



## Journal Issue

### **The Russian Budget**

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## THE RUSSIAN BUDGET

- ANALYSIS  
The Russian Budget: Why So Much Fuss? 2  
By Philip Hanson, London
- ANALYSIS  
A New Step in Russia's Budget Policy 5  
By Evsei Gurvich, Moscow
- ANALYSIS  
Russia's Pension System: Back to the Future 8  
By Peter Rutland, Middletown, CT
- ANALYSIS  
In Search for a New Social Base or  
Why the Russian Authorities Are Changing Their Relations with Business 10  
By Andrei Yakovlev, Moscow

## The Russian Budget: Why So Much Fuss?

By Philip Hanson, London

### Abstract

Disagreements among policy-makers over budget plans have become unusually open. They reflect profound differences of view within the elite over Russia's future development. Those who seek rapid fiscal consolidation have little faith in state intervention and also seek fundamental reforms in the state pension system and in the state's control over energy assets. Such disagreements will not be quietly resolved.

### A Budget Storm...

In September 2012 the Russian government was preparing and presenting a draft budget plan for 2013–15. On the 18<sup>th</sup> President Putin publicly castigated his ministers for failing to make provision for spending promises he had made in May. These were particularly about raises in public-sector pay. In early October Andrei Klepach, a deputy minister of economic development, spoke of adjusting the draft plan to allow for more expenditure on healthcare and education. Nonetheless the existing plan—primarily the work of the Ministry of Finance (MinFin)—went forward pretty much unchanged. The budgetary committee of the Duma (parliament) then announced that it was going to spend four days scrutinising this draft for the first reading, an unusually intensive procedure at this stage. Yet again, as over several other matters lately, the political elite were embroiled in a public spat. What is at stake?

The answer is: more than you might suppose. Budgetary policy in Russia is linked to the fundamental economic challenges the country faces: a medium-term decline in the workforce, an abrupt slowdown in supplies of credit from abroad, insecure property rights, weak domestic competition and vulnerability to volatile oil prices.

### ...in a Teacup?

At first sight, the issues at stake do not seem fundamental. The fiscal plan in question is only for the federal-level budget. Russia's recent budgetary balance has been much healthier than those of the Western world, and its public debt is, by OECD standards, laughably small. Couldn't a bit more be spent without any harm being done?

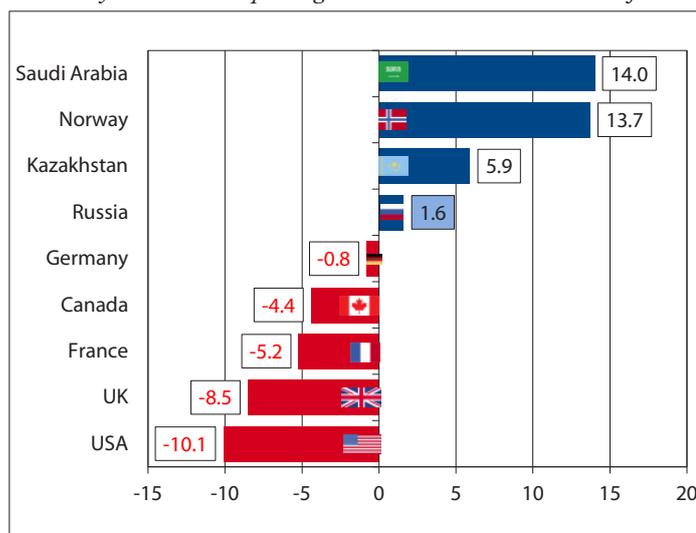
First, the matter of multiple Russian budgets: it is true that the federal budget accounts for only about four sevenths of general government spending, and has latterly been around 20–21% of GDP. However, transfers from it prop up regional budgets. Regional and municipal officials have almost no independence in the choice of tax bases and tax rates. Federal transfers also plug a very large hole

(about 2% of GDP) in the state pension fund. The overall balance of government revenue and spending depends on the federal budget.

Second, Russia's fiscal health is currently good. Figures 1 and 2 present a picture that is, by OECD standards, one of glowing fiscal health. This applies not only to Russia but to several other large oil-and-gas exporters as well. In 2011 Russia, Kazakhstan, Saudi Arabia and Norway all had positive fiscal balances. The first three had comparatively very low public debt levels; Norway, with a highly developed welfare system, had an intermediate debt level.

Recent Russian experience, however, points to a serious downside risk. When oil prices fell steeply in 2008–09, its GDP fell by 7.8% (2009 over 2008). This was the largest percentage fall among G-20 nations. Strikingly, other major oil exporters, such as Saudi Arabia, experienced only a slowing of growth, not an outright decline.

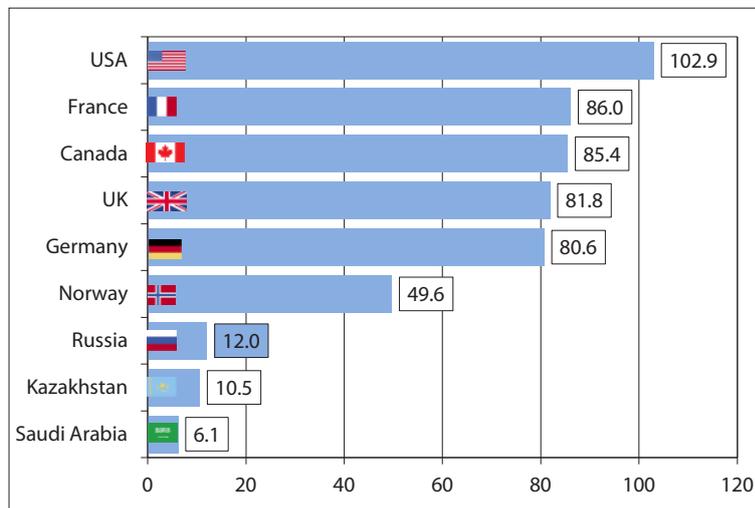
Figure 1: General government balance (surplus +, deficit -) in 2011 in selected hydro-carbon-exporting and advanced economies, % of GDP



Source: IMF World Economic Outlook database, October 2012

This sensitivity is not easily explained. It may stem from a particularly severe lack of confidence in Russia's ability to cope with lower oil prices, on the part of both Russian business and global markets. It may therefore be the

Figure 2: Gross government debt as % GDP, end-2011, selected hydrocarbons-exporting and advanced economies



Source: IMF World Economic Outlook database, October 2012

outcome of a self-fulfilling prophecy. Aleksey Kudrin, the much-admired, long-serving finance minister who resigned last September, has argued that Russia could not easily, at short notice, borrow to plug a budgetary deficit of 3% of GDP. In the same vein, he has consistently maintained that Russia could not allow itself the luxury of a public debt much above 30% of GDP. Figure 2 illustrates the vastly more luxurious debt ratios that leading western nations have allowed themselves.

### Two Views of Russia's Way Ahead

For most of the 21<sup>st</sup> century so far, Russian policymakers have seen the petrodollars flooding in. There have been two opposed reactions to this inflow: spend it, and save it. That is, of course, simplifying things, but not by much. Revenue from the mineral resources tax and the export duties on oil and gas has been providing around half of federal budget income. For most of his decade as minister of finance, Kudrin resisted the would-be spenders. From 2004 he built up a stabilisation fund—subsequently split into the Reserve Fund and the Fund of National Prosperity. In 2008–09 it propped up state spending when hydrocarbon revenues fell. It allowed Russia to cope with a sharp recession without running up major debts.

This stance has been maintained by Kudrin's successor, Anton Siluanov. However, both Siluanov and Kudrin have been unable to stop the rise in spending. In 2007 the Urals oil price at which the budget would have exactly balanced was \$29 per barrel. In 2012 it is \$117 per barrel.

Part of the pressure to spend more comes from officials with their own plans to siphon off funds from state projects. Accordingly, one of Kudrin's objections to more spending was that in Russian conditions much of it simply

did not go where it was supposed to go. But there is also a school of thought that favours more spending on healthcare, education and science as part of a strategy to develop and diversify the Russian economy. This view has in recent times been represented, departmentally speaking, by the Ministry of Economic Development (MinEkon). It was espoused by the large army of economists who have presented proposals to revise an existing national economic strategy to 2020.

One view therefore is that of the Ministry of Finance, counselling fiscal consolidation: a return to budgetary balance by 2015 and to building up the Reserve Fund and the FNB. Their priority is that Russia must be seen to be in good shape to cope with another drop in oil prices. On the other side there are two constituencies. There are the big spenders with dubious motives,

and there are also those who espouse liberal views on the need for more privatisation and for the establishment of an independent judiciary—in short, for millions of hectares of level playing fields—but who at the same time advocate more state spending on infrastructure, education and health for the sake of long-run growth.

### The Danger of a Fall in Oil Prices

In the first nine months of 2012 oil and gas revenues, as officially defined, accounted for fractionally over a half of federal budget revenue. The real budgetary impact of oil revenues is greater than this. 'Oil and gas revenues' in the MinFin sense do not include profits-tax revenues, which are split between federal and sub-national budgets. Moreover, the flow of oil and gas revenues, even though part of it is 'sterilised' (removed from the circulation of domestic income) by diversion into the Reserve Fund and the FNB, affects incomes and thereby demand, and therefore levels of economic activity more generally in Russia. That means that changes in oil prices have a secondary effect on the state's revenues from non-oil-and-gas activities.

The risks from lower oil prices are not immediately obvious from recent federal budget numbers. On the face of it, Table 1 overleaf displays a sound initial state of affairs in 2012 and then projections of the Urals oil price over the next few years that are rather conservative, in a scenario in which a very modest deficit is smoothly reduced. It should however be pointed out that federal budget spending regularly surges in December, so that this year's outcome will be less benign than the current figures suggest. Also, the projected oil price over 2013–15 could indeed prove to be unduly modest, but it could also prove to be not modest enough. One

Table 1: Average annual Urals oil prices and the balance of the federal budget (\$/barrel and % of GDP), 2010 Actual—2015 Plan

	Oil price	Fiscal balance
2010A	78.9	-4.0
2011A	109.6	0.8
2012J–O	111.2	1.5 (Jan–Sept)
2013P	97	-1.5
2014P	101	-0.6
2015P	104	-0.1

Notes: A = Actual. J–O = January–October Actual; P = draft MinFin plan. Sources: Central Bank of Russia; Vedomosti.

thing we know about oil prices is that they move around a bit. MinFin's aim is to reduce Russia's vulnerability to sharp movements in the oil price, in part by curbing spending so that the federal budget will balance at just over \$90/barrel, from \$117 this year.

Given the disarray and (on a good day) stagnation in Europe, the prospects of a 'fiscal cliff' in the US and the slowdown in China and some other emerging economies, horror stories (from Moscow's point of view) of oil at less than \$80 or even \$60 are not wholly implausible. The Kudrinist view is that Russia should be prepared for such eventualities. That view also carries the implication that additional government spending is not going to transform Russia's prospects for the better.

### Guns, Pensions and Rosneftegaz

The basic disagreement about budgetary policy is linked also with conflicts of views about defence spending, the reform of the state pension system and the control of energy-sector assets. For reasons of space I shall not try to describe those here. A few points will, I hope, suffice.

This year public spending on defence and security is rising faster than GDP or budget revenue. Kudrin now, like MinEkon's Klepach, criticises the draft budget for neglecting infrastructure, healthcare and education, but implies that spending on defence should be cut to accommodate them.

The Ministry of Labour's proposed 'reform' of the

pension system would leave it still subsidised from the federal budget in 2030.

The struggle over the privatisation of some major state electricity assets is tilting towards eventual control of those assets by Igor Sechin's state holding company, Rosneftegaz.

None of this is good news for reformers, but *la lotta continua*.

### Conclusions

Current disputes among policy-makers over fiscal policy are important in their own right. The downside risks of protracted global recession, as far as Russia is concerned, support the case for curbs on public spending.

Suppose, however, that fundamental economic reforms were to be put in place. A Russia that had independent courts, a rule of law and secure property rights would be a country in which the rate of investment was higher, competition was more powerful and the manipulation of oil-and-gas rents was no longer at the centre of political life. It would therefore be a country that could support a larger burden of public debt without causing investor panic, and in which public spending on infrastructure and education had a chance of generating benefits for the wider public.

Then the downside risks of a fall in oil prices, that loom so large at present, would be much less. Choices in macro-economic policy would be different because the rules of the micro-economic game had changed. As things are at present, however, it is hard to argue against the Russian Ministry of Finance's view of the options.

Equally, it is hard to see the current public disagreements over the budget and related matters as simply part of the routine friction to be found in any government. More to the point, they do not seem to conform to the normal functioning of the Putinist order as we have known it since the early 2000s. The disputes are too numerous, too public and have too much bearing on the competence and legitimacy of different parts of the state system. In the words of a Polish analyst, there may be turbulence ahead.

#### About the Author

Philip Hanson is an Associate Fellow of the Russia and Eurasia Programme at Chatham House and an Emeritus Professor of the University of Birmingham. His books include *The Rise and Fall of the Soviet Economy* (2003) and (co-edited with Michael Bradshaw) *Regional Economic Change in Russia* (2000),

#### Further Reading

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## A New Step in Russia's Budget Policy

By Evsei Gurvich, Moscow

### Abstract

Russia's state revenues grew considerably during the 2000s, fell sharply during the international financial crisis, and have since recovered. Looking forward, revenues are likely to remain steady or fall as Russia's physical oil output plateaus. While the president plans to honor the promises he made during his campaign, Russia will impose budget discipline beginning in 2013. Some critics of Russia's budget policy complain that cutting budget expenditures will hurt economic growth. Others complain that saving oil profits in a Reserve Fund deprives the economy of infrastructure investment. While macro parameters of Russia's fiscal strategy may be on track, currently the expenditure structure is deteriorating with less money spent on infrastructure and human capital and more going to defense and security. Russia can improve the effectiveness of its budget expenditures, but only if it make this goal a top government priority.

### From Surplus to Deficit and Back

The fiscal policy of the 2000s was for a long time determined by memories of the painful crisis of 1998, when the drop in the price of oil to \$12/barrel led to a sharp debt and currency crisis. After that event, the government significantly cut its expenditures and introduced new fiscal rules that required saving part of the oil revenues during times when oil prices were high so that the state could cover losses to the budget when oil prices fell. The consistent rise in oil and gas prices to the record levels of mid-2008 meant that the budget was typically in surplus for most of the decade (during 2004–2008, the surplus was 4–8 percent of GDP).

In 2009 the international financial crisis sharply curtailed Russia's budget revenues. The accumulated petrodollars in the Reserve Fund made it possible not only to compensate for the losses to the budget, but also to increase expenditures to stimulate demand. Support for the banking system and the labor market combined with high social expenditures facilitated relatively low unemployment and an almost unchanged level of income for the population, despite the sharp fall in production.

As in other countries, in the extraordinary conditions of the global crisis, the existing fiscal rules were put on hold. This "natural experiment" demonstrated the importance of placing limits on adopting more spending obligations—without strict checks, the government sharply increased such obligations. Unfortunately, the growing spending was not always focused on overcoming the crisis. Thus, a significant number of the expenditures were not one-off outlays (as an anti-crisis program would suggest), but long-term commitments. For example, the expenses of the pension system grew by more than 3 percent of GDP.

In the years since the crisis, income grew in parallel with the reduction of expenditures and, as a result, in 2011 the budget again returned to the black.

### Future Budgeting Priorities

The fiscal policy of the upcoming next few years will largely be determined by the conditions in which the Russian economy develops. First, one cannot overlook the possibility of a new international financial crisis. There is a significant possibility that Greece will leave the Eurozone within the next year, which would have a serious impact on the European and world economies, as well as on the international financial system.

The next factor which must be taken into account is the long-term reduction, starting in 2013, in state revenues as a percent of GDP. This reduction results from the fact that the physical output of oil in Russia is reaching a plateau, and, as the government projects, will remain at its current level for the foreseeable future. In previous years, this decline was balanced by a rapid rise in the price of oil. However, as soon as the price drops or stabilizes (as budget forecasts expect), the overall share of the oil sector in the economy (which continues to grow) will begin to shrink. This contraction will automatically lead to a reduction in budget revenues, since the tax burden in the oil sector is 2.5 times higher than in the rest of the economy. Since hydrocarbon revenues are concentrated in the federal budget, it will suffer the main losses. The income of the federal government will fall from 21 percent of GDP to less than 19 percent of GDP in 2014–2015. Finally, over the next three years, there will be a continuation in the growth of expenditures for defense as part of the government's large-scale rearmament program. Another driver of increased expenditures is connected to promised higher salaries for doctors, teachers and other public sector workers. President Vladimir Putin signed decrees mandating such raises after his inauguration in May this year. Regional and local budgets will finance most of these new outlays.

In a situation in which revenues are dropping and the state faces additional expenses, the government can either raise taxes or increase the budget deficit. However,

both options harm economic growth since they both deprive economy of resources for growth and reduce stimuli for investment in the private sector. In this light, a decision was made to reject both of these “easy” options. In the president’s budget address, he promised not to raise taxes on the non-raw material sector of the economy before 2018. This pledge provides transparency and predictability in the state’s tax policy, increases the competitiveness of the tax system, and improves the investment climate in general. The second principled decision was that beginning in 2013, fiscal rules will be restored (in a modified version as compared to the pre-crisis period); in other words, we will return to strict budget discipline. Budget expenditures will no longer be based on the anticipated price of oil, but on the average price for several past years. This approach significantly reduces the dependence of the budget and the entire economy on the fluctuations in the oil market, since expenditures will not depend on the current oil price. Saving money in the Reserve Fund during period of high energy prices will guarantee the budget’s integrity at times when oil prices fall.

Enforcing budget discipline and simultaneously carrying out promises already made is not a simple task. The upcoming two years will be particularly difficult as expenditures will stay at the same real level and increase only at the rate of inflation. These years will be transitional, and then, beginning in 2015, we will carry out the budget rules in full measure. At that point, we will return to a balanced federal budget. Overall between 2013 and 2015, federal budget expenditures will drop by more than 2 percent of GDP.

### Criticism from All Sides

Critics of all persuasions complain about recent budget decisions. Some economists argue that budget consolidation measures planned for upcoming years will undermine economic growth. This supposition would be correct if the volume of production in the Russian economy was much less than its potential level. However, our economy now is growing close to the level of its potential growth—we have practically full use of competitive capacities combined with low and dropping unemployment. Therefore, at present, the main task is not to support demand through additional budget expenditures, as in the majority of developed countries, but to enhance investment (primarily private investment). But, now Russia is experiencing an outflow of capital—financial resources which could go to investments are leaving the country—and it is necessary to end this process. Otherwise we will not secure even the current pace of growth in the economy. To resolve this problem, a prudent macroeconomic policy is the top priority.

The other criticism is that saving hydrocarbon income in the Reserve Fund deprives the economy of resources for development. However, no one denies the need to have a “rainy day fund” in case of negative external shocks. The government outlined a compromise course: rents from the hydrocarbon sector will be directed to the Reserve Fund as long as the money there does not reach 7 percent of GDP. Beyond that level, natural rents may be used to finance infrastructure projects.

With hard budget constraints in place, the general approach should be to spend budget funds more effectively. There are significant reserves for doing this. For example, there is so much waste in state purchases that experts estimate that Russia loses up to one trillion rubles a year. Now the government is considering plans to overhaul the system of public procurement. In comparison with other countries, Russia is much less efficient in building roads and other state investments. To address all such issues, the government adopted a program to increase the efficiency of its expenditures by providing new incentives for those who receive funds from the budget. One of the main points is the transition to a “program budget,” which provides a framework so that any expenditure will be linked to the result which should be achieved as a result of the expenditure. This will create serious stimulants to increase efficiency in public sectors and among individual recipients of budgetary funds.

Additionally, regional budgets will have to end their current practice of inefficient expenditures. The difference from the federal budget is that the need to improve efficiency comes for the latter from the reduction of revenues while regional budgets face higher labor costs in the spheres of education and healthcare. The regions will have to improve efficiency and tap internal reserves by cutting low priority expenditures. But this task will take more than one year. It is necessary to change the mechanisms for financing sectors and specific organizations and create incentives so that the high pay matches the level of qualifications of the specialists and their work.

It is necessary to guarantee that the increased pay in the public sector is matched by increased worker productivity. Now, in terms of the number of people employed in the public sector per thousand in the population, Russia surpasses both developed countries and emerging markets. At the same time, the size of the labor supply will shrink beginning in the new year by about 300,000 to 400,000 people per year. So that the shortage of workers does not become a factor holding up the development of the economy, it is possible to use such reserves as reducing loss-making employment in the public sphere.

### Fixing State Expenditures

While budget policy is on the right path from the point

of view of general strategy, the structure of state expenditures is deteriorating. During the pre-crisis period, the most quickly growing category of expenditure was directed toward development of the economy (including investment in infrastructure) and the expansion of human capital (education, health-care). During the crisis itself, the top priority was social expenditures, especially pensions. Now, the leaders are military expenditures and police and security outlays. Such shifts are not justified for two reasons. First, by increasing pensions to 9 percent of GDP and expenditures on defense and security to 6 percent of GDP, we have significantly exceeded what is characteristic for countries of the OECD (which Russia is planning to join), where 7.5 percent of GDP is typical for pensions and 3.5 percent is usual for defense and security. Additionally, Russian expenditures on health-care—3.5 percent of GDP—are significantly less than the OECD average of 5.8 percent. Second, according to cross-national research, “productive” state expenditures focus on developing physical and human capital, which facilitates the long-term growth of the economy, while other types of expenditures do not affect development.

A key problem of budget policy is the fate of the social safety net system. In 2002 Russia adopted reforms that created a contemporary pension system with three principle components: basic pensions were designed to provide a minimum social guarantee to pensioners; insurance pensions, which were built on the notional accounts principle (similar to the Swedish model), and a funded pillar. However, recent steps have pushed the pension system from its original design. The decision to reduce the level of pension contributions in 2005 and the increase in the size of the pensions in 2009–2010 led to a result under which more than half of pensions are now financed from general budget funds rather than pension contributions. In 2010, the government cancelled the basic pensions, and now the government is discussing the proposal of the Ministry of Labor and Social Development to significantly redistribute income from the funded pillar to the pay-as-you go pillar. This is necessary, in part, because the state agency (that is managing a bulk of pension funds), until recently, did not succeed in earning positive real returns, and partly due to the need to carry out a fiscal consolidation. Anyway, the draft of the new reform does not include proposals

making it possible to define a new strategy to address the looming demographic reality that the old-age dependency ratio is rapidly going up. Russia is not unique in facing this problem, which is also looming for Europe and other developed countries. This means that we must return to the issue of pension reform and sooner or later adopt unpopular, but necessary, changes: increasing the pension age, lengthening the minimum term a person must work before gaining access to a pension, limiting the receipt of pensions by people who continue to work, using smaller pensions in payment indexation, etc. By all these parameters, the Russian pension system is one of the most “generous.” Women can receive a pension at age 55, while men can start at age 60, as long as they have worked for 5 years. Additionally, almost one third of workers, for one reason or another, have the right to receive their pensions at an earlier age. There are no limits on people currently working also receiving a pension, with about a third of pension-aged people working.

Of course, it is easy to understand why the authorities do not want to take responsibility for unpopular measures. However, of the 15 former Soviet republics, 12 have already increased their pension age, with Belarus, Russia, and Uzbekistan being the only exceptions. The average pension age in post-Soviet countries is 58 for women and 62 for men. This year Ukraine has gradually begun to increase the pension age for women. That experience just provides further evidence of the natural and inevitable character of such policies and efforts to reject them will only make the future increases in the pension age more difficult from the economic and political points of view.

### Conclusion

Overall, it is clear that the decision to restore implementation of fiscal rules was an important step in returning to a prudent budget policy. The key step now is to compensate for the consequences of the deterioration in the structure of state expenditures by increasing their effectiveness. This is not a simple task, but one that is, in principle, possible to implement as long as it becomes a priority for the government, which it should. In parallel, it is necessary to make economic policy more consistent, removing those elements that contradict announced general principles prioritizing long-term budget stability.

#### *About the Author*

Evsei Gurvich is the head of the Economic Expert Group.

## Russia's Pension System: Back to the Future

By Peter Rutland, Middletown, CT

### Abstract

Russia's 2002 pension reform is not working and the system requires ever larger bailouts from the state budget. So far attempts to fix the problem are flagging because Russia's leaders are reluctant to adopt unpopular decisions.

### A Failing System

For the past several years, the Russian government has been arguing over what to do with the pension system. A major overhaul was launched in 2002. In addition to contributions for a minimum state pension (the first pillar), it introduced mandatory contributions to a private pension fund (the second pillar) and allowed for additional voluntary private contributions (the third pillar). As of 2012 the State Pension Fund levies a 22% charge on payroll, of which 16% goes to current retirees and 6% to private savings accounts.

The reform is now generally considered a failure, and the deficit in the pension fund is requiring ever-larger bailouts from the state budget.

On August 31, 2012, the Ministry of Labor and Social Protection published a new pension reform plan, the "Draft Strategy for the Development of a Pension System in Russia until 2030." The government came up with a draft "Strategy for Pension Reform," which it presented to President Vladimir Putin on October 1<sup>st</sup>. The plan marks the abandonment of key elements of the 2002 reform and, if implemented, would effectively mean a return to a state-run pay-as-you-go (PAYG) system for the majority of workers.

The plan promises that the state pension will be kept at two and a half times the subsistence minimum (approximately 20% of the average wage, depending on the region) and at a level equal to 40% of the average salary for those with a 35-year work record, commitments that are in line with International Labor Organization recommendations.

### The International Origins of the 2002 Reform

In the 1990s, the World Bank and International Monetary Fund began encouraging countries to restructure their pension systems. As part of the neoliberal agenda of rolling back the state, it was considered important to have individuals save for their own retirement, with funds invested in financial markets, rather than have worker contributions cover the benefits of current pensioners (the PAYG system). This would ease the burden on state budgets—a growing problem because of the aging population in all developed countries. It would

also encourage saving; provide a pool of capital for private investment; and decrease state influence over economic decision-making. Chile, which switched to a fully market-funded system in 1981, was held up as the model for a successful pension reform.

Any country shifting from PAYG to a funded system faces an actuarial challenge: existing pensioners must be paid out of current contributions and at the same time those contributions must be increased to create funds for the future. This means that the country will be paying a double pension bill for the transition period, which may stretch into decades. It is not clear that the Russian government grasped the magnitude of this challenge when it launched the reform a decade ago.

Experience in Latin America and elsewhere shows that the problems do not end there.<sup>1</sup> In transition economies capital markets may not be deep enough to absorb the flood of new savings and provide them with a reliable rate of return. Economic downturns can cause pension funds to lose value—as many reform countries experienced in 2008. Finally, the administrative costs of the private funds are often much higher than a single state system. These kinds of difficulties led seven of the 13 former socialist countries that had privatized their pension systems to partially or completely renationalize them by 2012.<sup>2</sup>

### The Russian Experience

The system Russia inherited from the Soviet Union was characterized by a high level of state financing, a low level of actual pension benefits, much inequality, and a disconnect between pension and work record. The Soviet Union had a pension age of 55 for women and 60 years for men, after 20 or 25 years' service respectively. It set a replacement rate of 55% of the average wage, plus 1% for each year above 20/25. This "pension socialism" lived on after the Soviet collapse, but in the 1990s the state budget did not have the funds to maintain the real

1 Carmelo Mesa-Lago, *Reassembling Social Security: A Survey of Pensions and Health Care Reforms in Latin America* (New York: Oxford University Press, 2008).

2 Sarah Sokhey, "The politics of pension reform," Association for Slavic, Eurasian and East European Studies annual convention, New Orleans, 16 November 2012.

value of the pension. Part of the problem was the high level of informal employment, with many workers paid off the books in order to avoid paying taxes. By 2000 the base pension for Russia's 38 million pensioners had fallen to 33% of the average wage.<sup>3</sup>

The average age at which Russians become eligible for the pension is 53 for women and 56 for men—very low by international standards. Only 39% of Russian men aged 60–64 were employed in Russia in 2008, compared to 59% in the US. Despite efforts to increase the real pension, wages were rising faster in the 2000s, so the replacement rate—the pension as a proportion of the average wage—was 35.7% as of 2010, which is in line with international levels.<sup>4</sup>

In Russia, the IMF estimates that “the ratio of the population 65 and older to the working age population is projected to nearly double from around 18% to 36% between 2010 and 2050.”<sup>5</sup> This would pose a massive burden on current workers, and would inevitably lead to cuts in the pension level. So the theory was that the reform should be introduced as soon as possible—before the surge in the pension-age population kicks in. Economic policy-making in the first Putin Administration was in the hands of liberals, such as Economics Minister German Gref and Finance Minister Aleksei Kudrin. Apart from the pension reform, they also introduced more market-friendly labor legislation and a 13% flat income tax.

The 2002 reform aimed to get the state out of paying pensions for the current generation of workers while guaranteeing the benefits for current pensioners. All workers born after 1967 would be subject to a 20% payroll tax (later raised to 22%), of which 14% would go to the state Pension Fund and 6% to a personal account in a private fund. However, workers distrusted the new private funds: anywhere from 70–85% took the default option and sent their contributions to the state-owned Vneshekonombank. But if all the money from private savings is being invested in government securities, then that defeats the fundamental market rationale of the reform.

Total spending on pensions jumped from 5.5% of GDP in 2008 to 8.9% in 2010—a result of a deliberate policy to shield pensioners from the effects of the economic crisis. However, this spending spike led to a deficit in the Pension Fund estimated at 1.3 trillion rubles

(\$40 billion), equal to 2.2% of GDP.<sup>6</sup> This had to be covered by subsidies from the federal budget, with pensions now accounting for 23% of federal spending. This led to dire warnings of a budgetary crisis from Kudrin. Projecting out to 2050, pension spending could rise to 16% of GDP.

While other European countries have been raising retirement ages to 65 and above, this has remained anathema for Russian leaders. Putin specifically ruled out any increase during his presidential election campaign. Back in 2005, a move to shrink and monetize in-kind social benefits had triggered protests by pensioners in dozens of cities, something that the Kremlin is anxious to avoid.

The government presented its draft “Strategy for Pension Reform” to President Putin on October 1.<sup>7</sup> The document included some controversial changes in eligibility requirements in the “pension formula,” such as tying the pension to the work record and lengthening the minimum work requirement for the maximum pension to 40 years. In a meeting with Deputy Prime Minister Olga Golodets, Putin advised her to cut that requirement to 35 years, but even that may be too unpopular to survive into the final draft, which should be released in December.<sup>8</sup> An earlier version of the draft was critically received by experts, who condemned it as a patchwork of budget-saving measures that lacked a long-term vision.<sup>9</sup>

### What Comes Next?

The release of the Labor Ministry draft in August and the government's strategic plan in October was accompanied by an open and bitter debate amongst government officials over what parts of the 2002 reform can be salvaged, and who is to blame for the current mess.

Finance minister Anton Siluanov and Economics Development minister Andrey Belousov defend the importance of preserving the 6% private savings requirement as key to the long-run viability of the pension system; while Prime Minister Dmitrii Medvedev and Golodets favor cutting it to 2% and returning to a more PAYG system.<sup>10</sup> The cut from 6% to 2% would shift about 30

3 Marek Gora et al, “Pension reform options for Russia and Ukraine,” CASE Center (Warsaw) Report no 91, 2010. <http://econpapers.repec.org/paper/secnrepo/0091.htm>

4 Frank Eich et al, “Reforming the public pension system in the Russian Federation,” IMF WP 12/201, August 2012.

5 Eich, *ibid.*, p. 9.

6 Scott Rose, “Russia funds band together,” Bloomberg, 25 October 2012.

7 “Strategiya dolgosrochnogo razvitiya pensionnoi sistemy Rossiiskoi Federatsii,” 29 September 2012. <http://www.rosmintrud.ru/docs/mintrud/projects/44/>

8 “Rabochaya vstrecha s Zamestitelem Predsedatelya Pravitel'stva Ol'ga Golodets,” 16 October 2012. <http://kremlin.ru/news/16662>.

9 “Strategiya zatykaniya dyr i lataniya trishkinogo kaftana,” Moskovskii komsomolets, 27 October 2012. <http://www.mk.ru/economics/article/2012/10/25/766204-ctrategiya-zatykaniya-dyir-i-lataniya-trishkinogo-kaftana.html>

10 Igor Naumov. “Dmitrii Medvedev zadumalsya o pensii,” Neza-visimaya gazeta, 6 November 2012.

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 3<sup>rd</sup> 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.<sup>11</sup> 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.<sup>12</sup>

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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<sup>1</sup>

## 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.<sup>2</sup> The state in such societies does not have a monop-

oly 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

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.

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:

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).<sup>3</sup> 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 stripping, 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 particular, 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 busi-

ness. 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 respond 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 120<sup>th</sup> to 20<sup>th</sup> 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.

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## ABOUT THE RUSSIAN ANALYTICAL DIGEST

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