted economy’ which highlights the link between the ‘power vertical’ and the economy and the impact of Putin’s rent management system on the economy. In this report the model has been developed to include not only a rent creation sector and the ‘addicts’ (here termed the ‘rent dependent sector’) but also a ‘new private sector’ which symbolises the small and medium-sized enterprises. The new private sector is not directly involved in the rent management system but includes enterprises that try to survive under the market rules that are in place in Russia.

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<sup>2</sup> The same basic model is used and similar ideas are expressed in Gaddy and Ickes (2013a; 2013b).

The study makes use of Russian official statistics for basic macroeconomic and federal budget data. Data from the international survey World Governance Indicators, the World Bank Doing Business Index and Transparency International are used to describe and analyse the quality of institutions in Russia. Studies based on the Russia Longitudinal Monitoring Survey are referred in connection to data on the informal economy and income differentiation.

## 2 The economic system under Vladimir Putin

In 2002 EU proclaimed that Russia was a market economy (EU Commission 2007: 5) and most technical assistance in the economic field ceased. However, despite the dramatic change of economic system in the beginning of the transition, all through its transformation towards market and democracy Russia has preserved remnants of the old Soviet economy. When prices and trade were liberalised in 1992, a new private sector started to emerge, driven by new entrepreneurs. Trade was the activity in which many of these gained their initial capital. The result of this change is that over 20 per cent of Russian GDP comes from small and medium-sized enterprises (SMEs) and they account for around 22 per cent of total employment (OPORA 2010). Some of these new private companies have even grown into big corporations. Yet this is still a very low share of GDP for SMEs. In most developed economies a share of over 50 per cent would be expected. However, in Russia the informal sector plays a large role in the economy and since 2012 several policy measures, e.g. the increase of social taxes, have led many SMEs to de-register and continue their activity informally. The role of the small-scale sector may therefore be larger than what official statistics reveal (see further discussion in section 3.1 below).

However, parallel to this market-oriented development, large Soviet-type companies, sometimes privatised but mostly state-owned or state-controlled, have survived in the defence sector and other parts of machine building and traditional heavy industry. These companies coped with the transition with different survival strategies. As described by Gaddy and Ickes (2002), in the 1990s barter chains and a 'virtual economy' emerged that kept these companies alive. The phenomenon of 'wage arrears', a specific characteristic of the post-Soviet space, was widespread. It means that labour is not laid off, but instead wages are not paid and, in the best cases, workers are paid in kind. This has kept open unemployment down, but wage arrears are an alien form of adjustment compared to what usually happens in a Western capitalist market economy, where labour market adjustment takes the form of unemployment. When demand for products in a specific sector falls, labour is reallocated to other, more productive sectors. This is how productivity and economic efficiency rise.

In the 2000s, oil prices surged and growth picked up. This implied that the fiscal situation improved and Russia entered a period of high growth when inefficient companies with low productivity could be subsidised.<sup>3</sup> However, in 2009 this inefficiency became expensive and more problematic, since financial and real resources had become scarce. At first it seemed that the Russian government intended to address these problems with then President Dmitry Medvedev's modernisation programme, but since Vladimir Putin became president again in 2012 the 'Soviet-type sector' has regained government support both morally and financially, and instead of energy, IT and pharmaceuticals, quoted by Medvedev as core industries for the modernisation, the defence industry is seen as a driver in the attempt to increase growth and innovation (Oxenstierna 2009: 44; Putin 2012d). However, assessments of the Russian defence industry show that it is obsolete and inefficient. The Russian Audit Chamber noted in its report to the Duma Defence Commission in 2012 that 30 per cent of the defence industry companies were loss-making and that only 20 per cent of the companies were deemed to be in such a shape that they could be modernised. According to the Audit Chamber the remaining 50 per cent of the industry is in such a state that it would be meaningless to restructure it. Instead it would be better to build new companies and replace them (Oxenstierna 2013: 114).

Soft budget constraints and soft credit prevail and obviously conserve the old industrial structure. Why is the subsidised sector kept alive and why is it so difficult to modernize it? The reasons are several. First of all, it is evident that Putin during his election campaign made promises to regions dominated by such companies to continue to support them. In Russia there are still so-called monotowns, cities or even regions that are dependent on one single company. It is estimated that there are around 400 of these, of which half are big energy and exporting companies, and half belong to sectors that are problematic (Oxenstierna 2011: 8). These companies fulfil a social role and it is difficult to close them because there are no other employers in the city or region. The relative geographical isolation of many defence companies has further contributed to immobilising the workforce, who have few alternative job openings (Oxenstierna and Westerlund 2013: 15–7).

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<sup>3</sup> As an example of low productivity, on SIPRI's lists of the world's 100 largest defence industry companies between 2007 and 2010, the few Russian companies included have between twice and four times as many employees as Western companies with comparable sales revenues (Oxenstierna and Westerlund 2013: 17-8).

## 2.1 The rent dependent economy

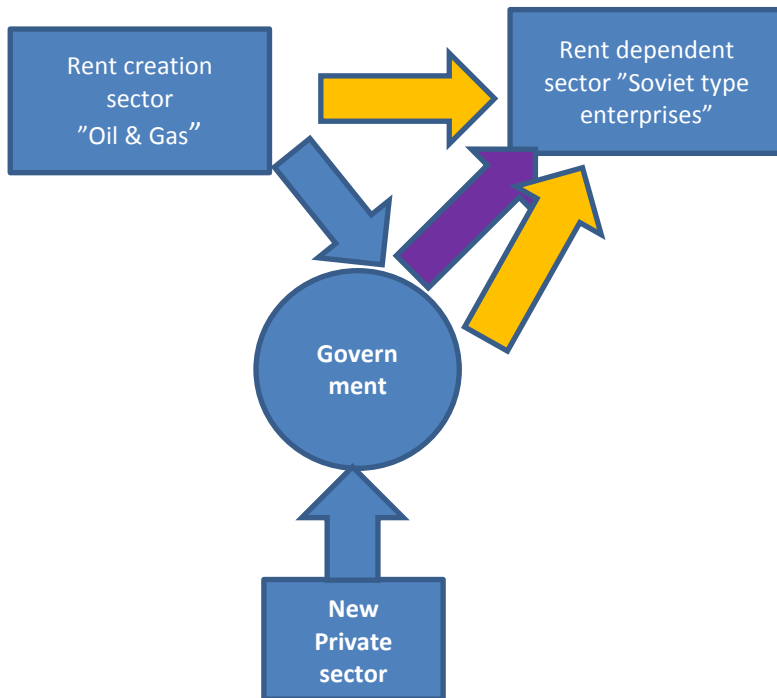
The more general explanation for the continuing existence of loss-making firms in the economy is that they are an important part of Putin's power and control system and part of what Gaddy and Ickes (2010) characterise as 'rent addiction' in the Russian society. The concept 'rents' refers to the profits earned from owning or controlling an asset, usually natural resources. In the Russian case it is the extraction and exporting of commodities such as oil and gas that generates rents. Rents are redistributed by the regime and Gaddy and Ickes also introduce the concept of a 'rent management system', which means that rents are distributed to where they are needed to balance the power elites. In Gaddy and Ickes' model the use of rents to subsidise loss-making companies creates 'addicts' that demand more and more rents and, since many people are employed in these enterprises and they represent important political support for the regime, it is impossible to get out of the vicious circle. Rent addiction creates a distorted allocation of resources, inefficiency and excessive costs of production that are borne by all actors.

The rent management system is a heritage from the Soviet era when extra money such as oil rents in periods of high oil prices could not be spent on private capital or consumption goods by the power elites for ideological reasons. To open a factory and spend the money on productive assets was possible, however. In addition, the advantage of productive assets, unlike financial assets or consumption, is that they can be used to extract more rents over a long time since they employ workers and have a need for investment. The system of rent management is an important part of Putin's power vertical and one rationale behind the inefficiency that prevails in the Russian economy. Rents may be collected by the state in form of taxes. They may also be collected and redistributed in the form of the excessive costs for inputs and services, e.g. high prices for railway transport, or high-cost construction which is typical for companies in the rent dependent sector (see Annex figure). The indirect costs of lack of infrastructure and other societal services also affect the economy and create extra costs for all economic actors.

In this study the emphasis of the analysis lies not on rent addiction in itself but on its effects on other parts of the economy. Beside the 'rent creation sector' and the 'addicts', the 'rent dependent sector', a third sector, called the 'new private sector', has been added to the model. The 'new private sector' represents the SMEs, the parts of the economy that are not directly involved in the rent management system but operate on the market. This is the part of the economy

that is most affected by prevailing market institutions. Figure 1 depicts a simplified model of a rent dependent economy with four sectors: the government, the rent creation sector, the rent dependent sector, and the new private sector. The *rent creation sector* earns rents by selling commodities, in Russia predominantly oil and gas. It pays taxes to the government [blue arrow]

**Figure 1 Model of a rent dependent economy**



Legend:

Blue arrows	Tax payments
Purple arrow	Transfers/subsidies from the government
Yellow arrows	Extra costs due to high prices of rent dependent sector, inefficiency, monopoly pricing or side payments.

Source: The Author



and rents are redistributed by the government to the *rent dependent sector* in the form of subsidies, transfers and state orders [purple arrow]. However, the state also redistributes rents when it procures goods and services from the rent dependent sector or invests in this sector by paying a high price due to inefficiency and excessive costs in the rent dependent sector [yellow arrow]. Also the rent creation sector has rents extracted directly by the rent dependent sector when it buys goods, invests or lend money to rent dependent companies directly or to loss making regions [yellow arrow].

The new private sector, consisting mainly of SMEs, operates in a market framework and pays taxes [blue arrow]. It is also indirectly affected by the rent management system by high cost levels, lack of infrastructure etc., but it is not a formal part of the rent management system. This is a reason why the conditions for SMEs have been highly neglected and many times worsened under the present regime.

The model could also be interpreted in terms of donor regions and loss-making regions, where donor regions would play the role of the rent creation sector and the loss-making regions that of the rent dependent sector. In the leading oil and gas extracting regions these industries play an important role in the regional economies, creating well-paid jobs and providing large revenues for regional budgets. Rent distribution was an important instrument for equalising incomes between the regions in the 2000s. The ratio between the incomes of the richest oil- and gas-extracting Tyumen region and the poorest regions, such as the underdeveloped Republic of Ingushetia, fell from about 30 in 2005 to 13 in 2010 (Zubarevich 2014).

## 2.2 Consequences of rent management for the economy

The rent management system and Putin's need to balance the power elites lie behind many of the structural problems in the Russian economy that could also be labelled 'systemic':

- **Allocative inefficiency.** Since it is more important to allocate rents in a way that preserves the power balance than to direct investment and public spending to their most productive use, the factors of production are locked up in activities without perspective, while competitive entities experience shortages of labour and capital and have difficulty

expanding. As a direct result of rent redistribution, since 2009 public sector wages have risen dramatically and social transfers have increased, especially in low-income regions.

- **Lack of competition.** In many industries there is only one company providing the goods or services and it can charge monopoly prices, thereby causing excessive costs of production for others. Moreover, when some companies are subsidised, they compete on unequal terms with those not receiving any support and productive activities are crowded out.
- **Problems of ‘entry’.** The politicised economic system has created a business climate in Russia that is difficult particularly for SMEs (see Table 3). To start a business is tough and, due to lack of transparency in regulations and the negative attitudes of the control organs towards businesses that are making money, it is difficult to expand. The fact that it is difficult to enter a market also means that there is not even ‘potential competition’ of new entrants, which lowers efficiency.
- **Economic inefficiency and low productivity.** The fact that production takes place and expands at loss-making firms instead of at innovative, efficient firms leads to low efficiency and productivity.
- **Corruption.** Corruption is difficult to control in this politicised system where vested interests and personal discretion rule instead of the rule of law.
- **Lack of innovation and modernisation.** Innovation and modernisation could upset the rent management system and the power balance and are opposed by the groups that profit from the system. In Medvedev’s modernisation programme sectors like energy, IT and the pharmaceutical industry were named as leaders. The need for institutions that support competition and entry was part of this agenda but is not part of Putin’s modernisation agenda. Instead, Putin sees the defence industry as the driver in technical innovation, although a large part of this industry is beyond hope and the remaining 20 per cent needs investment and modernisation (see above).
- **Democracy and the economy.** Since the government must ensure that the rent dependent sector is provided for, public funding is distributed according to the leader’s priorities rather than according to what would be the best use for society. Public funding is not subject to satisfactory democratic control. The Accounting Chamber reports each year on misuse of public funds, but apart from selective ‘anti-corruption’ responses, this does not have much effect. The lack of transparency impedes the accountability of the regime.

### 3 Economic development and economic policy

Economic growth was 1.3 per cent in 2013 according to estimates in early 2014. This is less than half of growth in 2012, which was 3.4 per cent. which in turn was considerably lower than the over 4 per cent anticipated in many forecasts. During 2012, the Ministry of Economic development (MED) adjusted growth forecasts for GDP 2013 several times from around 3 to 1.8 (*Vedomosti* 2013) and finally to 1.5 per cent. In the end growth was even less and has dropped to less than a quarter of the average level in the 2000s. Domestic demand that was the main driver in GDP growth during 2012 slowed down during 2013. The structural problems in the economy that are summarised in section 2.2 are impeding growth despite oil prices having remained at a high level.

**Table 1 Economic development 2008-13**

	2008	2009	2010	2011	2012	2013**
GDP, y-o-y %	5.2	-7.8	4.5	4.3	3.4	1.3
Investment, y-o-y %	9.8	-16.2	6.0	8.3	6.7	NA
Federal budget balance, % GDP	4.1	-5.9	-4.1	0.8	-0.1	-0.3
Inflation CPI, p-o-p %	13.3	8.8	8.8	6.1	5.1	5-6
Reserve Fund bn USD e-o-p	137.1	60.5	25.4	25.2	62.1	86*
National Wealth Fund, bn USD e-o-p	88.0	91.6	88.4	86.8	88.6	85*
Share of energy in export, %	65.9	62.8	63.5	65.5	65.4	NA
Share of loss-making companies, %	25.2	30.1	27.8	28.1	NA	NA
Share of credits in investments, %	17.6	20.1	14.3	12.8	NA	NA
Real disposable income, index (1999=100)	251.5	259.3	272.5	274.7	279.6	NA
Average monthly wage, USD	697	588	698	806	859	909*
Unemployment, % (ILO definition)	7.8	8.2	7.2	6.1	5.3	5.6

Source: World Bank (2013). Minfin (2013). Wage from Rosstat (2014) April; reserve and wealth funds from Minfin (2013).

Notes: \*Own calculation. RUR/USD 32.4. \*\* Forecast or preliminary]. Y-o-y year on year; p-o-p period on period; e-o-p end of period.

In September 2013 the MED published an adjusted forecast for the period 2013–16 based on estimated GDP growth in 2013 of 1.8 per cent. According to the new scenario, growth was expected to recover in 2014 to 2.8–3.2 per cent and to 3.2–3.4 per cent in 2015 and 3.3–3.7 per cent in 2016 (*Vedomosti* 2013). In December the MED lowered the forecast for 2014 to 2.5 per cent. In January 2014 no growth was reported which indicates that the around average 3.5 per cent yearly growth that IMF (2014) predicts up to 2018 will be difficult to attain.

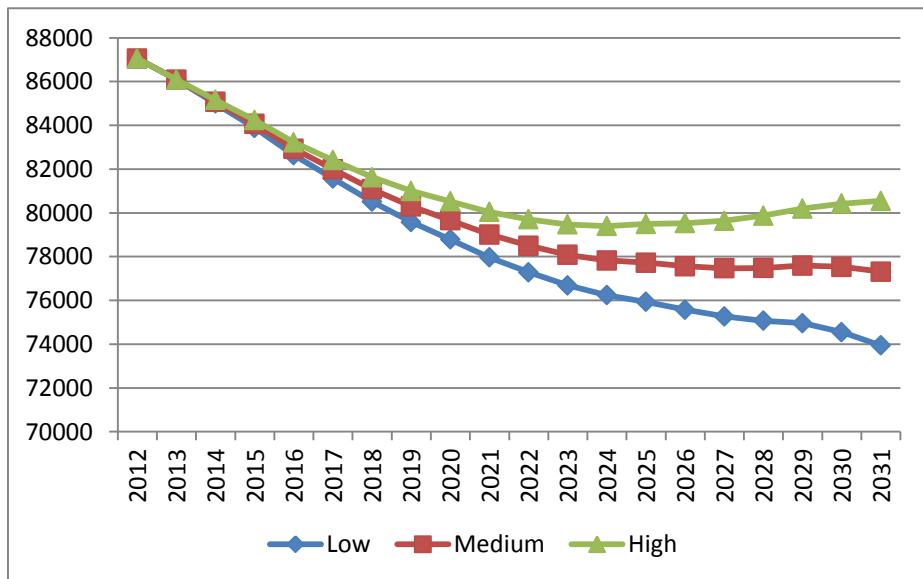
After the Russian invasion of Crimea in February 2014 and the crisis in eastern Ukraine that followed, there is even more uncertainty surrounding the development of the Russian economy. Bringing Crimea with its population of about 2 million up to Russian standards of living implies extra costs for the federal budget. Economic sanctions may upset the energy trade. Capital flight out of Russia will increase and foreign direct investment will be depressed. Russian assets abroad may be frozen. Many Ukrainians work in Russia and what will happen with labour migration is unknown. An escalation of the conflict may complicate international trade and the mobility of both labour and capital. Many observers guess at zero growth or even a decline of GDP in 2014. The World Bank (2014b) expects at best 1.1–1.3 per cent growth in 2014–15 and, in a more pessimistic scenario, a contraction by 1.8 per cent in 2014. The loss of confidence as to whether Russia will maintain basic business principles such as respect for private ownership, keeping agreements and honouring contracts is making investors hesitant and the much-needed technological cooperation with the West will suffer. The uncertainty created by the crisis as to what economic framework will prevail in the future is probably the worst threat to Russia's long-term economic development.

### **3.1 Demographic developments and the labour market**

Despite the pronounced decline in the growth rate, employment remains high and unemployment is at a low: in 2012 it was 5.3 per cent and in 2013 around 5.6. This indicates the persistence of low productivity, which is estimated at between 2.5 and three times lower than in the developed countries (Government of the RF 2013: 9), and suggests that growth still depends on increasing inputs rather than on better use of them. The labour shortage has become a limiting factor to growth, and qualified labour in particular is in short supply. The restrictive migration policy hinders the necessary labour migration which could mitigate the marked decline in the numbers of people of working age, which is becoming more severe.

In 2012 the economically active population<sup>4</sup> was 75.7 million and of those 71.5 million were employed and 4.1 million unemployed (Rosstat 2014). As may be seen in Figure 2, which depicts Rosstat's demographic forecast with a low, medium and high scenario, the working age population (15–72 years of age) will shrink from 87 million people in 2012, in the best case, to 81 million, and in the worst case to 74 million persons, in 2031, i.e. there will be in between 7 and 13 million fewer persons of working age at the end of this 20-year period (Figure 2).

**Figure 2 Russia's working age population 2012-31, thousand persons**



Source: Rosstat (2014)

On the one hand this is good news. If the economy were to undergo restructuring and modernisation, which would inevitably result in the displacement of workers, a certain labour shortage and fewer persons entering the labour market each year would make adjustments easier. On the other hand,

<sup>4</sup> The economically active population is the part of the population that is employed or is actively searching for employment. The difference between working-age population and economically active population is accounted for by people outside the labour force, the 'non-employed' (students, persons on parental leave, discouraged workers, persons on early retirement etc.). Working pensioners are part of the economically active population.

labour shortages and low mobility of labour make it difficult for new companies to grow since labour is locked into the old sector and new private companies have difficulty recruiting labour. Because labour is an asset for employers in the old sector, labour hoarding is common. Geographical mobility is low in Russia and the housing market in expanding regions represents a restriction. As discussed below, medium-sized companies see the lack of qualified personnel as their main constraint.

Labour market adjustment in Russia has taken its own particular course since the transition started. Prior to the start of the economic reforms in 1991, labour market experts were convinced that market oriented economic reform would lead to displacement of workers and high unemployment. This conclusion follows from standard economic theory, but in addition Poland and other transition countries provided empirical evidence of this outcome. At the time, predictions of unemployment rates of around 25 per cent were common (Gimpelson and Kapelyushnikov 2013: 693-4). However, in Russia this did not happen. Instead the main part of labour market adjustment took place through wage flexibility. Wages fell dramatically while employment fell only marginally and unemployment rose slowly. High wage flexibility and low sensitivity of employment to fluctuations in output has been a trade mark of the Russian labour market in the 2000s as well. GDP doubled between 1998 and 2008, but total employment grew by only 7–8 per cent over this ten-year period (ibid.: 695). Real wages, however, grew by 10–20 per cent annually and cumulatively tripled over this period (ibid.: 701). During the 2009 crisis wage arrears increased and real wages decreased, while unemployment even declined, which shows that a large part of the economy is not competitive (Oxenstierna 2009: 20–1).

The growth of regional disparities in employment continued until the crisis of 2008. One of the causes was low investment in the less developed regions and a lack of new jobs, which reinforced the regional differences in unemployment rates. Inter-regional differences in per capita money incomes have been declining due to the federal redistributive policies and outstripping increase of public sector employees' wages (Zubarevich 2014).

Another characteristic feature of the Russian labour market is the persistence of a substantial informal sector. According to the study by Gimpelson and Kapelyushnikov (2013) which is based on the Russia Longitudinal Monitoring Survey (RLMS),<sup>5</sup> in 2009 informal employment accounted for 24 per cent of employment (ibid.: 12). Of the informally employed 20 per cent are hired workers and 80 per cent are self-employed. The border between formal and informal employment is soft. Many people work part-time in the informal sector while keeping a regular job as well. Wages in the informal sector are on average 15–20 per cent lower than in the formal sector but there is a substantial spread in the distribution, with some jobs being better paid in the informal sector, some worse (ibid.: 38).

Labour is a scarce resource in Russia and it will become scarcer if the government does not succeed in increasing productivity, reducing labour hoarding at loss-making companies and motivating labour to move out of the low-productive old sectors to new high-productive jobs. As remarked by Vladimir Mau<sup>6</sup> (2013: 14) if new jobs are to be created, as envisaged by Putin's plan to create 25 million new high-tech jobs up to 2020, old jobs need to be eliminated since there is no labour surplus to employ (see section 3.2 below).

Labour migration already plays an important role on the Russian labour market. Registered work permits to foreign citizens amounted to 2.4 million at their peak in 2008 and 1.1 million in 2011 (MPC 2013: 4). Of these 80 per cent come from the Commonwealth of Independent States (CIS) countries, especially from Central Asia. However, a large part of labour market migration is unregistered, which means that to understand its real size, estimates are used. Russian demographers estimate labour migration at around 3–7 million persons per year (ibid.). Also, taking into account the fact that some of the migrants work in the informal sector, it is estimated that in total about 10 per cent of all employed in the Russian economy are foreign migrant workers (ibid.). Workers from the CIS countries working in Russia make considerable contributions to their home economies. Remittances to their home countries amounted to USD 18.2 billion in

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<sup>5</sup> The Russia Longitudinal Monitoring Survey (RLMS) is a series of nationally representative surveys designed to monitor the effects of Russian reforms on the health and economic welfare of households and individuals in Russia. Data have been collected 19 times since 1992. Of these, 15 rounds have been run jointly by the Carolina Population Center at the University of North Carolina at Chapel Hill and the Demoscope team in Russia.

<sup>6</sup> Vladimir Mau is a long-time reform economist and rector of the Presidential academy.

2012. Total remittances from all migrant workers amounted to USD 20.9 billion (MPC 2013: 4, based on Central Bank of Russia statistics).

## 3.2 Economic development and economic policy

Economic policy under former Minister of Finance Alexei Kudrin was praised for its restraint and low government debt. Crisis management during the 2009 economic decline of minus 8 per cent of GDP resulted in Russia recovering from the crisis and growth in 2010 was 4.5 per cent (Table 1). After Putin's return as president and Kudrin's resignation, the direction of economic policy has been less consistent and the idea of Russia taking its own route with a 'Russian economic model' has evolved. The main champion of this policy direction is Sergey Glazyev, who became Putin's personal economic advisor in July 2012. Glazyev is a convinced nationalist and statist (in favour of state control) and advocates state capitalism, protectionism and a much looser monetary and fiscal policy which he claims would spur growth (Åslund 2012: 375–6). Another person with increasing influence over economic policy is Dmitry Rogozin, a former chairman of the nationalistic political party Rodina who was appointed Deputy Prime Minister in charge of defence and space industry in 2011.<sup>7</sup>

Glazyev's economic programme is far from the liberal market-oriented policies advocated by reform economists. His main idea for revitalising the economy is technological leap-frogging through militarisation of the economy and a stronger role of the state (ibid.: 380). He favours state intervention and military-industrial development and argues that increased military expenditure would stimulate the demand for new technological products. His strategy demands nationalisation of even more large enterprises and state planning. His macroeconomic policy calls for expansionary monetary and fiscal policy. Glazyev is an enthusiastic supporter of the Eurasian Customs Union (see further section 3.4 below) between Russia, Belarus and Kazakhstan, believing that it will boost the economies of its members (ibid.: 381).

The Russian liberal economists have heavily criticised Glazyev, in particular his proposals for macroeconomic policy that would lead to surging inflation and his

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<sup>7</sup> As responsible for the defence industry Rogozin is also in charge of the [Russian Foundation for Advanced Research Projects in the Defence Industry, DARPA](#). He is a close ally of Glazyev who succeeded Rogozin as leader of Rodina.



industrial policy that would hardly lead to modernisation but rather pull Russia back into a 'Brezhnev-like stagnation' that characterised the Soviet economy during its last decades. Liberal economists stress that the economy needs market reform to be able to compete in the global environment and that the key problem is the economy's inability to overcome poor capacity and support innovation (ibid.: 382). Liberal economists have also started to emphasise the need for real democracy for enabling modernisation. However, re-privatisation is not mentioned to any great extent.

In 2012–13 Putin appeared to favour the Glazyev-type policy, which is also reflected in the economic programme of the Government RF (2013) and the speech to the Federation Council 12 December 2012. However, the weak growth in 2013 shows that the policy is not paying off and it will be difficult to achieve higher growth with fiscal expansion and even more state intervention. Nevertheless, the market oriented-view seems to have prevailed in fiscal policy that has remained restrained. The budget for 2013–16 shows that there is an aim to reduce the federal budget as a share of GDP from 20 to 18 per cent by 2016. Social policy expenditures that have had high priority since 2009 are to fall from 6 to under 5 per cent of GDP. The shares of education and health also show a declining trend. Defence spending remains at a high level and is planned to rise from 3.1 to 3.8 per cent of GDP by 2016 (Table 2).

When it comes to policy goals during the coming five years, President Putin issued a number of decrees setting the framework of different policy areas immediately after his inauguration in May 2012 (Putin 2012a–d). In the decree on economic policy Putin (2012d) spells out the economic improvements that should be achieved by 2018–20. These include:

- the creation of 25 million highly productive jobs by 2020;
- an increase in the share of investment in GDP to 27 per cent in 2018;
- an increase of investment in state priority industries;
- an increase in labour productivity by a factor of 1.5;
- preparations for the privatisation of state assets outside the commodity-energy sector; and
- an improvement of the rating of Russia in the World Bank Doing Business Index from 120th place in 2011 to 50th in 2015 and 20th in 2018.

**Table 2 Federal budget 2013-16, per cent of GDP**

	2012	2013	2014	2015	2016
<b>Federal budget as % of GDP</b>	<b>20.6</b>	<b>19.8</b>	<b>18.7</b>	<b>18.6</b>	<b>18.0</b>
Share of total outlays in consolidated budget system		52.7	52.3	52.5	51.7
General state issues	1.3	1.4	1.3	1.2	1.1
National defence	2.9	3.1	3.4	3.8	3.8
National security and legal	2.9	3.0	2.8	2.7	2.4
Support to the economy	3.1	2.7	2.5	2.4	2.3
Housing and utilities	0.4	0.2	0.2	0.1	0.1
Environment protection	0.0	0.0	0.0	0.0	0.0
Education	1.0	1.0	0.8	0.8	0.7
Culture	0.1	0.1	0.1	0.1	0.1
Health	1.0	0.8	0.6	0.4	0.4
Social policy	6.2	5.7	5.2	4.9	4.7
Physical culture and sport	0.1	0.1	0.1	0.1	0.1
Media	0.1	0.1	0.1	0.1	0.1
Debt service (state and municipal)	0.5	0.1	0.6	0.6	0.6
Interbudgetary transfers	1.0	0.6	0.9	0.8	0.8
Deficit/surplus	-0.1	-0.8	-0.5	-0.6	-0.6
<i>GDP bn RUR</i>	<i>62 599</i>	<i>67 519</i>	<i>73 921</i>	<i>81 940</i>	<i>91 205</i>

Source: Annex table A1

In May 2013, the government had to present results on all the assignments and the president criticised ministers who had not coped (Putin 2013). As a result, several ministries published 'five-year plans' on their websites in June 2013 describing how Putin's decrees are to be fulfilled by 2018, or in some cases by 2020. The government adopted a more detailed economic programme for the period 2013–2018 (Government RF 2013). The programme is generally characterised by more state intervention and regulation instead of more market solutions. It shows that the present regime is opting for an even more politically managed economy in an increasingly centrally controlled political system. These

administrative regulations will hardly increase competitiveness or enhance the modernisation and growth that are needed to solve the structural problems of the economy.

### 3.3 The business climate

Putin (2012d) in his initial economic decree calls for an improvement of the rating of Russia in the World Bank Doing Business Index from 120th place in 2011 to 50th in 2015 and 20th in 2018. How do Russian businesses experience the business climate? Various surveys have been conducted to investigate this question.

The European Bank of Reconstruction and Development (EBRD) and the World Bank periodically poll executives of firms in transition countries in the Business Environment and Enterprise Performance Survey (BEEPS) which exists since 1999 (Treisman 2013: 210). The 2012 BEEPS<sup>8</sup> for Russia nationally and of 37 regions shows that most enterprises in Russia identify corruption, lack of access to finance and lack of workforce skills as the main constraints for doing business. Medium-sized enterprises put workforce skills as their main constraint ahead of access to finance. Large enterprises suffer primarily from lack of properly skilled workers followed by corruption. Innovative companies have more problems with the business environment as a whole than an average enterprise (BEEPS 2012). In some regions deficient infrastructure – transport, electricity, telecommunications – is a first-hand binding constraint. However, tax administration, business licensing, and customs and trade regulations do not seem to be perceived as constraints at all (ibid.). The latter point at measures intending to ease the starting business procedure and tax payments over the years have had some effect.

The World Bank ‘Doing Business Index’ is widely used to compare the business climate in different countries and it provides a ranking of the relative attractiveness of the business environment. This is the index that Putin chose to relate his business climate targets to. Judging from this index the business climate in Russia is not very attractive. In 2013, an improvement to the 92rd rank (from 120th in 2011) was registered (among a total of 189 countries). The index has 10 different aspects that are listed below in Table 3 and after each indicator

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<sup>8</sup> The survey comprises more than 4 200 randomly selected enterprises.

the separate rank is indicated. As seen in Table 3, only in enforcing contracts and resolving insolvency is Russia among the top 50, the rank sought according to Putin's plan by 2015. Russia is flanked by Croatia (89), Albania (90), Barbados (91), Serbia (93), Jamaica (94), and the Maldives (95). China is ranked 96th (World Bank 2014a).

**Table 3 Russia in World Bank 'Doing Business Index' 2013**

	Rank among	Rank among
	all 189 countries	26 EE & CA countries*
<b>Ease of Doing Business Rank</b>	<b>92</b>	<b>21</b>
Starting a business	88	22
Dealing with construction permits	178	22
Getting electricity	117	14
Registering property	17	7
Getting credit	109	22
Protecting investors	115	21
Paying taxes	56	9
Trading across borders	157	21
Enforcing contracts	10	1
Resolving insolvency	55	8

Source: World Bank (2014a). \*Eastern Europe (EE) and Central Asia (CA).

If Russia is compared to the group of 26 countries in Eastern Europe and the former Soviet space, it has a total rank of 21 and is only followed by Serbia, Ukraine, Bosnia and Herzegovina, Tajikistan and Uzbekistan. Russia's partners in the Customs Union, Belarus, with a global rank of 63, and Kazakhstan with 50, do much better, with rankings of 11 and 8 respectively, among the former socialist countries. Also, in this entourage Russia scores best on enforcing contracts (followed by Belarus as second), registering property and paying taxes (Table 3).

Thus, despite years of measures and legislation aiming at making the business climate more appealing, Russia is still near the bottom of the East European and

CIS league and just in the middle of the 189 countries ranked in the index. The reason is that such a big part of the economy is part of the rent management system and that the large companies and strong economic players in Russia are not particularly interested in changing the situation. Making it easier for new companies to enter the market and thereby getting competitors is not in their interest. The rich companies can always manage by ‘insourcing’ services, and the loss-making companies rely on their political contacts and their lobbying strength.

### **3.4 Trade cooperation: World Trade Organization and Eurasian Customs Union**

On 10 July 2012, the Duma ratified Russia’s accession to the World Trade Organization (WTO). By joining the WTO, Russia committed to bringing its trade laws and practices into compliance with WTO rules.<sup>9</sup> Russia has been the largest economy outside the WTO and the country with the longest accession agreement negotiations in the history of the WTO. The Working Party on Accession of the Russian Federation to the WTO was established 16 June 1993 (Tarr and Volchkova 2013: 593).

WTO accession affects a wide range of policies and institutions, including tariff policy, customs administration, standards, the rights of foreign investors, agricultural policy, intellectual property and government procurement, to name only a few. Changes in these institutions should move the economy towards an open trade and investment model of economic development. There are studies assessing the gains for Russia of entering WTO at 3.3 per cent per year of GDP in the medium term and 11 per cent per year in the long run (ibid.: 595). In summary, WTO accession should improve efficiency and reduce poverty. Regions that establish a better investment climate would reap greater gains, but most important are the effects of Russia’s commitment to undertake its own internal reforms, in particular in the service sector (ibid.). Since Russia already had ‘most favoured nation status’ with all its significant trading partners before

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<sup>9</sup> These commitments include: non-discriminatory treatment of imports of goods and services, binding tariff levels, ensuring transparency when implementing trade measures, limiting agricultural subsidies, enforcing intellectual property rights for foreign holders of such rights, and forgoing the use of local content requirements and other trade-related investment measures (Connolly 2013: 61).

becoming a member , less than 10 per cent of the gains is expected to come from improved market access (ibid.).

It is still too soon to assess the effects on the Russian economy of the WTO entry, but since it is mainly by internal reforms that gains will occur it remains uncertain to what extent Russia can exploit this opportunity of an 'external anchor' to modernise its institutions and policies. If inertia and reliance on raw materials prevail, Russia will get nothing from membership of the WTO. Both the Soviet Union and Russia have been able to sell hydrocarbons and other raw materials without it.

Russia formed the Eurasian Customs Union (ECU) together with Kazakhstan and Belarus on 1 January 2010. The ECU is part of the integration attempts among CIS countries to form the Eurasian Economic Community (EvrAzEs). The practical achievements of the union so far include a common customs tariff and a common customs territory, and internal physical border controls have been abolished as of 1 January 2011. According to Dragneva and Wolczuk (2013b: 3) the ECU's agenda is a 'future-oriented modernisation agenda' with tangible economic benefits. Unlike previous integration frameworks in the CIS area, the ECU should operate in harmony with the commitments associated with WTO membership.

The emergence of the ECU has raised many questions. Is this something more than a political vehicle for Russia to increase its influence in the CIS space, particularly in Central Asia? Is it a genuine attempt at economic integration that will produce economic benefits for the smaller states as well? The authors in Dragneva and Wolczuk (2013a) appear to agree that the ECU is primarily a geopolitical instrument and that it will not result in significant economic or institutional gains for its members. 'Instead, it is likely that domestic processes will remain the most important factors in shaping the potential for positive economic and political change across the region' (Connolly 2013: 78).

### **3.5 Challenges in the medium and long term**

For growth to pick up all the structural-systemic problems need to be addressed. However, does the Russian leadership want that? As long as rents are sufficient to enrich the power elites, is there any incentive? Yet lower growth does represent a risk since the political system also rests on increasing living standards for the population. Between the mid-2000s and 2008, the living standards of the Russian population rose twofold. This was largely the result of the economic

reforms of the 1990s, helped by high oil prices. The population accepted decreases in their liberties in exchange for higher living standards in the 2000s. However, with less growth and high ambitions both in defence spending and in social policy the situation may become difficult. Social stability is a prioritised goal for the regime and rent distribution might become more complex.

Mau (2013: 14) lists four major medium- and long-term challenges:

- Lack of structural change that would modernise the economy.
- After the crisis of 2009 the imbalance in the economic structure has become worse. Production in the extractive industries has grown more than production in manufacturing industry.
- Capital continues to leave the country.
- Extremely low unemployment creates labour shortages and difficulties for new, innovative companies in finding qualified labour.

Mau also notes that a large part of the educated population, the educated middle class living in the big cities, is ready to leave the country. It is usually not a question of emigration, but a large part of the population go abroad for medical treatment and education, they buy real estate and they send their children there first for education, then to live there permanently (ibid.: 15). Russian surveys indicate that 70 per cent of Russians with an income over the average want their children to study and work abroad and over one third would prefer their children to go abroad permanently. This is a very dangerous tendency since it means that the qualified demand for education and health services will disappear, and this will depress the quality of education and health in Russia (ibid.).

The polarisation of economic-political views is a reflection of the fact that only a minority of the Russian population sees market solutions and democracy as attractive and self-evident ways to move forward, and only a minority still remembers the hard realities of Soviet life. Economic policy is therefore divided and confused and there is great uncertainty regarding medium- and long-term development.

## 4 Are stronger institutions a remedy?

Institutions are a set of basic principles essential for the economic system to work that are upheld by structures in the economy (Ericson 2013: 59). For instance, competition is protected by laws that are followed up by state agencies such as an anti-monopoly or a consumer protection agency. Free trade that is considered vital for growth and development, is reflected in a country's trade policy, protected by multilateral agreements and upheld by international organisations such as the WTO. It is evident that the institutions supporting a market economy differ from those found in the Soviet command economy. However, it deserves to be noted that even though formal institutions collapsed quite quickly in the 1990s, the informal institutions of the Soviet system have remained mostly intact throughout the transition, and this has disturbed the modelling of the new market-oriented institutions in Russia. It follows that the institutional environment for transitional Russia has largely been formed by Soviet attitudes rather than by the formal Western models on which market institutions are based (ibid.).

The politicised economic model introduced under Putin has further aggravated the difficulty of developing a fully market-oriented institutional framework. As was presented in section 2.1 above and can be seen in Figure 1, the economic model has three sectors of which it is the 'new private sector' that would primarily profit from better market institutions. This sector could grow if the business climate, entry and competition improved and governance became more business-friendly. The rent dependent sector, however, would not gain from more market orientation. It defies competition and is better off with the informal rules that give it preferential treatment on a non-market basis. The rent creation sector with its dual framework – the external market on the one hand and the politicised rent distribution on the other – could gain from better market allocation on the domestic market; however, since this sector also suffers from efficiency problems, stronger competition from private companies may not be readily accepted.

Russia's deficient institutions are reflected in the *Worldwide Governance Indicators* (WGI 2014). The WGI project constructs aggregate indicators of six broad dimensions of governance. The six aggregate indicators are based on 31 underlying data sources reporting the perceptions of governance of a large number of survey respondents and expert assessments worldwide:

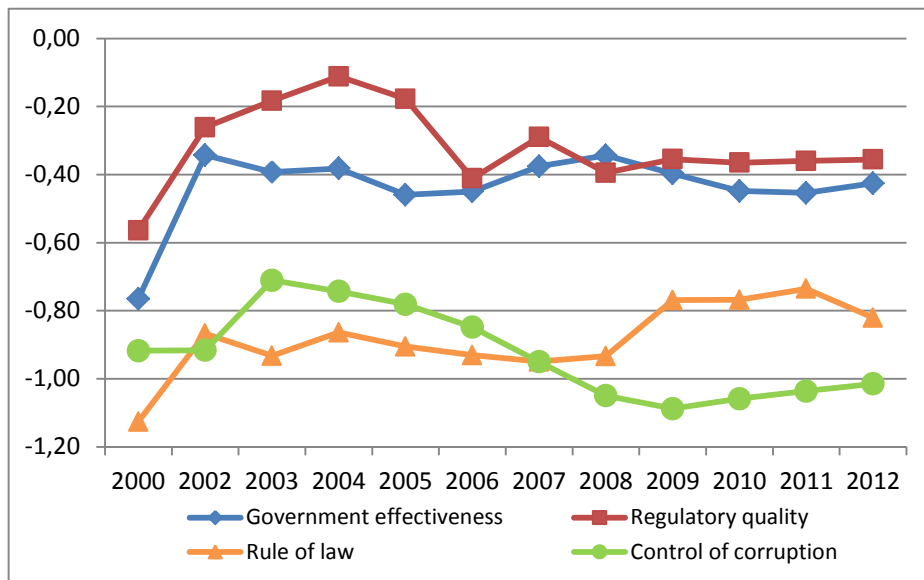
- Political Stability and Absence of Violence/Terrorism
- Voice and Accountability



- Government Effectiveness
- Regulatory Quality
- Rule of Law
- Control of Corruption

The aggregated estimate of governance lies between  $-2.5$ , very weak, and  $+2.5$ , very strong. I will not comment here on the indicator 'Political Stability and Absence of Violence and Terrorism'. However, the last four reflect the quality of vital market-supporting institutions, and the indicator 'Voice and Accountability' reflects the degree of democracy and the possibility of making politicians responsible.

**Figure 3 Russia in WGI 2000-12**



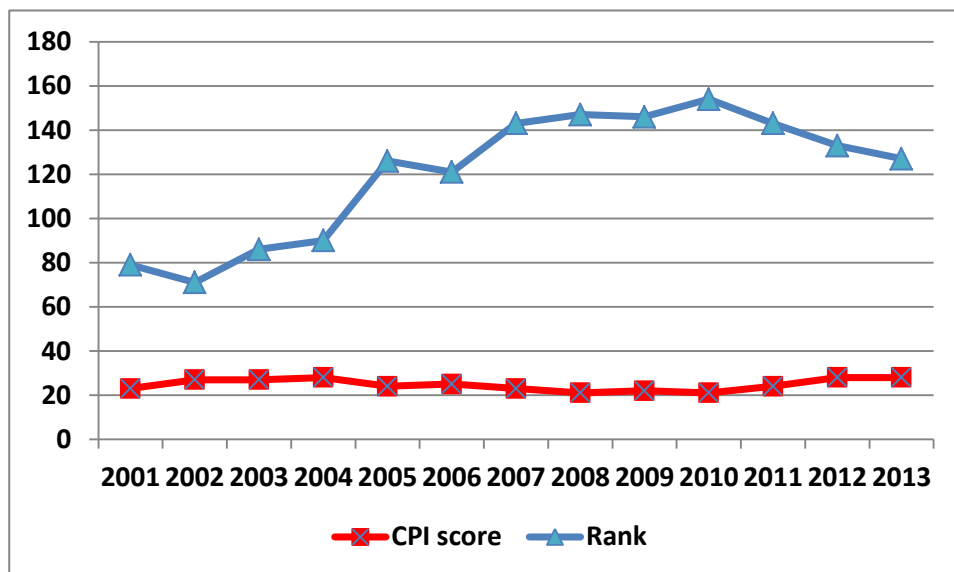
Source: WGI (2014).

Note: WGI - Worldwide Governance Indicators

In Figure 3 the red curve describes regulatory quality and the blue curve government efficiency. As can be seen, both these indicators improved dramatically in the beginning of the 2000s. This was under Putin's first presidency and the time of the 'Gref plan' which to a large extent consolidated the reforms of the 1990s. Both these indicators deteriorated, however, in the mid-2000s during Putin's second term and have since stabilised at around  $-0.4$ .

Figure 3 also depicts the development of rule of law, orange line, and control of corruption, green line. On both these indicators Russia scores much worse than it does for government effectiveness and regulatory quality. Rule of law improved from a low of  $-1.2$  in the beginning of the 2000s to about  $-0.9$ , where it stayed until 2008 when it improved slightly to over  $-0.8$ . Control of corruption, however, has deteriorated since an improvement in 2002–03 and is now under its value at the beginning of the 2000s.

**Figure 4 Russia's TI Corruption Perception Index (CPI) score and rank 2001-13**



Source: TI (2014)

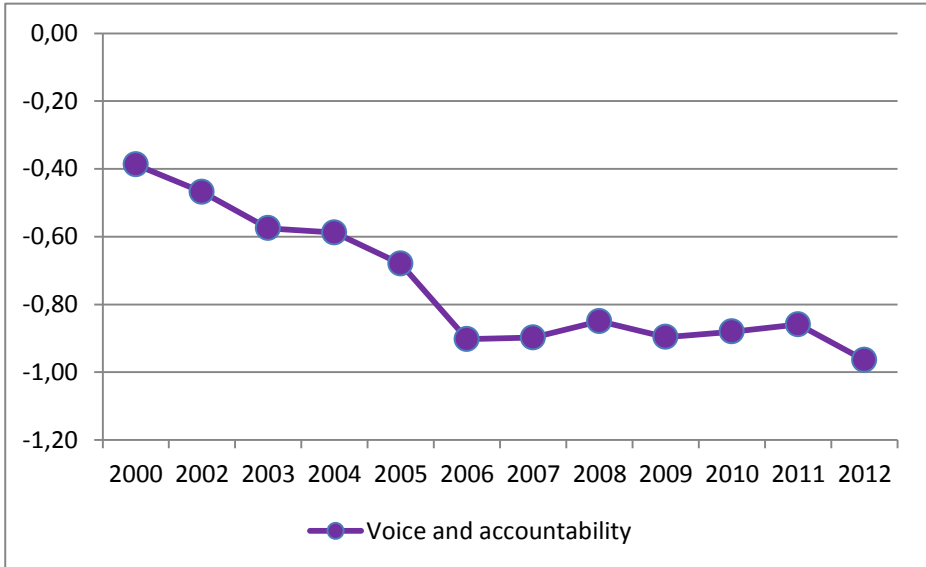
Corruption is usually defined as the misuse of public office for private gain. It comes in many varieties – from the extortion of bribes and kickbacks from businessmen and citizens to the embezzlement of budget funds (Treisman 2013: 209). The worsening of the Control of Corruption WGI indicator is accompanied by an inferior rank in Transparency International (TI), Corruption Perception

Index (CPI) ranking. As Figure 4 shows, in 2013 Russia's rank in the TI CPI was 127th among 177 countries surveyed and its score was 28. TI considers that a CPI under 50, on a scale from 0 (highly corrupt) to 100 (highly clean), indicates a serious corruption problem. The rank is considerably worse than it was in 2001, when it was 79, although at that time Russia's score was even worse, at 23. This reflects the fact that a country's ranking is dependent on which other countries are included in the survey and how they score. In 2013, several countries have the same score and rank as Russia: Azerbaijan, Gambia, Lebanon, Madagascar, Mali, Nicaragua and Pakistan. The only countries in the former Soviet space that have a worse CPI than Russia are Kazakhstan, rank 140 (score 26), Ukraine, 144 (25) and the Central Asian republics.

That citizens have voice, i.e. the opportunity to voice their opinions and to influence their situation, and that politicians can be made accountable are essential ingredients in a democracy. In Putin's Russia the voice and accountability indicator has seen a steady decline since Putin first came to power in 2000 when the estimate was  $-0.4$ . In 2012 it was down at  $-1.0$  (Figure 5). I would argue that the low voice and accountability indicator largely explains the low score in other WGI indicators such as 'rule of law' and 'control of corruption'. The declining trend in the voice and accountability indicator summarizes the increasing democracy shortage in Russia and implies that citizens have very limited opportunities to influence policies in their country.

The analysis of Russia's institutions using the WGI shows that the institutional framework is weak and even deteriorating. The fact that such a large part of the economy is governed by political goals and the leadership's need to balance power, rather than by economic logic, makes it difficult to anticipate improvements of the institutional framework. Better institutions would benefit the 'new private sector' that would get better opportunities to expand under stronger rule of law and less corruption. However, for the rent dependent sector, which relies on its political contacts, stronger institutions would be a disadvantage (see Figure 1).

**Figure 5 Russia in WGI: Voice and Accountability 2000-12**



Source: WGI (2014)

Note WGI –Worldwide Governance Indicators

## 5 Democracy and the economy

The weak rule of law and voice and accountability in the Russian economy reflect the fact that the separation of power between the legislative, executive and judicial branches of state power, defined in the Russian Constitution from 1993, is not manifested in Russian society. The executive branch, represented primarily by the president, is involved in all branches of power and there is no independent judiciary. Developments since 2012 with diminishing citizens' rights and basic freedoms follow from this breach of the constitution.

The restrictions on the freedom of speech and assembly in Russia, the lack of independent media and the crackdown on civil society organisations imply that there is very limited room for Russian citizens to voice their opinions and influence social and economic development. Instead, development in Russia is again unilaterally managed from above and politicians are not accountable to their electorate in any efficient way. In this section I argue that the lack of channels of 'voice' of the population and the resulting weak civil society results in missed opportunities to improve the direction and functioning of the Russian economy. With the present leadership economic development will be restricted by the continuation of the subsidising of unprofitable 'rent dependent' industry and the redistribution of oil rents. The main goal of Putin is to remain in power and to secure his position, and the rent distribution system is needed to regulate the power balance between different groups. This is a quite different goal compared to stimulating growth and supporting innovative new companies.

### 5.1 The strengthening of 'voice' by a developed civil society

The concept of 'voice' in the economic literature comes from the theory of *Exit, Voice and Loyalty* by Albert O. Hirschman (1970). Hirschman takes as his starting point standard economic theory and attempts to explain behaviour that is not predicted by standard economic models. Market actors express 'voice', i.e. try to influence the quality of goods and services instead of just choosing another provider. 'Exit' is the predicted behaviour for an economic agent that is dissatisfied with a good or a service, at least in a competitive environment where there are alternatives. Hirschman also introduces the concept of 'loyalty' as a bridge between exit and voice. If the individual has a loyalty bond with the

organisation or company that he/she is dissatisfied with there is a greater chance that he/she will try to use voice to improve the situation before taking the exit option.

Translated into a political setting, 'voice' is how citizens try to influence the political elites and get their main concerns onto the political agenda. In democracies there is a mutual interest in effective channels of voice since power elites and political parties want to stay in power and adjusting to citizens' demands may increase their chances of doing so. Citizens may also choose 'exit' by voting for somebody else. When that is not possible, however, and the space for voice is restricted, exit may take the form of emigration or of 'internal emigration' which means that citizens withdraw from political life and do not participate in social activities that require an interface with power structures. They vote with their feet. Internal emigration was a common behaviour in the communist states of the past where political opposition was repressed.

Civil society strengthens 'voice' in a society by giving support, structure and sustainability to certain ideas and movements. It strengthens 'voice' and makes individuals refrain from 'exit' by offering organised channels of expression and protest and a party for negotiation with power. For that reason a strong civil society is seen as an important ingredient of democracy. It can also provide alternative goods and services, which increases welfare. The concept of 'civil society' here refers to *the real sector of collective action outside the state, market and family*. This is what in the literature is often called an 'empirical-analytical' approach. This stands in contrast to a 'normative-theoretical approach' that assesses visions and models of what civil society should be (Heinrich 2010: 22). Civil society is often described as the 'third sector', a domain outside market and state. Civil society organisations have been shown to contribute to social participation and democracy. In addition, the economy is deemed to profit from a vibrant civil society. Multilateral and bilateral donors, including the World Bank and the UNDP, advise developing and transition countries to nurture and support independent civil society as an adjunct to the state and the market (Clarke 2011: 960). A healthy civil society is regarded as an essential ingredient of a functioning democracy that aims at incorporating the concerns of the poor through a market economy calibrated to deliver pro-poor growth.

The real civil society consists of a large array of different types of organisations that may be formal, large registered organisations as well as informal local organisations. Civil society in this meaning includes traditional religious organisations, political parties, trade unions, other trade and professional organisations, scientific associations, ecological groups and modern mass

movements, action groups and IT-based social networks (Ghaus-Pasha 2004: 2–3). In this paper civil society thus refers to a broader concept than just the often mentioned non-governmental organisations (NGOs).

## 5.2 Civil society in Russia

According to the Russian Statistical Agency, Rosstat, there were almost 220 000 civil organisations in Russia in 2012. Of these 25 000 are religious organisations (Annex table A2). The number of officially registered civil society organisations (CSOs) has declined since the mid-2000s. Do these official figures of registered CSOs give an idea about the size of Russian civil society? Probably not. Many of these organisations are closely linked to the state and do not have their own independent agenda. Also, CSOs are sometimes registered by state organisations or private enterprises for technical reasons to avoid taxes and other regulations.

Besides the official register data there are surveys estimating the size and direction of Russian CSOs. From a Russian survey by CIVICUS and the Higher School of Economics (HSE) in Moscow we learn that Russian citizens do not typically participate in CSO activities. According to the survey, the core of civil society consists of only 7–8 per cent of the Russian adult population, who are in some way regularly involved with work in CSOs. An additional 25 per cent of the adult population are said to be ready to take active part. They do engage in charity work and are quite well informed of what civil society is about. Yet another 25 per cent are not particularly interested. The remaining 40 per cent of the population has a weak idea of what civil society is (CIVICUS-HSE 2010: 17). Thus, all in all around 30 per cent of the adult population might understand what civil society is but only a small fraction takes active part.

Putin showed a positive attitude towards civil society in his political programme in 1999, but when in power he tried to bring independent NGOs under state control. The Civic Assembly initiated in November 2001 was an attempt to establish platforms of communications between the state and NGOs but it failed (Siegert 2011: 538). A complete breakdown in the dialogue between the state and the civil society came with the arrest of Mikhail Khodorkovskiy, who had used the Open Russia Foundation to finance NGO projects and the ‘orange revolution’ in Ukraine. From the Kremlin’s point of view, NGOs supported by Western donors played an important part in the events in Ukraine (ibid.: 539). During Putin’s second term control over civil society increased.

Real voice was heard when protesters took to the streets after the Duma elections in December 2011. The message on *Bolotnaya ploshchad* in Moscow and in other large cities was clear. The protesters demanded ‘honest elections’. Other slogans such as ‘for Russia without Putin’ were also heard and written on white ribbons worn by the participants in the demonstrations. The protesters were a mixture of ordinary citizens marching for their rights and representatives of political parties and civil society organisations. After Putin was inaugurated to his third term in May 2012, repressive laws were issued and several leaders of the protests have been arrested. The restrictions imposed on the freedom of speech and the right of assembly have resulted in silence and very limited public voice. By far the most significant of the new laws is the so-called ‘NGO foreign agents bill’. This piece of legislation imposes a new definition of ‘politics’. Everything is now politics and, as a result, the state prosecutors have found politics in everything: sociology is now politics; environmental initiatives are politics; legal scholars and practising lawyers exerting influence on the practice of law and the dispensation of justice is politics; providing advice to local government is politics; monitoring legal violations by the state is politics. To ‘conduct political activity’ is forbidden if NGOs gets foreign funding (Siegert 2014).

Until the end of 2013 about 1 000 NGOs had been controlled by prosecutor’s offices, the Ministry of Justice, the tax authorities and several other government bodies. About 60 NGOs received an administrative decision from the prosecutor’s office. More than 20 of these NGOs have been ordered to register as a ‘foreign agent’ because, from the point of view of the prosecutor’s office, they have been violating the law and virtually been acting as ‘foreign agents’. The other NGOs received a ‘warning’ that they might violate the law and were asked to register as a ‘foreign agent’ in advance of ‘conducting political activities’ (ibid.).

### **5.3 Informal networks and protest movements**

Mistrust of communist organisations and the persistence of friendship networks have been advanced as factors impeding citizen engagement in formal CSOs in post-communist countries (Howard 2003: 105–14). Membership in the communist organisations was forced and the argument is that due to their experience of these organisations people do not trust them and do not want to enter formal organisations even though they are now voluntary and not controlled by the state or party. The friendship networks refer to the extended



private networks individuals in communist countries were involved in due to the shortage economy. In order to get anything, from day-to-day goods to more complex services, people depended on connections and on being part of a supply chain of relatives and friends. The hypothesis is that these networks are substitutes for the more organised CSOs that will not develop as strongly as they do in other countries.

Evans (2012: 233) stresses the deep distrust that Russians share of the whole public sphere, including not only institutions that exert political authority but also social organisations that aim to achieve goals that would benefit a large number of people. It is claimed by many scholars that ‘Public disinterest, not repression, is the number one problem facing civil society movements in Russia’ (ibid.). Few NGOs try to expand their membership or recruit volunteers beyond the close group of people that originally formed the organisation, which is believed to be largely due to distrust on both sides. Yet Evans finds that protest movements that address concrete problems that directly affect people and their families are more likely to gain support than those that focus on abstract more general ideas.

## 5.4 The roles and functions of civil society

What functions could civil society perform and why is it so important for the economy that people participate in it? Research identifies four central areas where civil society performs different functions that affect the economy indirectly or directly.

Civil society is often associated with its *advocacy* role. Civil society can identify problems that are not addressed by the political elite and bring them to public attention, thereby creating public opinion, awareness and change. In many countries NGOs have taken on a ‘watchdog’ function: they monitor consumers’ rights, freedom of speech, ecological matters or anti-corruption schemes and generally act as bodies that hold the politicians accountable. These issues are represented both by local civil society organisations and by international NGOs such as Greenpeace, Amnesty and Transparency International.

Economists often refer to civil society when investigating the development of *social capital* (see Glaeser et al.: 2002). Participation in civil society organisations gives individuals the opportunity to develop as they meet and work with people outside their own group, class or work environment, which

strengthens *social cohesion*. Large parts of civil society are engaged in expressive functions such as theatre companies, Facebook groups and book clubs and play an important role in forming and diversifying social capital.

It is seldom mentioned in standard economic analysis, but in many countries civil society is an important *economic actor* in itself, generating employment and value added. As reported by Ghaus-Pasha (2004: 4–5), a survey of 36 countries by Johns Hopkins University shows that the civil society sector spent on average 5.4 per cent of GDP and employed an equivalent of 4.4 per cent of the economically active population in the period in the surveyed countries 1995–2000. According to another report by the Johns Hopkins University (2013) the employment share is as high as 10 per cent in individual countries. Finally, some civil society organisations complement or replace the state in certain functions and *regulation*. In many countries, trade unions and employer organisations are fully responsible for wage negotiations within a framework set by the state. Another example of the state delegating regulatory functions is the occurrence of certain professional associations that certify their members' right to operate in their profession with a certain title, e.g. lawyers, auditors – so-called 'self-regulation'.

In Russia all these functions of civil society are still embryonic. Due to the present restrictions on the freedom of speech and assembly, organised civil society will not develop. Because real citizen participation is not encouraged, the economy forgoes many initiatives from the population that would improve the quality of life and standards of living. When civil society is weak society has to rely solely on reforms from above and when the regime is neither democratic nor market-oriented modernisation and democratisation are far-fetched.

## 6 Conclusions

Market forces play only a limited role in the Russian economy and to improve the prospects for growth with ‘western’ economic policy or to improve the institutional framework will be difficult and have a limited effect. Only parts of the economy profit from market reforms and stronger institutions. The old rent dependent sector has strong political support. It follows that more substantial political reforms are needed to solve the structural impediments and efficiency problems of the Russian economy. Society needs to become more democratic and more transparent,

The present politicized economic system does not facilitate a more efficient allocation of resources between sectors, less resource waste, productivity increases or stronger competition by enabling ‘entry’ of new actors into different areas. Thus economic growth cannot be restored to previous levels within the present economic system. Forecasts of GDP growth for the next few years vary around 1–2 per cent. The confidence crisis caused by the Ukrainian events in early 2014, causing capital flight and uncertainty regarding to what extent Russia will respect its commitments, adds to this picture. GDP may very well contract in 2014 and it is hard to see that growth would pick up during the nearest years during these circumstances.

The reforms in the 1990s and their subsequent consolidation in laws and regulations in the early 2000s managed to break the hegemony of the Soviet command economy and introduced a private sector and strong market elements in the Russian economy. However, the changes never completely overcame the old Soviet heritage that is embedded in the infrastructure and industrial structure. Many Soviet-type enterprises survived and with them formal and informal behaviour. Even though formal institutions were abolished, informal institutions and networks stayed, which has systematically undercut the development of new market-oriented institutions and their supporting social capital.

The remedy to attain stronger growth is to let the new private sector, mainly consisting of small and medium-sized enterprises, grow. This requires stronger market-oriented institutions. Growing innovative companies need to be able to rely on the primacy of basic institutions such as rule of law, that corruption is at a reasonable level, rationality of economic policy and on a high quality of governance. They must also be able to access financial resources and profit from

a supportive business climate. The old loss-making sector, however, is not interested in changes in that direction and has strong political leverage to maintain the existing order where personal ties to the political hierarchy rather than competitive business activities can ensure survival. For change to happen, the rent dependence and rent management system needs to be deconstructed, and that is not in the interest of the present regime. Redistribution of rents is a vital tool to maintain political stability. It may therefore be expected that political management of the economy and state intervention will continue, with economic stagnation as a result.

The restricted possibilities to voice different opinions, to organise collective action around new ideas and to hold politicians and other decision makers responsible mean that there is no effective reform pressure from below. Instead, improvements of the economy's performance are dependent entirely on reform initiatives from above, and initiatives that could spur growth are not forthcoming under the present leadership. The Russian campaign to destabilise Ukraine may be seen as a way of diverting attention from already stagnating living standard. The uncertainty it has caused regarding Russia's reliability also in economic matters has hurt confidence for the Russian state as a business partner and made growth prospects even gloomier.

The democracy shortage in Russia is thus closely interlinked with the efficiency challenges of the economy. The preferences of the population are not reflected in the direction of economic development since economic policy does not rest on a democratic foundation. Indicators reflecting the institutions 'voice and accountability' have followed a downward trend since Putin's first presidency. Today the Russian society is polarised on many political and economic issues, but civil society is weak and restricted and cannot fulfil its function either as watchdog or as a channel of ideas and entrepreneurship. Without political reform and a market-oriented democratic government it is difficult to see how the performance of the economy could improve.

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# Annex

## Annex Figure

### Stylized picture of costs of a rent creation company



Source: Gaddy and Ickes (2010: 311). Author's interpretation.

**Annex table A1 Federal budget 2013-16, billion of RUR**

	2013	2014	2015	2016
BNP	67519.0	73921.0	81940.0	91205.0
Federal budget	13387.3	13847	15235.7	16451.8
Federal budget % of GDP	19.8	18.7	18.6	18.0
General state issues	920.8	973.7	1006.8	1023.3
National defence	2098.4	2527.0	3114.6	3445.7
National security and legal apparatus	2048.2	2101.4	2197	2178.7
Support to the economy	1798.8	1877.5	1936.0	2053.0
Housing and utilities	154.3	145.0	109.0	63.0
Environmental protection	24.5	30.5	31	32.1
Education	681.5	594.2	629.7	653.2
Culture	98.7	91.4	96.7	99.8
Health	515.0	417.4	336.9	344.5
Social policy	3864.4	3810.2	4037.1	4249.3
Physical culture and sport	62.0	79.8	102.9	101.2
Media	75.3	65.9	54.6	49.9
Debt service (state and municipal)	75.3	469.5	508	568.8
Inter-budgetary transfers	408.4	663.6	694.7	766.6

Source: Minfin (2013).

**Annex table A2 Registered civil organizations as of 1 January selected years**

	2000	2005	2009	2010	2011	2012
Civil organisations	19863	149201	123406	119247	114392	108736
of which:						
Organisations with						
members	17745	63125	54351	54113	52626	53246
Movements	679	6643	1882	1808	1749	1739
Foundations	1172	8643	7250	6972	6657	5737
Establishments	127	859	647	626	612	763
Recreational-expressive	0	222	189	185	179	172
National-Cultural	335					
Other types	120	70552	59087	55543	52569	47079
of which:						
Trade unions	7582	57515	47007	43522	40801	35792
National cultural		578	727	746	829	932
Political parties	748	43	13	7	7	7
Non-commercial organisations			73212	79988	83881	85185
International NGOs			256	253	240	240
Religious organisations	20215	22144	22507	23494	23848	24624
<b>Total</b>	<b>40826</b>	<b>171388</b>	<b>219394</b>	<b>222989</b>	<b>222368</b>	<b>218792</b>

Source: Rosstat selected years.

Note: Many questions may be asked around this table. Questions so far has focused on the independence of these CSOs from the state and if they play any role in the public discussion. It has been included in the annex mainly to draw attention to its existence and the fact that the Ministry of Justice has this register. In future research a next step could be to get information about registration criteria and investigations could be made as to whether the register could be used to attain meaningful information about real CSOs.

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