

Market and Democracy: Does Russia Become a 'Normal Country'?

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Abstract: Russian “normalcy” compared with democratic, free-market oriented states the topic that this paper addresses. Its contributions are threefold. First, the paper defines the concept of normalcy using definitions of free market, democracy and government efficiency. Second, it reports evidence that substantiates the claim that Russia is not only institutionally different from the G7 group but that it stands further apart than comparable large middle-income countries (Brazil, India). Third, the paper identifies mistrust and subsequent corruption as the main obstacles for the Russian convergence to the G7 level and discusses two approaches to solve this problem.

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1. Contemporary Russia's Debate: Normal Country or Unusual State?

“Who lost Russia?” debate, that has continued with the varying degree of intensity since the Russian sovereign default of 1998, has flared under a new heading following Shleifer and Treisman (2004). They have stated “Russia has become a typical middle-income capitalist democracy” implying that this country has the same sad deficiencies in her adherence to democratic principles and free market that are ubiquitous in Brazil, Mexico and elsewhere in the Third World. However, many Russian watchers have expressed strong reservations about this conclusion. For example, Rosefielde (2004: 5) disagrees totally claiming “Russia is an abnormal political economy unlikely to democratize, westernize or embrace free enterprise any time soon”.

One of the reasons for disagreement is obvious. The work by Shleifer and Treisman make a problematic definition of normalcy. They assume implicitly that Russia was never a developed country and, therefore, it is appropriate to compare this country with the countries belonging to the developing world. This assumption does not square well with the political weight that Russia carries in international affairs raising the objection that it should be judged by the standards more appropriate to the group of G7 countries. Second, critics of the Shleifer and Treisman's thesis feel that their definition of “normalcy” betrays ideals that the Russians fought for in 1991. Rosefielde (2004: 16) concludes that “the best measure of (Russian) “normalcy” ... avoids conflating perversity with normality, twisting logic to deduce that what is normal is right” implying that there is a normative dimension in the quality of being a normal state.

This cursory exhibition of the debate indicates that to advance our understanding of Russian “normalcy” involves, first, defining this concept. This is not a purely linguistic task, the interest in which is limited to academic circles. Western policy makers develop their stance towards Russia making assumptions about the “normalcy” of this country. ‘Is Russia a reliable partner? Do we have confidence in the integrity of its leadership?’ are the questions that one hears repeatedly. Experience is a poor guidance in this respect as expert opinions differ widely. What is required is to consider the evidence that determines Russian correspondence to principles that represent “normalcy” in the Western sense. Second, it is important to consider how Russia performs relative to the G7 countries and other comparable nations. Such a comparison is interesting because it helps to foresee the position that this country assumes in the world. After the collapse of the socialist bloc, the world has become more homogeneous as the importance of democratic values and free market economy grows throughout the globe. New politically and economically homogeneous clusters are likely to appear reshaping the pattern of international politics and trade. If Russia manages to become quickly an integral part of the Western world, the importance of Europe increases. Finally, determining relative strengths and weakness of this country helps to advance the debate on the

perennial Russian question ‘Chto delat?’ (‘What to do?’), thus contributing to the discussion on potential scenarios of Russian reform.

The substantive part of this paper starts with the discussion of Western perspective on normalcy. It defines the concept building on the notion of “like-mindedness” that the OECD has developed for the admission of new members. The paper proposes to estimate normalcy using three broad criteria – free market economy, democratic principles and government efficiency – that it links to cross-country indicators assembled by World Economic Forum (WEF, 2005), World Bank (2005a) and others. The main findings are threefold. First, unlike Shleifer and Treisman (2004) whose comparison of Russian institutions is less systematic, the paper concludes that Russia differs from large middle-income economies like Brazil or India that stand closer to the G7 group. Second, a relative comparison of indicators shows that strengths of this country (physical infrastructure and labor market) represent its Soviet legacy and weaknesses (poor corporate practices, judiciary and democratic principles) can be traced to the problems of transition. Third, the paper discusses two reform strategies (evolutionary and proactive) and considers conditions under which their use is appropriate.

2. On Normalcy: Defining the Concept

The word “normalcy” has two closely related meanings. One is the state of affairs that is common or regular within certain limits. The other describes expectedness as a consequence of being usual or regular. When applied to countries, these meanings are ambiguous. They imply that a country is normal if it satisfies the criteria defined either on logical grounds or on norms that an observer considers typical in her or his life. Because the emphasis of this study is on compatibility of Russian norms with the norms acceptable to an average Western observer, the paper defines “normalcy” as the situation common in a representative, albeit idealized, developed country. To avoid the trap of blind mimicking the traits specific to certain countries of Western Europe or North America, it is important to define objectively the commonalities that these countries share. In this respect, the OECD (2004) provides a good starting point. This document has resulted from the work done to define criteria for inviting new members. The OECD admits that this task is challenging as it involves building the consensus among current members. Eventually, the OECD secretariat has agreed on two key parameters that this section describes. They are the notion of “like-mindedness” and the concept of “significant player”. The OECD (2004: 16) mentions that the members could not arrive at a general definition of “like-mindedness” because the expressed opinions did not converge. As the minimal common denominator, it offers two the most fundamental parameters that seem to enjoy consensus: free market-based economy and democratic principles that the paper discusses below.

(a) Economic Principles

The following normative sentence expresses the minimal idea of free market economy: the state guarantees private property rights and private agents are free to produce and to trade.¹ Proponents of free market economy validate the idea that the actions of private agents should have supremacy over the state on two logical grounds. First, under the condition of informational asymmetry, individuals are better suited to detect and to realize socially valuable opportunities in production and exchange than a vertically organized state is. This proposition appeals to the concept of efficiency because it implies that free market is good because it improves the standard of living compared with the state planning alternative. Second, there is reasonable concern that democracy becomes hollow if citizens depend on the state for their living. In this case, the stress is on the first word in “free market” suggesting that market-based economy is a means to achieve something unrelated to economics, namely “freedom”. The paper will return to considering what of these two reasons is dominant discussing the concept of democracy. For time being, it suffices to state that the principle of free market is universally shared by the OECD countries. Among its basic tenets are the requirements that citizens command productive facilities and financial funds; that they have the right to own assets privately or to rent from other agents; and that they should be able to accumulate resources through long-term investments. Other requirements include the right of citizens to organize legal entities such as firms and to conclude contracts with customers, suppliers and employees in their own name or using the name of their organization. In free market environment, the government’s role is to protect private property and to enforce contracts that is to be an impartial arbitrator in the conflicts that private agents may have dealing with one another.

In reality, this idealized account of free market economy is uncommon. Several reasons exist to expand the scope of the state role beyond the role of a simple mediator in conflicts and guarantor of private rights. First, unfettered markets ignore social conventions because they seem to be inefficient. However, the conventions embody values whose significance goes beyond economics. Using *reductio ad absurdum* argument, Aune (2001) points out wittingly that the logic of unfettered market implies that donors should be free to sell their body parts to reduce waiting list for transplant organs and parents should be free to sell their children to minimize search costs of foster parents. Second, unregulated markets ignore the problem of externalities. For example, it is against the nature of a profit-maximizing firm to consider the costs of environmental degradation or health hazards that the society pays as a whole. In both cases, the OECD countries maintain that the state

¹ Compare with the definition of the Heritage Foundation (2005, Ch. 5): “economic freedom is ... the absence of government coercion or constraint on the production, distribution, or consumption of goods and services beyond the extent necessary for citizens to protect and maintain liberty itself. In other words, people are free to work, produce, consume, and invest in the ways they feel are most productive.”

has the authority to intervene. It may prohibit some operations within national borders (like prostitution or drug trade) or order firms to pay for public hazards (for example, for medical treatment of smokers). To limit abuses, the state should follow a certain procedure, namely, popular vote. The last observation is important because it suggests that the West values democratic principles at par or more than free-market standards. The argument of market failure leaves the door open for government intervention as well. Market forces can stop working for various reasons impeding the provision of goods and services. In this case, the state has the right to enter in production and exchange but the Western countries disagree on what is the appropriate scope for government intervention.

(b) Democratic Principles

The previous discussion has indicated that the link between country's adherence to democratic principles and its "normalcy" cannot be explained through economic considerations alone. Moreover, strict adherence to the principle of economic efficiency may render democracy irrelevant to the discussion because some economists argue that democracy can generate suboptimal results compared with other forms of governance.² Nevertheless, one can say with certainty that democratic values are widely recognized being important in the modern world.³ While causes of this development are not clear, historical reasons may explain why the developed countries attach high value to democratic traditions. The twentieth century has evidenced horrible instances of human sufferings at the hands of autocratic regimes particularly during the two world wars initiated by authoritarian elites in Europe and the Pacific region. In the aftermath, the Western countries have become convinced that democracy is a safeguard mechanism that precludes destructive conflict resolutions. In this respect, the creation of the OECD has been a part of the process to advance democracy in the post-war Europe. This grouping grew (in 1961) out of the Organization for European Economic Cooperation (OEEC) that was organized in 1948 as an extension of the Marshall Plan for reconstruction and development. Its objective was "the revival of a working economy in the world so as to permit the emergence of political and social conditions in which free institutions can exist".⁴ Predictably, the OECD statutes embed the goal of upholding democratic credentials, which has become one of the standards that measure "normalcy". OECD (2004)

² See, for example, Barro (1996) or Besley and Coate (1998).

³ Sen (1999) – reflecting on the major events that took place in the twentieth century – concludes that the rise of democracy is the key recent development. He continues that in the twentieth century the focus has clearly shifted from the discussion of "whether one country or another was 'fit for democracy'" to discussing whether "it has to become fit *through* democracy" (*italics* in original).

⁴ From the text of the speech given by United States Secretary of State, George C. Marshall at Harvard University on 5 June 1947.

assumes that democracy is a self-explanatory concept leaving the task of its formalization to someone else.

A good starting point is to define democracy in its modern liberal variant. Democracy itself is a periodic choice in any system of government, liberal or authoritarian, defined and legitimized by elections. Liberal democracy is democracy that incorporates protection of certain individual rights. Some characterize democracy as the political system where majority rules and minorities have rights.⁵ The first feature stipulates that citizens have the right to vote and that the majority of voters elect state authorities through open process. This arrangement is efficient under the condition that voters have well defined social interests and they know how alternative candidates plan to promote their interests. The second feature rests on a qualitatively different foundation. It says that the public authority is not free to pursue every agenda that the current majority approves. Liberal democratic government operates within the limits set constitutionally and citizens can bring a claim against its actions using independent courts. The combination of these two features implies that liberal democracy contains inherent contradiction. This conclusion is not entirely surprising because, as has been indicated above, the resolution of conflicts is one of the problems that democracy addresses. The protection of minority rights serves the purpose of resolving the problem of “tyranny of majority”. Independent judgment is required to distinguish between reasonable and fair majoritarian agendas and laws which are tyrannical because they are unnecessarily unfair or justifiably intolerable to the minority that opposed them. For example, suppose sacrificing one life may save many more lives. Is it appropriate then to vote on the list of candidates to die using the majoritarian rule? The answer is ‘no’ because the right to live belongs to the set of rights, called inalienable rights, that the majority cannot vote upon.

To specify essential conditions for a country to be “normal” on the democratic front, one needs to define the list of such rights. The concept of social contract of Rousseau and transcendental rights of Kant form the logical foundations of these rights. For practical purposes, the list stipulated in the Universal Declaration of Human Rights suffices.⁶ The basic rights are the rights to life, liberty and possession of property; non-discrimination based on sex, race or religious affiliation; freedom of thought and expression; equality before the law and the right to a fair and public hearing for alleged offenses by an independent and impartial tribunal.

⁵ See URL: <http://en.wikipedia.org/wiki/Democracy>

⁶ Rousseau and Kant built on the previous work by Hobbes and Locke. Among modern works, the concept of the ‘veil of ignorance’ advanced by Rawls (1971) is a sensible guide albeit imperfect. It means that if citizens do not know in advance in what respect their position will differ of the position taken by majority, they vote unanimously supporting a certain set of rights. The Universal Declaration of Human Rights was adopted by the General Assembly of the United Nations on December 10, 1948 and has been ratified by 189 countries including the OECD members.

Efficiency of governmental operations is another characteristic of a democratic system albeit this time it relates to the concept of democratic, rather than economic, efficiency. The paper has stated above that peaceful conflict resolution and prevention of human suffering are important goals. The government of a democratic society minimizes the incidence of troubles addressing vigorously ethnical or religious strife, technological and environmental catastrophes, natural disasters, epidemics, etc. To this end, it promotes international cooperation and is able to learn from peers. Because the efficiency of government operations is an important characteristic of both free-market environment and democracy, the paper considers its indicators under a separate heading.

(c) The Concept of Significant Player

The second essential criterion that the OECD council mentions is the concept of “significant player”. It states that the admission of a new member is likely to contribute significantly to peer learning or to influence the design of policies important for the organization. Two interpretations that are compatible with one another are possible. First, although the OECD states that the significance is not equal to the global power of a new member in terms of GDP growth or world trade, these criteria are likely to go hand in hand. OECD (2004) lists the “Big Six” countries that it considers the prime candidates to join the organization: Brazil, China, India, Indonesia, Russia and South Africa. The OECD’s view on the group of countries to which Russia belongs coincides with Shleifer and Treisman’s position that Russia should be compared with other large middle-income countries. The paper follows this proposition comparing Russia both with the G7 countries and with the B5 group (after the “Big Six” countries minus Russia). Second, peer learning is meaningful if a member does not adhere to high standards of performance. The quality of public agencies’ work is a feature that deserves separate attention.

3. Empirical Evidence on Russia’s Institutions

The overall emphasis of this section is on finding relative strengths and weaknesses in Russian standing relative to the two reference groups – G7 and B5. The concept of normalcy implies the absence of considerable deviations in every respect rather than total ranking, which justifies comparing individual indicators rather than as a set. This section uses primarily information presented in two closely related studies. One is the World Economic Forum (WEF) work that develops the index of business competitiveness. The second is the World Bank (WB) program that compares the ease of business operations throughout the world. The goals of both projects are narrower than one of this study. They underrate the importance of democratic institutions that are seen as the means to establish favorable economic environment. The paper complements

democratic parameters estimated by the WB and WEF with indicators constructed by Polity IV, Amnesty International and other organizations that monitor democratic institutions worldwide.

The World Bank became interested in the issues of governance in 1990s as the previous emphasis of aid programs aimed at enhancing the productivity of capital and labor in developing countries delivered meager results. Numerous stories about the embezzlement of assistance funds, local corruption and dire inefficiency of projects' management surfaced attracting attention to the issues of governance. These revelations led to a concerted effort to identify key components of good governance and to develop a systematic approach to their monitoring. The World Bank maintains an extensive inventory of governance indicators collected through business surveys.⁷ The WEF set a similar objective of measuring the quality of business environment but it took a wider perspective on the necessary components of growth than the WB did. It considers some democratic parameters such as the freedom of press that is included in the WEF competitiveness index. Again, executive surveys represent the main source of information for the WEF. This reliance on the survey information may introduce a potential bias in comparative studies because of 'halo effect' when respondents report on one issue recalling their experience on another, unrelated to the first, topic. For example, if the respondents in one country believe that one public agency is corrupt, they may conclude that another state agency is corrupt as well even if they are unfamiliar with its work. Among other datasets, the paper uses most extensively democratic indicators monitored by Polity IV.⁸ It contains information on political regimes and authority characteristics.

(a) Free Market Economy Indicators

Free market economy is a multifaceted concept that is not easy to define. In its minimal form it means a system of ownership, production and exchange where private agents own and control productive and financial assets, initiate exchanges at free prices, conclude contracts, organize enterprises and invest in physical and human capital.⁹ In reality, the evidence of formal rights is insufficient because it is actual realization of these rights that matters. Essential conditions for market operations are hard to systematize but many economists agree that good physical infrastructure, labor market, judiciary, corporate practices and market structure are important.¹⁰ Modern economies rely heavily on physical infrastructure such as transportation facilities, communication networks, and electric utilities. The availability of well-educated and healthy

⁷ The WB dataset can be researched and downloaded at URL: <http://rru.worldbank.org/>

⁸ See <http://www.cidcm.umd.edu/inscr/polity/>

⁹ In such system, the main function of the state is to protect private property rights and to enforce contracts. The general discussion of state performance including these functions is provided in the section on democracy.

¹⁰ There are other market elements that one may consider following, for example, WEF (2005) or Heritage Foundation (2005). The paper limits the list to five areas for conciseness.

workforce is indispensable for the operations of many economic sectors. Independent judicial system facilitates resolution of commercial disputes. Finally, day-to-day operations of business entities require the development of various conventions that domestic firms use when dealing with customers, suppliers and their personnel. Countries may differ in the level of development of market infrastructure and compatibility of corporate practices. To be ‘normal’ in the Western sense Russia should be close enough to the G7 average in every respect.

The presence of essential physical infrastructure is the first element. The study has mentioned above that modern production facilities cannot operate without stable electric and water supply and the access to reliable transportation and communication network. In this respect, managers of Russian firms have a relatively low opinion of the quality of domestic infrastructure. Figure 1 shows that they are especially critical about the reliability of electricity supply and the availability of new telephone lines. Russian transportation gets higher grades with the quality of railroad services approaching the G7 countries.

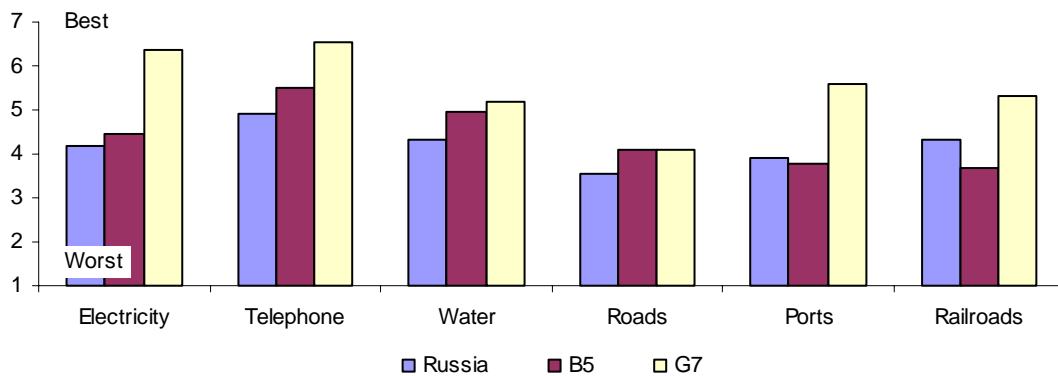


Figure 1: **Physical infrastructure:** international comparison. Sources: WEF (2005, variable 5.02-3, 5.05, 5.07) and WBES (2000, variables QPWK and QWAT, rescaled to 1-7).

In a free market environment, firms find educated and healthy workers through open market search. Workers with good education and professional training are able to produce sophisticated goods that have high value-added content. Moreover, the international division of labor benefits more countries that are capable of innovative research and development often associated with educational centers. Figure 2 shows that Russian managers consider labor market and prospects for research to be good. Other surveys corroborate this result. Finding qualified personnel is a lesser problem in Russia than in the B5 states.¹¹ Situation with health is more troubling. Disparity in health treatment between the rich and the poor is telling. Given that the rich of every country can

¹¹ Reported by the World Bank Group in Investment Climate Surveys, URL: <http://iresearch.worldbank.org/ics/jsp/index.jsp>. Unfortunately, it does not provide information about the tightness of labor market in the G7 countries.

afford about similar treatment, this parameter shows relative quality of health services in different countries. Other indicators confirm that the situation with health care is poor in Russia.¹² On the contrary, Russia boasts the level of tertiary enrollment that is comparable with the G7 standard.

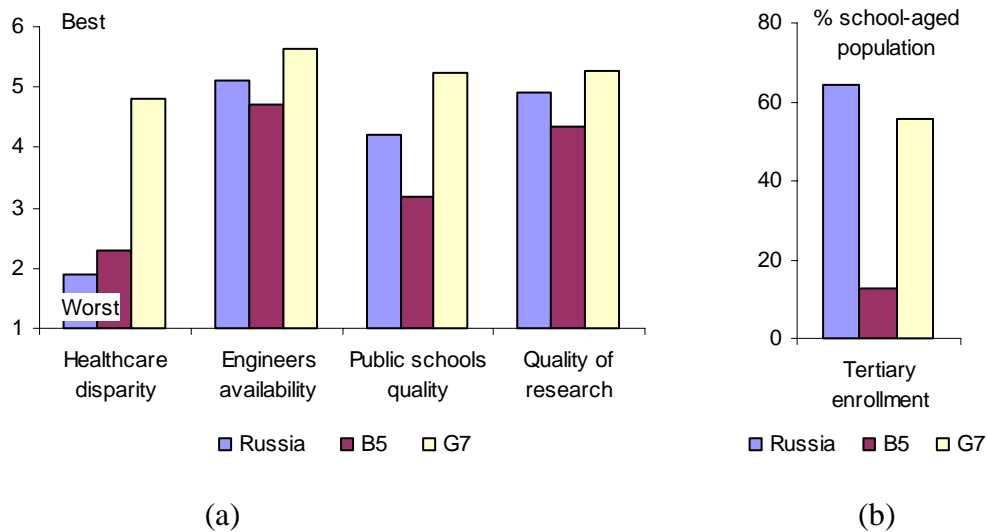


Figure 2: **Labor market.** (a) international comparison; (b) tertiary enrollment. Sources: WEF (2005, variables 3.05, 3.10, 3.18, 4.02, 4.04).

Reliable commercial court system is required to address trade and contractual conflicts. A weak legal structure does not allow third-party arbitration that is a quicker and less costly option than bilateral negotiations. As Figure 3 shows, Russian managers have low opinion of domestic judiciary. The only positive thing that they say relates to the affordability of legal services. Russian courts have the reputation of being unfair, unreliable and lacking authority.

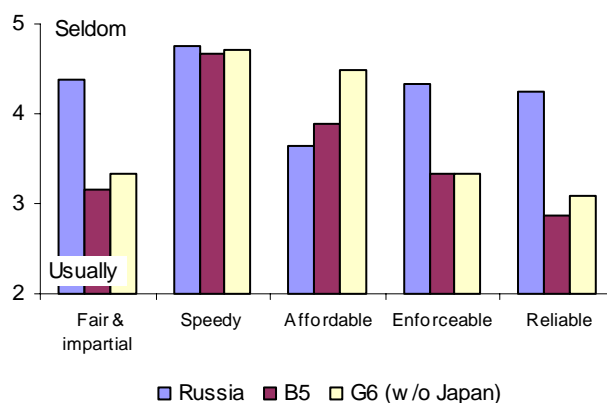


Figure 3: **Judiciary:** international comparison. Source: WBES (2000, variables FI_CRT, Q_CRT, AFF_CRT, ENF_CRT, CF_CRT).

¹² See, for example, life expectancy indicator that puts Russia (65.7 years) in the middle of the B5 group (World Bank, 2005b).

The presence of robust competition among suppliers and consumer dominance in marketplace is the fourth parameter that the paper considers. Figure 4a shows how managers view the behavior of their competitors in different countries. Russia fares better than the B5 average in price competition and state subsidization but underperforms by the parameter of tax evasion. This generally positive assessment of local competitiveness contrasts sharply with low scores, shown in Figure 4b, that this country gets on cooperation with foreign and domestic customers and suppliers.

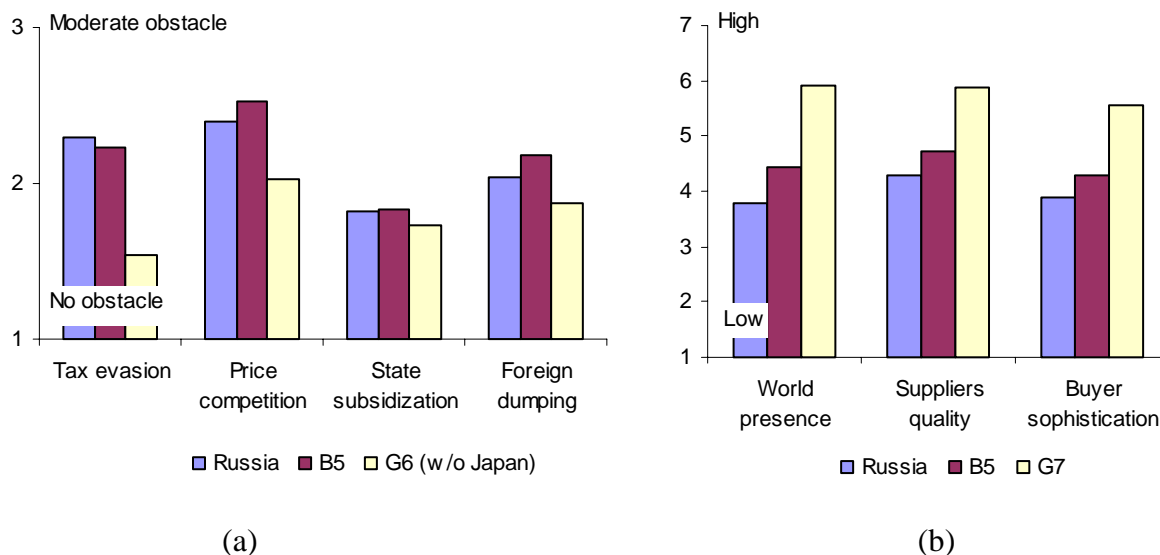


Figure 4: **Market structure.** (a) the impact of competitors' practices on firm's operations; (b) international comparison of market conditions. Sources: WBES (2000, variables CMPA, CMPD, CMPG, CMPC) and WEF (2005, variables 8.01, 8.03, 9.11).

The compatibility of business practices between Russia and the B5 and G7 countries is the final component of market environment that this study considers. Companies differ in their preferences for the sources of finance and protection of investors' rights; in their attitude towards training workers and designing incentive schemes for managers; and in their approach to the organization of technological chains, competing in markets and retaining customers. Russian companies are more reliant on internal sources of funds such as retained profit (Figure 5a) reflecting a smaller role played by banking sector in this country. This finding fits a more general picture of systematic mistrust between customers, suppliers and creditors in Russia compared with the G7 and B5 countries. Mistrust is costly. Stricter collateral requirements present one example of such costs in Russia (World Bank, 2005a). It is unsurprising that given lesser transparency and disrespect of minority rights, equity financing is practically absent in this country, see Figure 5b. On the other hand, a greater use of trade credit confirms that companies can cooperate in Russia if they commit themselves to honoring contracts.

Corporate labor practices include firms' policy on training and retaining employees; the degree of decentralization expressed in the level of supervision; and the incidence of performance-

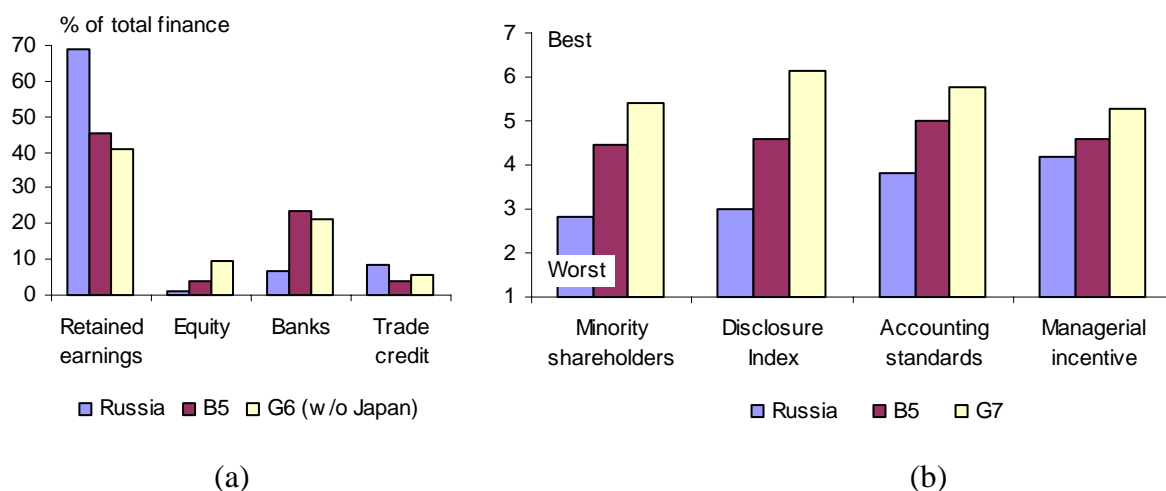


Figure 5: **Corporate attitude to outsiders.** (a) sources of firm's financing; (b) international comparison of corporate practices. Sources: WBES (2000, variables FN_RE; FN_SHARE; the sum of FN_DCM, FN_DVBK, FN_FKBK; FN_SCCR); WEF (2005, variables 10.14, 10.22, 10.24) and World Bank (2005a).

based compensation. Figure 6a shows that Russian managers prefer closer supervision of workers than their colleagues do in other countries. This finding is interesting because it suggests the pattern of mistrust similar to what corporate insiders demonstrate towards outsiders. Data on corporate attitude towards suppliers and customers, see Figure 6b, substantiates this claim. It is indicative that Russian managers have lower ethical standards than their colleagues have in the B5 or G7 countries. Interestingly, the lack of attention to labor training may also fit the pattern of mistrust, bordering on open conflict, between Russian managers and workers. While the former find that workers get what they deserve, the latter believe that a better work does not affect their wages.¹³

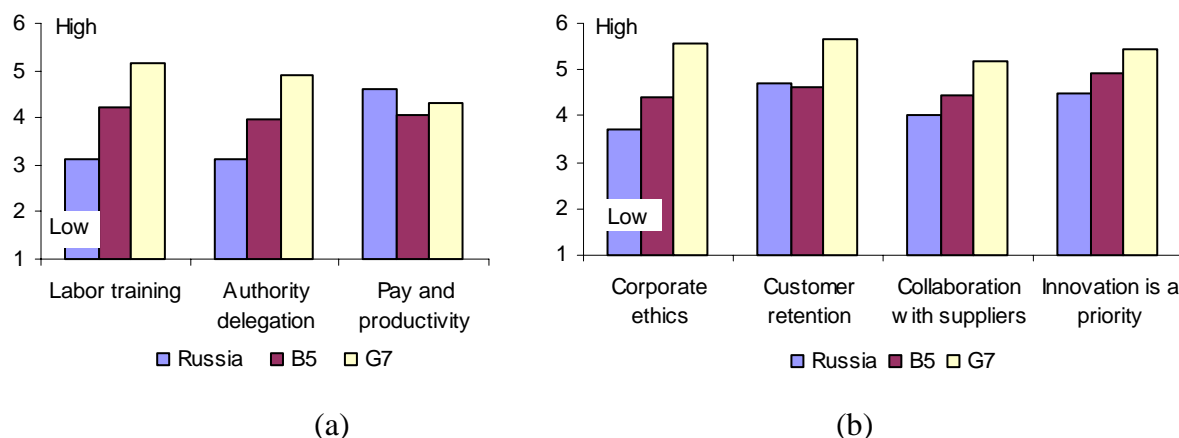


Figure 6: **Corporate labor and client practices.** (a) corporate labor practices; (b) corporate clients practices. Source: WEF (2005, variables 3.02, 8.07, 9.05, 9.08, 9.12, 9.21, 10.13).

¹³ The result of the FOM survey conducted in 2002, 1500 respondents. See URL: http://bd.fom.ru/report/cat/societas/problem_soc/rich_poor/before-tax_contributions_/of023904

Table 1 summarizes the main findings of this subsection. It contains the results of two tests of the equality of means. First is the Student t-test that assumes the normality of underlying distribution. The Mann-Whitney rank test is non-parametric and does not require this assumption. The first test applies to aggregate data (WEF, 2005); the second – to the datasets that contain individual values (WBES, 2000).

Area	Subject	Student t-test	Mann-Whitney test	Comparison with the B5
Quality of infrastructure	Electricity	-1.95		somewhat below the average
	Telephone	-6.96		
	Water		-8.51	
	Roads		-4.13	
	Ports	<i>2.14</i>		
	Railroads	5.50		
Quality of labor and research	Healthcare disparity	-3.96		somewhat above the average
	Research	6.87		
	Public schools	8.22		
	Scientists	5.56		
Quality of judiciary	Fair & impartial		-13.86	somewhat below the average
	Speedy		<i>-1.57</i>	
	Affordable		3.94	
	Enforceable		-11.60	
	Reliable		-15.88	
Quality of markets	Tax evasion		<i>-0.40</i>	somewhat below the average
	Price competition		<i>1.20</i>	
	State subsidization		<i>0.74</i>	
	Foreign dumping		<i>0.54</i>	
	World presence	-5.62		
	Buyer sophistication	-2.97		
	Suppliers quality	-3.42		
Corporate attitude to outsiders	Minority shareholders	-13.48		below the average
	Accounting standards	-11.68		
	Managerial incentive	-1.47		
Corporate labor practices	Labor training	-11.00		somewhat below the average
	Authority delegation	-7.05		
	Pay and productivity	2.85		
Corporate market practices	Customer retention	<i>0.19</i>		below the average
	Corporate ethics	-7.47		
	Collaboration with suppliers	-7.05		
	Innovation is a priority	2.85		

Table 1: Equality of means test. The sign of coefficient indicates the direction of the difference. Values in bold are significant at 1 percent, values in *italics* – at 5 percent. Author's calculations.

Indicators show that Russia underperforms relative to the B5 group on the free market front. This country has stronger positions in labor and research and retain good physical infrastructure. However, it trails behind the B5 group in other respects. The situation is particularly pathetic in the Russian judicial system that is much worse than, say, in Brazil or China. Poor corporate practices is

another issue that attracts attention. In general, it is reasonable to conclude that Russia is an atypical country by the B5 standards of free market economy.

(b) Democracy Indicators

Democratic values represent second distinct set of standards upheld by the vast majority of OECD countries. The list of democratic principles is the subject of study by the Polity IV Project run at the Center for International Development and Conflict Management, University of Maryland at College Park (Polity IV, 2002). The project describes democracy as the process of power change and political innovation that it divides into three elements. The first is the presence of formal procedures through which citizens exercise their right to choose leaders and express their preferences about alternative policies. The second is the existence of institutionalized constraints that monitoring authorities use to limit executive power. The third is the evidence of working mechanism that guarantees civil liberties to all citizens in their daily lives.

This depiction describes concisely the main elements of democracy. It establishes the existence of such common democratic principles as popular vote, the mechanism of checks and balances used by legislative and judiciary authorities and the freedom of press. In essence, it maps the more colorful definition of democracy as the state where “majority rules and minorities have rights” onto the space of measurable concepts. Given that constraints on executive power are not systemically different from the defense of civil liberties, the list of parameters collapses to two sets of indicators.

Polity IV defines the choice of leaders as democratic if the process follows well-established rules, any citizen can compete for the top position and the winner is determined through an open competition, which takes normally the form of free election. The composite of three factors – rules, competitiveness, and openness of participation – comprises the composite variable on executive recruitment presented on Figure 7a. It shows the closeness of formal rules to democratic values. By the standard of procedural closeness, Russia is almost at par with the G7 average and outperforms the average of B5 group albeit the gap has been closing in recent years. Yet, this indicator does not capture one important aspect of the selection of executive authority. How top candidates appear on the ballot matters because formal right to file candidacy does not imply that everyone has equal chances of winning the race. It is reasonable to expect that the chances are higher if the candidate relies on some form of public support. This is area where Polity IV detects a gap between Russia and the G7 group. Its data suggest that Russian candidates get endorsement from groups organized around regional interests. This situation is conducive to corruption because politicians have to satisfy the interests of numerous groups. Such approach breeds contempt to politics and prompts alienation of voters in general. Figure 7b presents data on corporate support of volunteerism.

Leadership in informal organization is the first step to political career in democratic countries and its low incidence does not bode well for the quality of political candidates. Russian managers appear to believe that participating in public affairs is not everyone's business. National surveys find that citizens think similarly; for example, Fund "Obshchestvennoye Mnenie" (FOM) reports that only 10 percent of Russians believe that they have the right to be elected compared with 21 percent who claim that they do not have such right.¹⁴

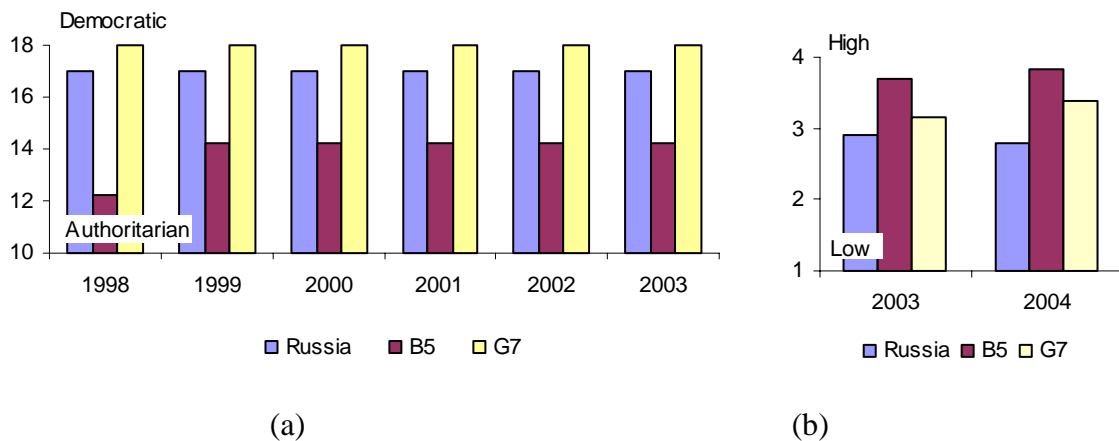


Figure 7: **Electoral process.** (a) The measure of democratic election process in Russia and reference groups (scale from 3 to 18); (b) corporate support of volunteerism. Source: Polity IV (2002, variable EXREG+POLCOMP) and WEF (2004-2005, variables 10.23, 9.26).

The second set of democratic elements deals with the effectiveness of constraints that the chief executive faces in her day-to-day operations. There are two reasons for constraints to exist. First, in their absence the leader is free to substitute the agenda entrusted by voters with her personal priorities. Second, without constraints majority may instruct executive authorities to maltreat some minorities. To prevent the abuse of power, democratic countries enact the process of regular auditing reviews by legislative authority. This limits the degree of executive deviation from received mandate because legislature monitors her performance. Polity IV estimates the power of accountability group, such as legislature, exercised dealing with the executive power. Figure 8a shows that legislature has the power comparable with the power of executive leader in the G7 group. Russian legislature controls executive branch to some extent but has less power than one in the average G7 or B5 country. An alternative method of monitoring, widespread in democratic countries, is the power of judiciary to check the observance of laws by other branches of power. To exercise their authority, courts have to be independent from political interference. Figure 8b shows the average response that managers give assessing the courts' independence from various interest

¹⁴ See URL: http://bd.fom.ru/report/cat/societas/problem_soc/chelovek_i_zakon/tb051213. The poll took place on March 19-20, 2005.

groups. Russia has underperformed relative other groups for the last five years. The FOM survey (*ibid.*, March 19-20, 2005) corroborates this finding. It indicates that 25 percent of respondents doubt that the legal system can challenge state officials compared with 9 percent who believe that they can obtain justice through courts.

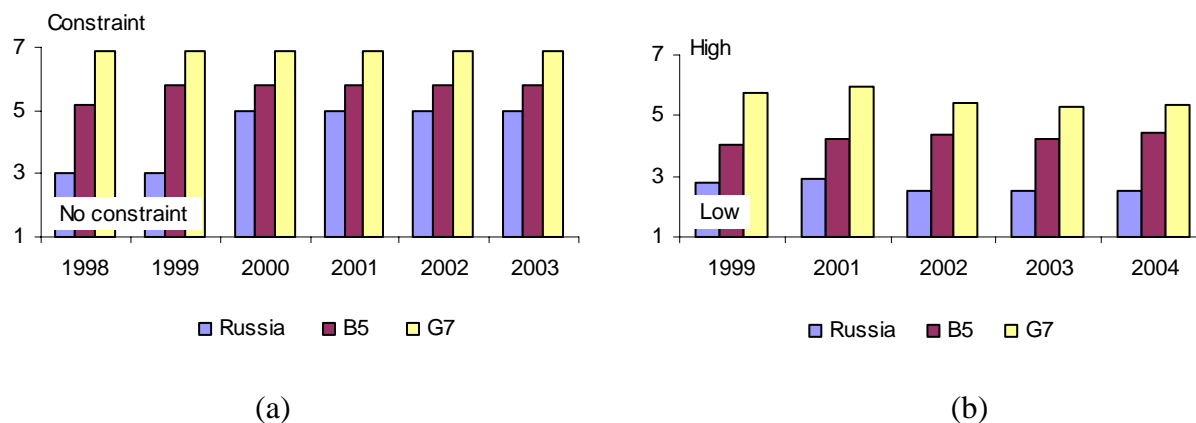


Figure 8: **Constraint on executive power.** (a) The measure of constraint imposed on executive authority by accountability groups; (b) judiciary independence. Sources: Polity IV (2002, variable EXCONST) and WEF (2000-2005, variables 8.05 (2000), 6.01 (2002-5)).

Apart from indirect evaluation of checks and balances, the respect of minorities' rights can be estimated directly. For example, Amnesty International (AI, 2004) monitors the observance of the Universal Declaration of Human Rights worldwide. Figure 9a shows the AI evaluation of the state protection of the right to life and personal dignity. Consistently with the previous indicators, Russia underperforms relative to the B5 average. However, caution is warranted in the interpretation of this result because the method that AI uses to collect data is questionable. It uses predominantly news reviews and, hence, the resulting estimates are biased in favor of highly publicized stories. For example, it is difficult to explain why Russia performed worse by the counts of religious freedom and of the freedom of movement in 2003 because this observation contradicts the public opinion in this country.¹⁵ A closer inspection reveals that AI considers alleged abuses of religious freedom and freedom of movement conducted by government forces in Chechnya. The index of press freedom – constructed by the Reporters without Borders (RWB), a non-governmental organization that records the potential acts of state-related intimidation of journalists around the globe – is another indicator. It measures the incidence of violence and impediments to media operations by public agencies. Given that the state suppresses freedom of press to conduct abusive policies, this indicator gauges if executive authorities stay within the limits of their mandate. Figure 9b shows

¹⁵ 32 percent of respondents consider that they have the right of religious freedom and 26 - the right to settle anywhere in the country compared with 2 and 9 percent who believe that they do not have such rights. The poll took place on June 1, 2004. See URL: <http://bd.fom.ru/report/cat/man/valuable/of042503>.

that the index of press freedom supports the conclusion that journalists are more vulnerable to state intimidation in Russia than in the B5 or G7 countries. Unfortunately, RWB assumes that if an incidence may involve public agencies it should be attributed to state violence. For example, it finds suspicious that police have assumed the death of a camera operator who collected information about illegal dragster racing on May 21, 2005 was a hit-and-run accident suggesting that authorities might be involved.

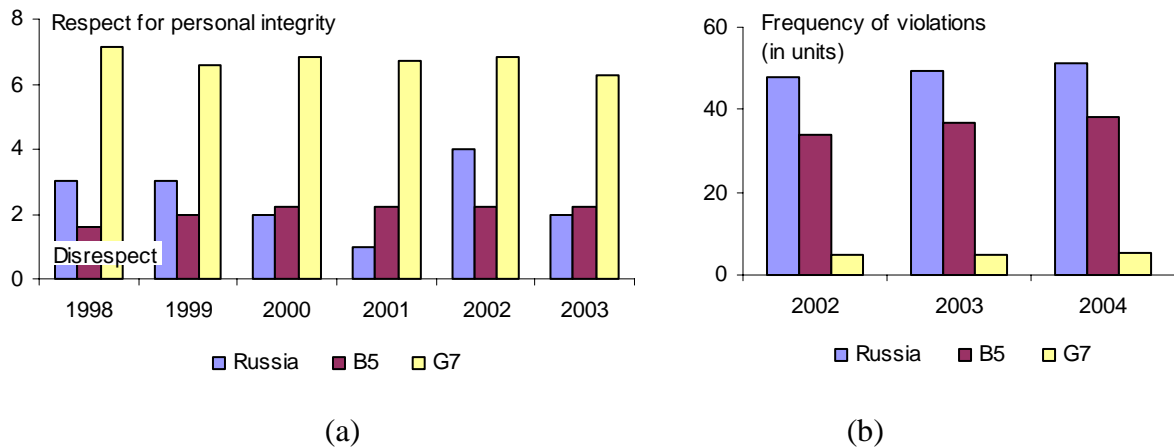


Figure 9: **Observance of human rights.** (a) Indicator of state respect for human life and personal dignity. Source: (b) Freedom of press index. Sources: Amnesty International (2004, variable PHYSINT); Reporters without Borders (2005).

The perception of personal integrity of politicians is a measure of political accountability. Figure 10 shows that Russian managers are more cynical about politicians in this country to be than their counterparts are in the B5 and G7 groups. The WEF (2005, variable 6.10) reports the same pattern of responses to the question on favoritism. Russian respondents think that government officials are more inclined to grant contracts and amend regulations reacting to the requests of well-connected companies relative to the B5 and G7 countries. Again, the order of ranking is preserved over time suggesting that this situation is stable.

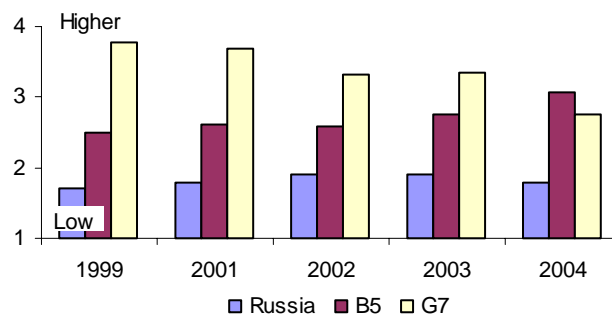


Figure 10: **Financial honesty of politicians.** Source: WEF (2000-2005, variable 7.10).

The last observation attracts specific attention to the issues of corruption among state agencies. Figure 11 shows that Russians believe bribing to be common in various publicly funded agencies. It is interesting to note that courts gain the worst reputation. This result is consistent with the low expectation of fairness, reliability and independence of judiciary in Russia reported above. The ranking of Russia and the reference groups is preserved across all agencies implying that the problem of corruption is systemic.

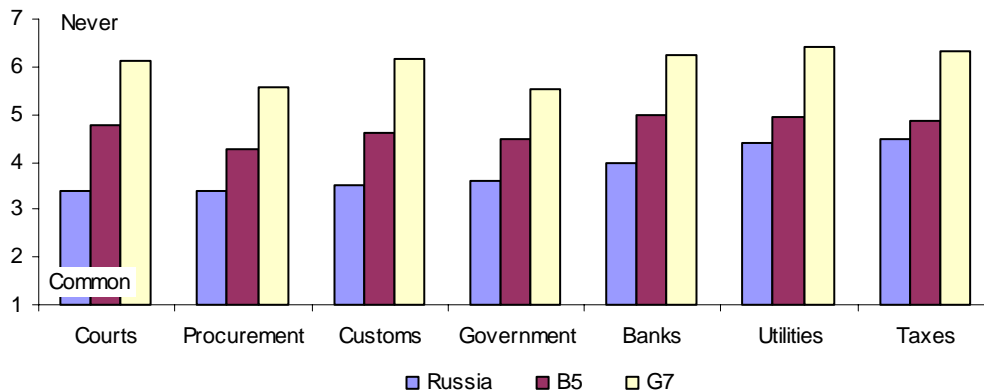


Figure 11: **Corruption.** Undocumented payments to public agencies. Source: WEF (2005, variables 6.21-27).

Area	Subject	Student t-test	Comparison with B5
Democratic control	Volunteerism	-11.14	below the average
	Judiciary independence	-15.79	
	Freedom of press	-0.27	
	Honesty of politicians	-16.53	
	Corporate responsibility	-12.40	
Corruption	Courts	-9.92	below the average
	Customs	-9.16	
	Government	-8.36	
	Utilities	-4.55	
	Procurement	-6.86	
	Banks	-7.10	
	Taxes	-2.96	

Table 2: Test of the equality of means between Russia and the B5 average; sign indicates the direction of the difference. Values in bold are significant at 1 percent. Author’s calculations.

Table 2 shows test statistics on the equality of means. Russia performs significantly worse than the average B5 country by all parameters. Judging by the results, Russia is particularly backward controlling for potential abuse of power by the executive authority. The performance of alternative centers of control – judiciary and legislature – offers little comfort. Recent poll by Levada-Center supports this pessimistic assessment of democratic institutions in Russia. It finds that 83 percent of respondents think that a small group of individuals whom voters cannot control

keeps power in this country.¹⁶ Interestingly, many Russians believe that big businesses have the power but politicians and public agencies are simply corrupt. This observation is important because it suggests the cause of corruption going from large corporations to bureaucrats and not vice versa.

(c) Indicators of Government Performance

Contrary to the *laissez faire* version of free-market economy, residents in the G7 countries take for granted that a modern government provides a range of public services such as the maintenance of favorable market environment and resolution of conflicts by democratic means. They expect governments to provide high quality services. While the evidence of inefficient government does not necessarily affect country’s standing on the counts of free-market economy or democracy, it is likely to be associated with greater economic and political instability that raises the prospect of power abuses. In some sense, citizens consider public agencies more legitimate if they perform better. Figure 12 shows that Russian respondents have low opinion about the performance of public agencies perform. Interestingly, the comparison of Figures 11 and 12 indicates that the estimates of efficiency and corruption are positively correlated in Russia but not in other groups.¹⁷ This finding supports the argument that Russian firms equate efficiency with corruption. Importantly, corruption appears to work well. Russian companies are much more assertive claiming that they have received what they paid for in bribes than firms in other countries are (WBES, 2000; variable sdpy).

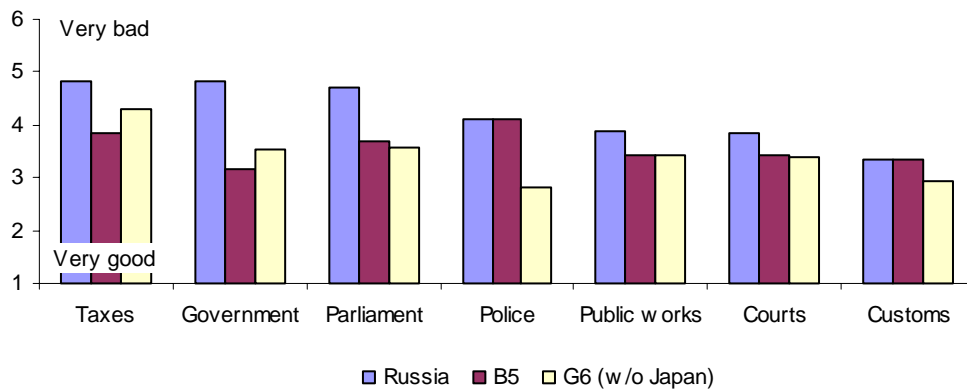


Figure 12: **Government efficiency.** Quality and efficiency of services delivered by public agencies. Source: WBES (2000).

¹⁶ See URL: http://www.chslovo.com/include/output_articles.asp?Id=31701. The poll took place in the beginning of June 2005.

¹⁷ The correlation of two parameters for six Russian public institutions (customs, taxes, courts, central government, public utilities, and courts) is 0.70 for 2003 and 0.64 for 2004. It is negative and insignificant for the two other groups.

Many consider that government intrusiveness in business activities should be limited because it disturbs commercial operations. Figure 13 shows that contrary to expectations, a less constrained Russian government (see Table 2) does not interfere more often than the average B5 or G7 government does. In fact, it behaves more restrained. This finding is paradoxical and not easy to explain. A potential reason is that private businesses have developed symbiotic relationship with public agencies in this country, which is the argument consistent with the evidence on corruption.

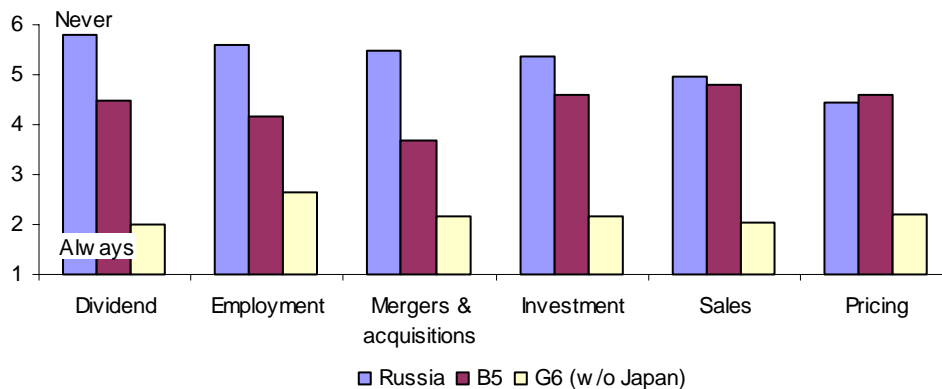


Figure 13: **Government interference** in commercial decisions. Source: WBES (2000).

The last statement attracts attention to the direction of causality between corruption and efficiency in Russia. Two possibilities may suggest strategies to improve efficiency. It can be that corporations have captured public agencies and government efficiency is low because various business interests interfere in bureaucratic process. Then, the appropriate policy is to curb the influence of large businesses. Another possibility is that bureaucrats behave inefficiently extorting affected businesses to pay bribes. If this is true, administrative reform is the way to raise efficiency. So far, the evidence has supported the view that large businesses influence bureaucrats and not vice versa. While formal testing of both hypotheses is beyond the scope of this paper, further comparative analysis clarifies somewhat the issue. Figure 14 shows that Russian companies complain about unpredictability of regulatory changes more often than firms do in other countries. If agencies enact new regulations to elicit bribes, one would expect that regulations represent a greater problem in Russia. In fact, in many cases firms see regulations as less problematic in this country. This result supports the proposition that regulatory changes are poorly advertised or explained but do not cause corruption in Russia. Note that the costliest area of compliance – tax regulation – is the least affected by corruption (see Figure 11).

Table 3 presents the results of this section in comparative form. The evidence on relative government performance appears to be controversial. On the one hand, Russian public agencies are less efficient than agencies in the B5 countries. This result implies that firms should incur high

regulatory costs in this country. In fact, government is less intrusive in business operations and firms find that regulatory compliance is relatively easy in Russia. This controversy between expectations and actual results requires further analysis. The paper has suggested that it may indicate that public agencies fail to perform their duties because they succumb to corruption sponsored by large corporations. In this case, severing the link between big businesses and public agencies in Russia would reduce corruption and increase efficiency of government operations.

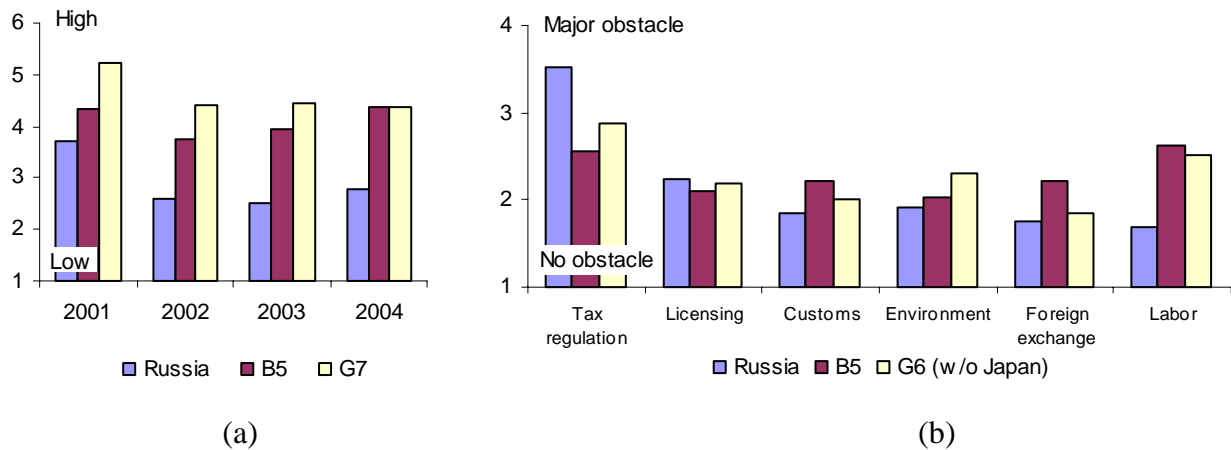


Figure 14: **Regulatory compliance costs.** (a) Transparency of regulatory changes; (b) Ease of compliance. Sources: WEF (2000-2005, variable 6.07) and WBES (2000, variables TXREG, BL_REG, CUS_REG, FRK_REG, LAB_REG, ENV_REG).

Area	Subject	Student t-test	Mann-Whitney test	
Government efficiency	Government		-16.75	below the average
	Central Bank		-11.32	
	Parliament		-10.40	
	Police		0.67	
	Taxes	-4.94		
	Courts		-4.95	
	Customs		0.46	
	Regulatory transparency	-15.23		
Government intervention	Mergers & acquisitions		15.58	above the average
	Dividend		12.36	
	Employment		15.53	
	Investment		9.74	
	Sales		3.48	
	Pricing		-0.67	
Regulatory compliance costs	Tax regulation		-13.99	mostly above the average
	Licensing		-0.87	
	Customs		6.73	
	Environment		3.08	
	Foreign exchange		7.35	
	Labor		16.09	

Table 3: Test of the equality of means between Russia and the B5 average; sign indicates the direction. Values in bold are significant at 1 percent. Author's calculations.

4. Perennial Russian Question “Chto Delat’?”

The presented evidence has answered the question of Russian standing relative to the B5 country by the standards of normalcy appropriate to the G7 group. Unsurprisingly, Russia performs obviously worse than the average G7 state. Moreover and contrary to Shleifer and Treisman’s claim, this country trails behind many middle-income developing countries of comparable size. This result is significant. It indicates that even if Russia may approach the G7 standards in absolute terms – the subject that the paper covers below, it converges not fast enough to warrant its full inclusion in the group before, say, India or Brazil qualify for joining the organization. This rather troubling finding necessitates asking the question “Chto delat’?” (“What is to be done?”) that Russian intelligentsia is so familiar with. This study has revealed several interesting patterns related to indicators themselves, potential causes of relative strengths and weaknesses and indicate strategies that correct for observed deficiencies. It considers two causes – the Soviet legacy and transitional developments particularly related to privatization – whose analysis prompts two distinct sets of policy advice. But, first, the paper reflects on the validity of presented indicators.

(a) ‘Halo Effect’: Is the Situation as Bad as It Seems to?

Section 3 has relied to the large degree on surveys whose results may be biased views due to ‘Halo effect’. Respondents build their opinion, either positive or negative, using a general impression or an experience that is vaguely relevant to the question. A casual observation of data in section 3 detects a pattern of excessive pessimism in Russia. For example, the perception of the quality of physical infrastructure (Figure 1) does not match data on the comparative development of these sectors in Russia (Figure 15). Situation with electricity losses in transmission and distribution, the availability of telephone lines and access to safe water is better in Russia compared with the B5 average but respondents think otherwise. Potentially, different definitions of what constitutes “the world” explain this paradox. The Russians appear to compare their country with not with the world

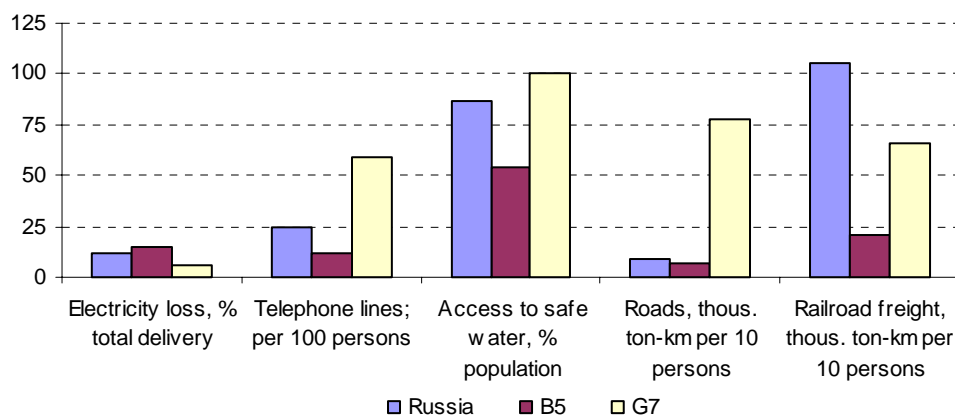


Figure 15: Data on electric power transmission and distribution losses, goods hauled by railways and roads, telephone mainlines, improved water access. Sources: World Bank (2005b).

average as managers do in the B5 countries but with higher European standards. Another reason is that a greater availability of infrastructure services in Russia coincides with a higher incidence of technical failures. Data from the Investment Climate Surveys (World Bank, 2005a) suggest that Russian firms complain more frequently of technical failures than their counterparts do in Brazil or Indonesia. The efficiency of public agencies is another area where perceptions may not match actual data. Relatively strong condemnation of regulatory practices and poor judicial work that firms express in Russia (Figures 14b and 3) do not agree with data on time and money costs that firms incur in this country complying with regulations or adjudicating conflicts in courts (Table 4).

	Starting a business (days)	Registering property (days)	Enforcing contracts (days)	Cost of enforcing contracts (% of debt)	Recovery rate in bankruptcy (% of debt)
Russia	36.0	37.0	330	20.3	48.4
B5	94.2	38.8	416	44.4	18.1
G7	17.6	45.4	370	11.9	68.0

Table 4: Costs of doing business, in time and money. Sources: World Bank (2005a).

Still, the perceptions of Russian respondents do not differ significantly from hard data, as ranking is preserved in many cases. For example, data on high cost of collateral and slow transfer of money substantiate the view that Russian banking sector operates less efficiently than in the B5 group. Alternative indicators of corporate practices and human rights (the last part of Section 3a and Sections 3b and 3c) paint a consistent picture of unethical corporate behavior, extensive violation of minorities' rights and widespread corruption. Overall, data suggest that the halo effect is present but not strong enough to question the validity of results in section 3. Still, it is important to notice that the Russians are overly pessimistic. This factor should concern policy makers in this country.

(b) The Soviet Cause of Russia's Institutional Successes and Failures

Russia has passed a long way from its Soviet past towards becoming a "normal" democratic and capitalist society since 1992. It has developed democratic and free market institutions such as holding regular elections for executive and legislative authorities or legalizing private property rights. However, Russian institutional development is a curious mixture of successes and failures some of which traceable to the Soviet legacy.

It appears that the areas where Russia performs well relative to the G7 or B5 groups are the ones where the USSR established strong presence pursuing its own, non-capitalist and non-democratic, agenda. They include heavy investments in physical infrastructure such as transport networks; high degree of import substitution; consistent emphasis on developing human resources,

especially in mathematics and natural sciences and constant outgrowth of research facilities that were necessary elements of self-reliance and competition for world influence. As a result, the Russians find that they have a competitive edge in the areas of transportation, educated and experienced labor force or wide assortment of locally produced machinery and parts. Curiously, Russian deficiencies mirror its strengths almost one to one. In a sense, they embody mistakes and omissions of the planning period that authorities have not corrected during the transition. For example, the low priority of information and communication technologies in the USSR finds its continuation in its relatively poor development in Russia today. The Soviet authorities disregarded marketing or customer retention practices and now Russian companies struggle to retain their market shares. Constant drive on rationalizing delivery chains, characteristic of planning system, led to the appearance of rigid market structure and Russian firms continue depending heavily on existing suppliers. The Soviet emphasis on centralization of decision-making has been particularly incongruent with demands of free market economy. After the system of central planning fell apart, Russian companies have had to learn basic market skills such as adjusting production to shifting market needs and operating within the system of decentralized exchanges and financing. The change in dominant philosophy has complicated the situation further. The collapse of collectivist ideal has led many Russians to believe in capitalism as the system where one is free to extract profit at any cost. Symptomatically, this country earns low scores in the areas associated with peer-level conflict resolution such as corporate ethics, business transparency, or protection of minority shareholders rights. To put it simply, managers, and later bureaucrats, have equated capitalism with “get-rich-quick” formula implying that reneging on contracts or cheating customers and partners is appropriate.

The last point deserves specific attention as it suggests the common reason for three arguably most serious shortcomings of Russia today. Section 3 has shown that its judicial system is poorer, corruption is more pervasive, and democratic institutions are weaker than in the average B5 country. Does Russian history provide a clue on these deficiencies? Yes, one can trace their roots to the disintegration of the Soviet system of vertical power. In a vertically integrated system, courts are redundant, decentralized discussions are suppressed and corruption is low because the superior has no need in independent adjudication and is free to dismiss miscreants or disloyal subordinates. In a decentralized system, enterprises do not only get a chance to use hidden resources to optimize performance. They also have to learn how to resolve conflicts using the third party judgment, which raises the need for independent courts. Greater decentralization of state agencies improves the quality of services because their responsibilities are delineated better. On the downside, lesser

supervision creates more opportunities for arbitrariness and associated corruption.¹⁸ Finally yet importantly, diminishing authority of vertical administration creates wide opportunities for political entrepreneurship, which corrupts the institute of power in general. Mature democracies solve the problem of power abuses using the system of checks and balances but the latter is absent in many young democracies (see, e.g. Keefer, 2005). Then, bidding for offices becomes a business venture that delivers private gains. In all three cases, judiciary partiality, bureaucratic corruption and political dishonesty are consequences of the same event – the collapse of central authority in Russia.

(c) The Impact of Transition on Institutions in Russia

The preceding analysis has indicated that general government inefficiency, corruption and weak judicial system are the key areas that need dramatic improvement in Russia. Observing the roster of current maladies and their common Soviet roots, it is natural to conclude that improving the work of public agencies is the key priority in this country. However, before making the final inference, it is important to investigate if events of the transition have contributed to deteriorated performance of public agencies. For example, time series in Figure 16 suggests that the Soviet legacy cannot fully explain the ubiquity of corruption. If it were the case, the incidence of corruption would have fallen since 1991. Since it has not happened, other developments related to the period of transition are a factor.

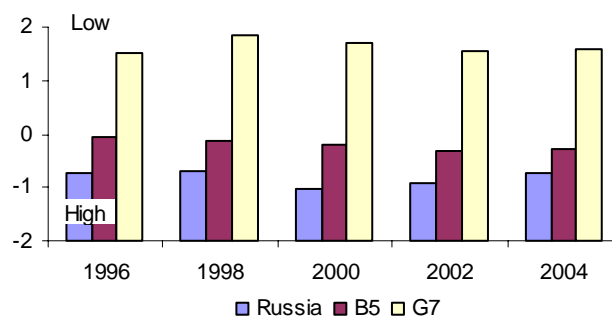


Figure 16: **Control of corruption index.** Source: Kaufmann et al. (2005, Appendix Table C6).

Two events have triggered the spread of corruption and increasingly inefficient work of public agencies in transitional Russia. First, the transition to capitalism discarded the Soviet tradition of resolving conflicts through peer group arbitration. Because of group responsibility for corporate performance, “red directors” maintained close relationship, which prevented conflicts from escalation. As old norms became non-operational in new environment, the importance of using third party adjudication became more important. The latter did not happen for several reasons. The Soviet system marginalized traditional ethical norms such as Christian values. As a result, Russians did not have the norms of what is morally right and wrong, which could provide a reference point in

¹⁸ Compare with Shleifer and Vishny argument (1993).

conflict resolution. In this respect, they are similar to residents of many other industrialized countries that keep “righteousness” to be the concept irrelevant to legal affairs.¹⁹ The latter relies on explicit adjudication conducted according to the accumulated body of legal documents. This process presupposes a lengthy evolutionary development that Russia could not afford. Moreover, the precipitous fall in the standards of living pushed residents of this country to move into survival mode of operations. Such approach disregards self-restraint in dealing with other people because dishonesty helps to endure current troubles. Together, weak social norms and low standards of living created environment where cheating is morally acceptable and beneficial. This development had particularly detrimental effect on corporate ethics in Russia that surveys find to be significantly lower in this country relative to the B5 group (see Figure 6b).

Second, the mode of Russian privatization has created two-layered industrial structure in this country. Enterprises differ in the concentration of wealth and access to power. Workers and managers of small and medium enterprises have acquired ownership rights through closed auctions forming the lower layer of enterprises. These firms do not generate significant cash flows but they are major employers that form the basis of social life in many cities. Such enterprises develop mutual dependency with regional authorities forming local coalitions that promote well-being of its members. Most valuable companies – particularly in natural resource sectors – shape the upper industrial layer. They were sold in rigged privatization deals, “loans-for-shares” being the prime example, to a small group of people, so called oligarchs. The oligarchs control large cash flows but their ownership rights on privatized assets are ambiguous. To forestall attempts on questioning the legitimacy of their holdings, they form informal coalitions with politicians and bureaucrats of national level. These coalitions are unstable because the importance of each member depends on the value of his or her contribution. Coalitions compete for the positions of influence lobbying for regulatory changes or judicial favors that result in regulatory uncertainty (Figure 14a) and low standards of courts’ work (Figure 3).

(d) The Cost of Mistrust

Mistrust is costly. Fukuyama (1995) lists three sources of such costs. First, mistrust hinders the development of modern corporations. To reduce the probability of being “sucked”, people limit their contacts to persons whom they know. Consequently, some business ventures fail to materialize because partners have misgiving of one another and owners of other companies fill managerial positions with people whose main advantage is unquestionable loyalty and not efficiency. Particularly damaging is the effect of mistrust on firm’s flexibility. Current improvement of information technologies increases the importance of decentralized networks as the prime mode of

¹⁹ See the World Values Surveys at URL: <http://www.worldvaluessurvey.org/statistics/index.html>

business operations. However, the environment of mistrust requires strict supervision over employees and suppliers. Consequently, firms forego business opportunities because subordinates fail to get approval of their superior. Suspicion over the reliability of new suppliers prompts corporations to refuse offers to provide inputs at better terms, which limits the extent of outsourcing. Second, mistrust reshapes organizational structures of public agencies. Authorities that mistrust public employees increase the complexity of regulations with which they are obliged to comply. This raises regulatory compliance cost that businesses incur. Third, commonality of mistrust among citizens prevents the creation of vibrant civil society that is a vital condition for the development of mature democracy. Being mistrustful of one another, voters extend the same attitude towards political candidates. This is particularly detrimental in young democracies where political competitors cannot make credible commitment to work honestly (see Keefer, 2005).

Section 3 presents numerous examples on mistrust in Russia. World Bank (2005a) reports that Russian banks have relatively higher collateral requirements requesting to incur as much as 11.6 % of income per capita in Russia compared with 7.5 % in the B5 and 1 % in the G7 groups in costs to create collateral. As a side effect, Russian enterprises have a different structure of corporate financing replacing loans with internal funds (Figure 5a). Companies avoid delegating authority to employees revealing how suspicious managers are towards workers in this country (Figure 6a). Mistrust in Russian judicial system (Figure 3b) limits the scope of business affairs to narrow circle of long-term partners.²⁰ When firms trust outsiders, they disclose more information about their performance (Figure 5b) prompting investors' interest and increasing collaboration with suppliers (Figure 6b). Especially troubling is the widespread mistrust in Russian political process (Figure 10) that hinders the process of democratization and breed corruption in this country (Figure 11).

The problem of low trust prompts non-cooperative behavior symptomatic of autarky and self-reliance. When cooperation is necessary, private agents circumvent the problem of low trust organizing coalitions that maintain commitments by introducing effective punishment for renegeing. This is a normal development in a civil society as it sponsors the formation of political parties, NGOs and business corporations but it also sponsors the development of special interest groups. The latter, if organized by private money and supported by affiliated politicians, inhibits formation of alternative trust-building institutions (independent judiciary or political parties). The problem is that coalitions are a tool to benefit their members at the expense of non-members. When non-members attempt to uphold their interests appealing in court, coalitions resist. They may choose incorporating the arbitrator as its member, thus corrupting the court. Apart from the spread of corruption, the development of special interest coalitions results in the stratification of the society

²⁰ Johnson et al (1999, Table 2) report that only 1.4 % of Russian firms are ready to replace their suppliers compared with more than 40 % of firms in Slovakia, Poland or Romania.

with consequent feeling of disfranchisement by many citizens. Unsurprisingly, 83 percent of Russians believe that the power in their country belongs to a narrow group of people that citizens do not control (see Levada-center, survey May13-17, 2005).

(e) Two Strategies to Address Institutional Deficiencies

The observed patterns in relative ranking suggest two approaches that Russian policy makers can employ to bridge the gap with the G7 standards. First, they can do nothing hoping that things will settle down in due course. Second, authorities can pursue proactive policy aimed at developing missing institutions and curbing corruption.

The first approach is appropriate in the case of weaknesses that Russia has inherited from the Soviet past. For example, the dynamics of evaluations shows that corporate practices in Russia tend to improve across a range of parameters over time, see Table 5. In this case, forces of market competition provide sufficient impetus to drive firms into accepting a more cooperative stance towards customers and investors. The quality of general infrastructure improves in electric supply and communication services. However, the availability of scientists and the quality of railway system have fallen due to neglect during the transition. This finding warns against broad acceptance of evolutionary approach as the only method to address Russian institutional problems. Other arguments warrant proactive policy as well. Ahrend and Tompson (2005) find that the current state of Russian institutions is conducive to the development of strong state presence in natural resource sectors that continue to be the backbone of Russian economy. Under this scenario, the country locks itself at the bottom of the international value-added chain. The stability of corruption indicators suggests that Russia may have settled at a suboptimal institutional equilibrium and that the Russian government must take a proactive stance to bring bribery under control.

Parameter	2001	2002	2003	2004
Positive trends				
<i>Infrastructure: Electricity</i>		3.7	3.9	4.2
<i>Infrastructure: Telephone</i>	4.1	4.5	4.6	4.9
<i>Quality of market: World presence</i>	3.6	3.2	3.4	3.8
<i>Corporate practices: Minority shareholders</i>				
<i>Corporate practices: Accounting standards</i>				
<i>Corporate practices: Managerial incentive</i>			2.6	2.8
<i>Market practices: Customer retention</i>	4.2	4.3	4.4	4.7
<i>Market practices: Corporate ethics</i>		3.2	3.4	3.7
Negative trends				
<i>Infrastructure: Railroads</i>	5.2	4.7	4.9	4.3
<i>Quality of labor market: Scientists</i>	5.5	5.3	5.4	5.1
<i>Corruption: Courts</i>		3.6	3.4	3.4
<i>Corruption: Customs</i>	3.8	3.8	3.5	3.5
<i>Corruption: Procurement</i>	4.6	3.8	3.4	3.4

Table 5: Historical changes in the quality of Russian institutions. Source: WEF (2000-5).

Proactive policy towards developing favorable market and democratic institutions is the second approach that Russian government can take. Apart from the obvious task of upgrading decaying infrastructure such as railroads, public education or health system; the state needs to address severe problems of corruption and inefficiency of public services. A potential approach that the Russian government explores in all but name is to take under control corporations run by oligarchs. The logic of this move is straightforward. The paper has suggested that privatization has contributed to the development of groups that interfere in public affairs pursuing private interests. This policy, if followed through, has two favorable implications. By reestablishing control over money flows, the state uncovers the veil of secrecy that oligarchs employ dealing with corrupt public officials. Next, a wider availability of public funds reduces the scope of corruption indirectly. More secure financial position of the state increases bureaucratic perception of greater stability of their income. Consequently, they are less likely to risk it losing for a bribe. Apart from addressing the problem of corruption, a greater state control may have other favorable consequences. For example, as incentive to hold office increases, more candidates are motivated to take part in the elections enhancing the quality of political process. On the negative side, one should note that the process of virtual re-nationalization of oligarchic corporations is fraught with certain dangers. First, the proposition to limit corruption through re-nationalization does not provide a natural limit on the list of corporations that the state should control directly because politicians have various incentives to expand the roll for reasons unrelated to the primary idea.²¹ Second, it raises the specter of authoritarianism in Russia because the incumbent realizes a greater payoff to office holding when the state increases control over economy. In these circumstances, the quality of voting process becomes a special concern as temptation to rig elections grows.²²

5. Conclusion

This paper has raised three main issues investigating the degree of relative convergence of Russian institutions to the G7 standards. It has formalized the concept of institutional similarity in section 2. Building on broad concepts listed in OECD (2004), the paper has substantiated the notions of free market economy, democracy and peer learning. In this respect, the paper has

²¹ A potential solution is to limit the list to the group of Russian *nouveau riches* that were involved in “loans-for-shares”-types of privatization deals. Judging by Klebnikov’s (2004) account of the “normal” Russian oligarch, he is a man who has his wealth pouring from natural resource companies and banking. This wealth came largely as the result of lucrative privatization deals and bank financing of government deficits in 1990s. The link between private fortunes and state management suggests a close association between private firms and personal interests of public servants.

²² This problem may not be as serious as it seems to be due to mitigating factors. Non-elected bureaucracy is likely to resist electoral fraud, as they need social stability to maintain the same level of state spending.

contributed to the literature on comparative measurement of institutions. Unlike the previous works, the paper has focused on comparing the subset of countries that are similar to Russia in terms of size and income per capita. Second, the paper has reorganized datasets available elsewhere and conducted a consistent review of main indicators of free market, democracy and efficient government in section 3. Here, the paper has followed the line of research advanced by Shleifer and Treisman (2004). Contrary to their findings, it has concluded that Russia is an atypical country by the standards of its peers. The difference between the two works has resulted from the use of different reference groups and sources. For example, Shleifer and Treisman refer to Turkey, South Korea, Argentina, the CIS countries in various places but this study compares Russia with the groups of G7 and B5 countries (Brazil, China, India, Indonesia, and South Africa) consistently throughout the paper. Third, the paper has detected several patterns of Russian institutional development and suggested policies that address the most troubling issues. It has noticed that Russia performs particularly dismally in the areas that involve trust-building measures such as judiciary, corporate practices and efficiency of public services. Touching briefly on the issue of causality, the paper has suggested that mistrust encourages the appearance of coalitions that compete for control of formerly state-owned enterprises. This development results in high incidence of corruption because belonging to coalitions becomes more important than serving the state. The paper has considered two policies that the Russian government may pursue. One is to allow the unimpeded development of private institutions of trust. This approach is appropriate for corporate practices that show signs of improvement over time. Another policy requires public interference in private affairs. It is superior to evolutionary approach when there are signs that the state has settled on a suboptimal equilibrium like in the case of corruption. The paper has considered if the policy of partial re-nationalization, conducted currently in Russia, may reduce corruption. It has inferred that it is possible because it uncovers secret links between private corporations and corrupt officials in this country. On the negative side, the paper has pointed out that greater wealth of the state increases the prospect of authoritarianism in Russia. The ambiguity of inference warrants a more detailed analysis of policies that the state can employ to fight corruption but this objective goes beyond the scope of this paper.

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