billion rubles ($10 billion) from the private funds to the state budget each year: only about a quarter of the Pension Fund deficit. On December 3rd Medvedev said a "mistake" had been made in designing the system in 2002, arguing it was unacceptable that those retiring after 2023 (that is, under the new system) will receive lower pensions than those who retire before.[11] Putin equivocated over the issue, before telling a government meeting on November 14 that the implementation of the new law, including the crucial decision about lowering the private contribution from 6% to 2%, will be postponed till January 2014.[12]

In Russia, as in many other transition countries, the logic of long-term reforms to ensure the stability of the pension system decades hence has run up against the reluctance of politicians to make unpopular short-term decisions, such as raising the pension age, increasing taxes or cutting benefits. The underlying problem is the lack of institutions of democratic accountability, which means that the decision-making process lurches forward through bureaucratic and inter-personal infighting—or sometimes stalls altogether.

About the Author

Peter Rutland is Professor of Government at Wesleyan University.

11 Kirill Sugrobov, "Oshibka Kasyanova," lenta.ru, 8 December 2012.

12 "Soveshanie po voprosam razvitiya pensionnoi sistemy," 14 November 2012. http://www.kremlin.ru/news/16823; Kirill Sugrobov, "Smelost ne khvataet," lenta.ru, 15 November 2012.

ANALYSIS

In Search for a New Social Base or Why the Russian Authorities Are Changing Their Relations with Business

By Andrei Yakovlev, Moscow[1]

Abstract

The future of Russia depends on whether the elites can agree on new rules of the game. Russia's highest officials recognize that in order to preserve the political regime, it is necessary to change the model of relations with business. However, the lack of correct stimuli for bureaucrats at the middle level continues to be a serious obstacle for development.

The State as a Group of Interests

The concept of "limited access orders" provides a useful perspective to understand what is happening in Russia today. According to this concept, developed recently by Nobel-Prize winning Economist Douglas North and his co-authors John Wallis, Steven Webb, and Barry Weingast, well-functioning markets and developed democracy represent an ideal toward which it is possible to strive, but the absolute majority of contemporary societies function within a framework of imperfect institutions.[2] The state in such societies does not have a monopoly on the legitimate use of violence in the terms of Max Weber, but rather represents a coalition of influential social groups, each of which has its own potential for violence.

According to North and his co-authors, such influential social groups have historically formed the elite of society. These groups have the ability to choose. They

1 This article is based on the results of projects carried out in the framework of the Program for Fundamental Research of the Higher School of Economics in 2011 and 2012.

2 North, Douglass, John Wallis, Steven Webb, and Barry Weingast. (2007). Limited Access Orders in the Developing World: A New Approach to the Problems of Development. Washington DC: World Bank Policy Research Working Paper No.4359, September 2007; North Douglass, John Joseph Wallis and Barry R. Weingast (2009). *Violence and Social Orders: A Conceptual Framework for Interpreting Recorded Human History*. New York: Cambridge University Press; North Douglass, John Joseph Wallis, Stephen Webb and Barry R. Weingast (eds) (2012). *In The Shadow of Violence: The Problem of Development in Limited Access Societies*. New York: Cambridge University Press.

can, based on their violence potential, seize the assets and incomes created by other, less influential groups. Or they can decline to use force against their fellow citizens, while simultaneously defending them against external threats. In the first case, the resulting "war of all against all" eliminates all incentives for any kind of productive activity and reduces the general income; therefore, the elites are inclined to agree to a mutual end to "military actions." However, this "non-aggression pact" can be stable only when its participants (forming the "ruling coalition") receive significant compensation for their "abstinence from violence" and simultaneously are capable of collectively preventing any violation of the agreement. Thus, in the absolute majority of cases in history and in contemporary societies, the creation and distribution of rents is the key mechanism supporting social and political stability, without which sustainable economic growth is not possible.

A sharp contraction in the size of the rents, especially if it happens quickly, is the main reason for reviewing previous agreements and changing the composition of the ruling elite. With smaller rents, the elites either start a new "war of all against all," or try to agree with each other. The latter is more likely in cases when the ruling coalition includes a wider range of social groups able to take responsibility for solving the problems facing society. In this context, social and economic development can be seen as a process gradually "broadening access," within the framework of agreements among elite groups, by attracting new participants, which ultimately guarantees a more stable, developing social order. This stability in the rules of the game is particularly important in conditions of shock—when a specific country must address the consequences of economic crises, toughening external market conditions, or social and political upheavals.

As is obvious, this approach differs significantly from the ideas and principles which guided World Bank recommendations in the 1990s on conducting reform in developing and transitional economies. In particular, the World Bank-supported programs of privatization, economic deregulation, and liberalization of foreign trade led to the destruction of barriers for business activity and should have enabled increased economic efficiency. However, the destruction of the barriers was accompanied by an erosion of the sources of rent that were the basis for the existing ruling coalition, and groups, wielding the potential to use violence, were incentivized to use violence in practice. This fact can explain why in many developing countries liberal reforms are accompanied by a growth in crime, sharp social conflicts, and civil war. These tendencies were characteristic for many countries in the post-Soviet space.

Rules of the Game in the 1990s and the Beginning of the 2000s

The size and stability of rent flows makes up the foundation of the Russian economy, determining the relations among groups within society, the development of institutions, and economic dynamics (stagnation or growth). In the 1990s, the main sources of rent were privatization, the colossal gap between domestic and international prices, and the domestic and foreign debts. The main players were the federal and regional bureaucracies, and oligarchic businesses. However, all these sources were temporary—by the second half of the 1990s, the most attractive assets had been privatized, domestic and international prices in many markets had converged, and the debt burden had reached a critical level. In these conditions, the absence of an agreement among the elites about taking each other's interests into account and observing a unified set of rules of the game led to chaos, a massive non-payment crisis, and constant redistributions of property. This "virtual economy" could not exist long, and it fell apart in August 1998.

The GKO (Government Short-Term Bond) default and the sharp devaluation of the ruble were not only an economic shock—they led to serious political changes when representatives of the Communist Party joined the government for the first time since 1991. The well-known Communist activist Dmitry Maslyukov became deputy prime minister in Evgeny Primakov's government with responsibility for the economic agencies. The 1998 crisis was a cold shower for the new Russian elite. The middle class bore the brunt of the crisis, however the elites understood that a repeat of such a social cataclysm could cost them their status and property. Recognizing this threat pushed various groups of the elite to negotiations about new rules of the game, which would create conditions for economic development.

The "Gref Reform" was a characteristic example, particularly with its tax component. Technically all the papers on the reform were signed in the Center for Strategic Research, under German Gref's leadership, in 2000. But the fundamental agreement occurred earlier—within the framework of active informal negotiations, which from the end of 1998 took place between various groups of elites in various venues (including the Council on Foreign and Defense Policy, Club-2015, and several others).[3] The result of these negotiations was an understanding that the economy could not exist without the state, but that the state could not function without taxes.

However, business could not afford to pay taxes by the irrational rules introduced in Russia in the 1990s.

3 One of the results of this dialogue was the draft "Scenarios for Russia" prepared by Club-2015 in 1998–1999 (http://www.club2015.ru).

It was necessary to change these rules, but simply rationalizing tax policy was insufficient. In exchange for paying taxes, the business elite wanted the state to impose a minimal amount of order, ensure legality, and invest in infrastructure and in public good provision. Mutual agreement between the bureaucratic and business elites on these conditions was the pre-requisite for quick realization of radical tax reform (including simplifying tax administration and introducing a flat income tax and a unified social tax) and for the resulting legalization of business and the rapid growth of tax collections. Taken together, these factors largely determined the successful development of the Russian economy at the beginning of the 2000s.

Such agreements about the new rules of the game were possible because the crisis of 1998, having destroyed the old sources of rent (connected to the GKO pyramid and games with the exchange rate and accounts) simultaneously created new potential sources of rent, deriving from economic growth. In particular, after the devaluation of the ruble and the end of the GKO pump, it turned out that the enterprises that had been privatized in the 1990s, and were mostly used by their new owners for liquid assets striping, could produce income from their primary activities. This understanding led to a wave of property redistributions (based on manipulating the norms of the bankruptcy law and corporate legislation). On the other hand, the changing external conditions stimulated people to begin developing productive capacities and invest, as well as agree to new rules of the game.

The 1999–2003 period is interesting because it was at this time that the mechanisms regulating relations between the state and business began to appear and started to evolve into self-sustaining institutions. Thus, within the framework of reforming the Russian Union of Industrialists and Entrepreneurs (RSPP), an Executive Bureau was created, which included all the oligarchs. They then began to meet once every six months with President Putin and discuss on-going events. These meetings objectively helped both sides better understand the actions of the other and reduced the level of uncertainty in economic policy. Additionally OPORA Russia was created to represent the interests of small business and the Business Russia association for medium-sized business.

However, despite all these positive developments at the beginning of the 2000s, "gray zones" remained in the relations between the authorities and business. One of those dealt with property rights. The famous meeting between Putin and the oligarchs in the summer of 2000 led to the conclusion of an informal contract according to which big business would not intervene in politics and the state would not revise the results of privatization. But in contrast to the discussion about taxes, which led to tax reform, this agreement remained informal. The oligarchs understood the guarantee to their property to mean that they had a right to receive all the income from their property while the bureaucratic elite thought differently. This uncertainty became the reason for the revision of this informal agreement when a rise in world oil prices led to the appearance of a significant source of rent.

Natural Resource Rent, the YUKOS Affair and the Changing Model of Relations with Business

Quick economic growth almost always leads to an increase in social differentiation. This process took place in Russia at the beginning of the 2000s when, under conditions of relatively liberal economic policy, a gap began to grow between rich and poor regions, various sectors, and social groups. The federal bureaucratic elite saw this tendency as dangerous because ensuring social stability was one of the fundamental bases of the existing political regime.

Accordingly, the state demanded additional budget incomes in order to reduce social inequality. Top officials viewed natural resource rents as the main source of such income, and by introducing taxes on the extraction of natural resources, the government tried to use the income from oil exports for its purposes. Big business opposed this effort because it saw the policy as an encroachment on its income. The business opposition (particularly from YUKOS, the largest oil company) occurred when "friendly" deputies in the State Duma blocked a series of laws introduced by the government and also in the financial support business provided to opposition parties, including the Communist Party of the Russian Federation and Yabloko.

However, the balance of power between the state and business had already changed by this time. Using the military, law enforcement, and security agencies (siloviki) as part of the overall policy of building a "vertical of power," the top members of the bureaucratic elite achieved the de facto nationalization of YUKOS while simultaneously sending its former owners to prison. The criminal case filed against the owners of YUKOS obviously represented a selective application of the law, since almost all big companies used similar schemes of tax optimization at this time. Nevertheless, as the results of the 2003–2004 parliamentary and presidential elections demonstrated, the broad public supported the state's actions against YUKOS. In my opinion, this support derived from the widespread feeling in society that the results of the privatization process were not just, a sentiment that big business had ignored.

The YUKOS affair led to the destruction of the business-state interactions model which had begun to take shape at the beginning of the 2000s and which was based on the distribution among the elites of the rents created by the quick economic growth in various sectors of the economy. 2004 launched a new period in which the main source of rents was hydrocarbon income, which benefited from the high international oil prices.

The relatively equal dialogue between the state and business that took place at the beginning of the 2000s was replaced by the undoubted dominance of the state. Big business became a "junior partner," subordinate to the state, and the key players became the top federal bureaucracy and siloviki. During this period, the "state people" believed that they knew everything and did not need any outside advice. Evidence of this supreme confidence appeared after the resignation of Prime Minister Mikhail Kasyanov's government, when the state adopted an active industrial policy (creating the Investment Fund, special economic zones, state corporations, etc.) and forced big business to secure state approval for all international agreements.

The 2008–2009 Crisis and its Consequences

Many liberally-inclined experts did not like this state-dominated model of capitalism. Nevertheless, it is necessary to admit that much of what the government did coincided with the interests and expectations of a significant number of market players. For example, the restoration of a unified economic space, which was the result of bringing the governors in line, was profitable for most businesses. While it is possible to support various opinions about what was done to YUKOS, most players did not like the Seven Bankers era of 1996–1998, when economic policy was obviously subordinated to the interests of a few large companies. Therefore most business people saw the new rules of the game, with the state dominant, as the "lesser evil."

An important factor in the support for this policy was that in the beginning and middle of the 2000s, the state basically did what it said it was going to do. While one could disagree with the methods used to remove the oligarchs from participating in politics, or with forcing the regions into the "vertical of power," the state set specific goals and then realized them in practice. As a result, people began to share a feeling of consistency and predictability in policy, which facilitated the formation of positive expectations for long-term social and political stability and made possible an active inflow of investment capital into Russia during 2006–2007. Members of the middle class who did not like the situation within the country had the chance to leave Russia thanks to the high demand for specialists in other countries. This migration allowed the country to let off steam.

However the 2008–2009 crisis demonstrated that the state capitalism model that developed after the YUKOS crisis was internally unstable. In reality, the system, which relied on the vertical of power and federal bureaucracy as its main social base, even before the crisis only worked when the signals from above more or less corresponded with the interests of people sitting at various levels of the bureaucratic hierarchy. A serious systemic failure of this model was the asymmetry in the flow of information signals, typical for large hierarchical systems: the lower levels only told their superiors about their successes, but did not inform them in time about problems and failures in their areas of responsibility. Accordingly, during the crisis, it became clear that the authorities knew far from everything that was going on and had only limited capability to take action.

In particularly, up until December 2008, government leaders went on state television to say that in Russia there were only a few problems on the stock markets and in the banking sector, caused by the bankruptcy of American companies and financial institutions. However, in reality, the large metals and chemical enterprises faced a significant drop in the demand for their products already in summer 2008 and the falling prices forced them to lay off workers starting from as early as August–September. In these conditions, the owners and managers understood that the government, at a minimum, did not have full information about what was happening in the real sector of the economy. And then, when the government began to try to "put out fires"—from promising to save everyone to sequestering budget outlays, while providing unemployment benefits that in several regions exceeded average salaries—the feelings about its incompetence in economic policy only grew stronger.

Therefore many company owners adopted the rational decision to put their businesses on hold and wait while the government clarified its economic policy. As a result, in 2009, the Russian economy lost 8 percent of GDP, a figure out of line with contemporary economic indicators: in contrast to the East European countries and Mexico, Russia did not have a significant external debt, did not face a large budget deficit, and was not suffering from high inflation. Rather, uncertainty and negative expectations about government policy drove the economy.

The break in expectations took place not only among the market players, but among state bureaucrats as well. During the "fat years" of the mid-2000s, the bureaucrats received control over the money flows of the public sector and private business and, before the crisis, they expected to receive dividends for many years. This situation, to some degree, reduced the burden of corruption on business. However, under conditions of quickly spreading uncertainty, they decided that it was better to receive everything and at once. The result was an increase in the scale of corruption and increased pressure on business. These moves provoked business to response with an intense capital outflow from the country.

Finally, the crisis also led to a mood change in society. Qualified specialists from the middle class, who did not like life under "managed democracy" and who could earlier consider emigration, now realized that, thanks to the global crisis, demand for their services in developed countries had fallen. This meant that they and their children had to live in Russia. Therefore, it is possible to view the massive protests against the electoral fraud at the end of 2011 as a result of the crisis—it was an outburst of the accumulated social tension, which earlier would have resulted in emigration.

New Tendencies

Despite all the points listed above, in my view, there are several reasons for optimism. The theses about modernizing the economy announced by President Medvedev in 2008 and the series of serious reforms carried out in 2004–2008 (including the reform of public procurement in 2005–2006, the decision to force public employees to declare their income, and others) demonstrate that the authorities understand the need for change. However, in the absence of significant pressure from outside or below (from non-elite layers of society), the ruling coalition is not ready to change the rules of the game or impose limits on the elite.

The 2008–2009 crisis and the resulting changes in the world market have significantly increased pressure on the authorities. Such pressure at first came from outside—due to the reduction in natural resource rents available for redistribution and intense capital flight to countries with a more attractive investment climate. But then it became stronger domestically—thanks to a shift in expectations and a split among the elites, as well as a change in public opinion. As a result, the authorities understood that counting only on the bureaucracy as a social base for the regime had not worked. In the crisis conditions, it became clear that the bureaucratic vertical built over the 2000s, including the law enforcement system, lived by its own rules, independent of the interests of society and the will higher-level decision-makers.

As a result, in the post-crisis period, the authorities had to adopt significant policy changes in reaction to the domestic and international pressure. They recognized that economic growth is necessary for preserving social stability, which is a key requirement for the functioning of the regime. But supporting high tempos of economic growth against the background of unstable international market conditions can only work in conditions of a radically-improving business environment in Russia. This situation led the authorities, in my opinion, to the turn toward a dialogue with business and set up mechanisms to gain feedback from the business community beginning in 2010 and 2011.

The authorities are clearly focusing on successful medium-sized business and hope to integrate it into the social base of the regime. This policy is based on the fact that medium-sized businesses, formed during the conditions of rapid economic growth during the 2000s, today have the greatest potential for economic growth. But, at the same time, due to a lack of sufficient political connections, such businesses are primarily an object for pressure by bureaucrats and the law enforcement agencies. While before the crisis, the losses from the poor business climate for these companies was compensated by their profitable operations on the Russian market, now they are not making such profits and the barriers for their business remain.

The first signs of this turn in policy toward dialogue with medium-sized business were the meetings between Putin and Medvedev and representatives of the 'Business Russia' association in the fall of 2010. Another indicator of the "new policy" of the government was the creation in the summer of 2011 of the Agency of Strategic Initiatives (ASI). Its main function is to define the problems hindering the development of companies, and together with business and the relevant state agencies, seek out solutions to these problems. ASI's further tasks were defined in Putin's February 2012 campaign statement and subsequent decrees on economic policy, which foresaw an improvement of Russia's position on the World Bank's Ease of Doing Business Index from 120th to 20th place, changing the way the governors and federal agencies are evaluated, and other measures. The practical result of ASI's work was the development of a roadmap for reducing barriers in getting construction permits, changing customs regulations, stimulating exports, and also introducing new standards for the activities of regional governments for providing an attractive investment climate.

So far we cannot say that these measures have led to a real change in the business climate. In particular, ASI experts note that the regional authorities and federal agencies quickly learned how to respond to the reforms by formally indicating that they were complying with the orders from above without changing their actual relationship with business.

The central problem both for the authorities and for the country is increasing the effectiveness of public administration so that the state apparatus did not work for itself, but began to work in the interests of society and implemented decisions from above. As the experience of post-crisis development shows—in the reform of the police, public sector organizations, and other measures—achieving these goals only by orders from above is impossible, especially in conditions in which the elites are divided. The principle condition for the further development of Russian society is to what extent the 'ruling coalition' (represented today by the top federal bureaucrats, the siloviki, and new oligarchs) can build mechanisms for dialogue and mutual understanding with wider groups within the elite, including not only medium-sized business, but also the regional elites and top-managers of public sector entities (like universities, hospitals and schools). In the terms of North, Wallis, and Weingast, launching such a dialogue would mean "broadening access" and creating the pre-conditions for sustainable economic growth.

The government still has an opportunity to form a new coalition from the most active social groups, which can propose solutions and take on responsibility. The main question is to what extent the top elite is ready to take such a decisive step and first of all to restrain itself.

About the Author
Andrei Yakovlev is Director of the Institute for Industrial and Markets Studies at the Higher School of Economics in Moscow.