

**Caroline Dufy**

c.dufy@sciencespobordeaux.fr

Lecturer, Sciences Po Bordeaux

**Why is Russia's Development Model uneffective ?  
The Rent Seeking Hypothesis versus Bureaucratic Capitalism**

President Dmitri Medvedev announced in October 2009 the end of the crisis in Russia and the economic recovery. Before the financial crisis, Russia had been able to reimburse ahead its debt to the Paris club of creditors. It was one of the four emerging countries that would have been able to challenge the leadership of western developed countries by 2020. Some Russian companies had become among the first leaders worldwide. In June 2008, Gazprom reached the third place in terms of capitalization on the stock exchange. The collapse of the Russian economy has surprised many observers. Its damages have been unexpectedly high and the shock has been severe for the Russian economy. The GDP is expected to fall to - 7,5% in 2009 from 5,6% in 2008 and 8% before the crisis in 2007 (World Bank and IMF data, 2009). During the first half of 2009, data showed a decrease of 10% per month. This crisis stops a ten year trend of continuous and significant growth – an average of 6% per year from 2000 to 2008.

Emerging economies were not spared by the crisis. Nevertheless, Russia differs by the depth of the recession in 2009. The average growth for the BRICS is 7,4% in 2008 and 3,4% in 2009 (Crédit Agricole, June 2009). But the comparison with Brazil is maybe more relevant. In 2008, Brazil and Russia had a similar growth rate (5,6% for Russia and 5,1% for Brazil). In 2009, Russia's growth decreased to - 6;8%, whereas Brazil's growth only to -1,5%.

Therefore the main issue we want to address here is why this crisis has been so severe in Russia. In my paper, I will firstly show how the financial crisis deeply challenges Russia's growth model. Russia's dependency on world trade seems to validate rent seeking and Dutch

disease analysis. As a result, the Russian economy is still an emerging country, in which growth is unstable.

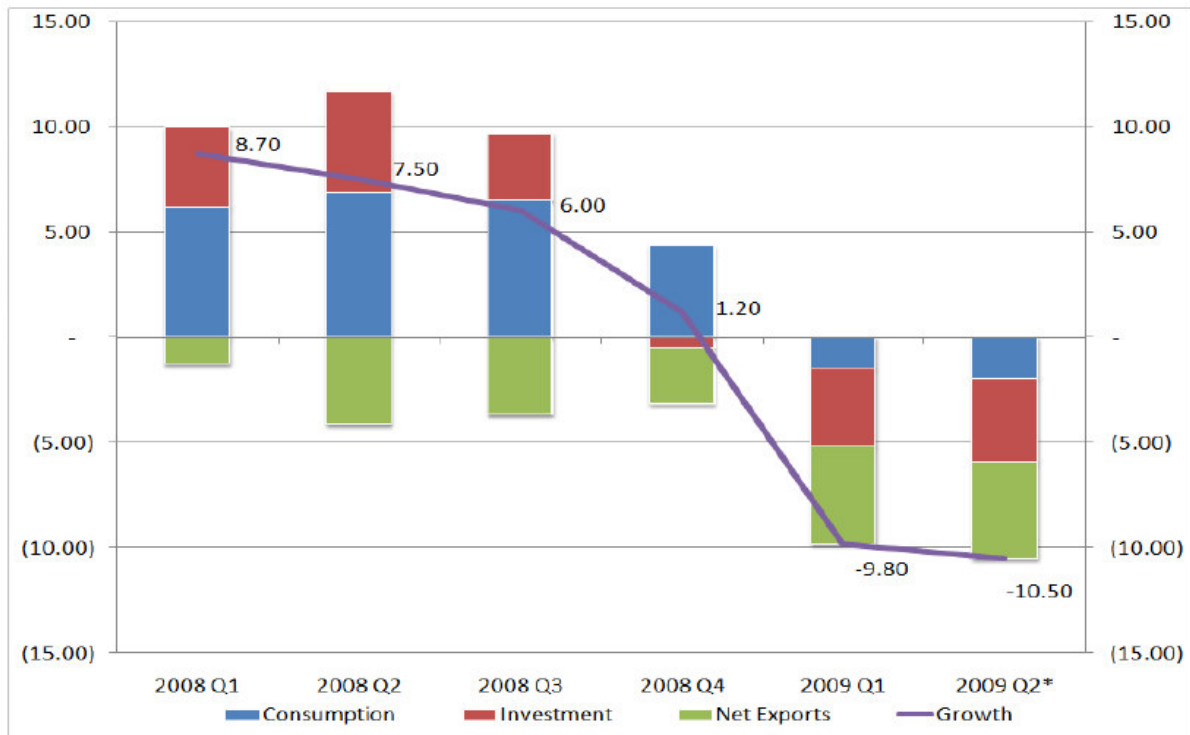
The second section examines the structural imbalances in the Russian economy: social vulnerability and important territorial inequalities are consistent with the rent seeking analysis.

However, this model has a lot of shortcomings. From a theoretical point of view, it doesn't take policy making in consideration. Besides, in fact, the Putin and Medvedev administrations have launched industrial programs, and have engaged in important investments to support research; policies that can be described as an authoritarian development strategy. Besides, there has been a huge concentration process in many sectors in order to facilitate economies of scale and diffusion of innovation. The industrial structure is significantly changing, but for now, with no result. Therefore the third part of my paper will discuss some hypotheses about that lock-in phenomenon. The consolidation of a bureaucratic form of capitalism is characteristic of Putin's mandates. Although, it can be highly effective in China for exemple, in Russia its inability to provide incentives for innovation is a key barrier toward sustainable growth. This communication is still a work in progress and takes place in a global research project devoted to industrial change in Russia.

### **The Financial Crisis in Russia: From Heaven to Hell**

The financial crisis began to affect Russia during fall 2008 but it hit it especially during the winter. Within a few weeks, the GDP fell from 6% to 1,20% as we see below.

### **Graph 1 : Growth and it components in Russia**



World Bank, *Russian Economic Report*, n°19, june 2009.

The issue here to address is why the collapse has been so fast and so deep. Dutch disease is a relevant analysis interconnecting high dependance on trade, overheating of final consumption low level of investments out of the energy sector and real appreciation of the ruble. Each one of these three factors have contributed to deepen the crisis.

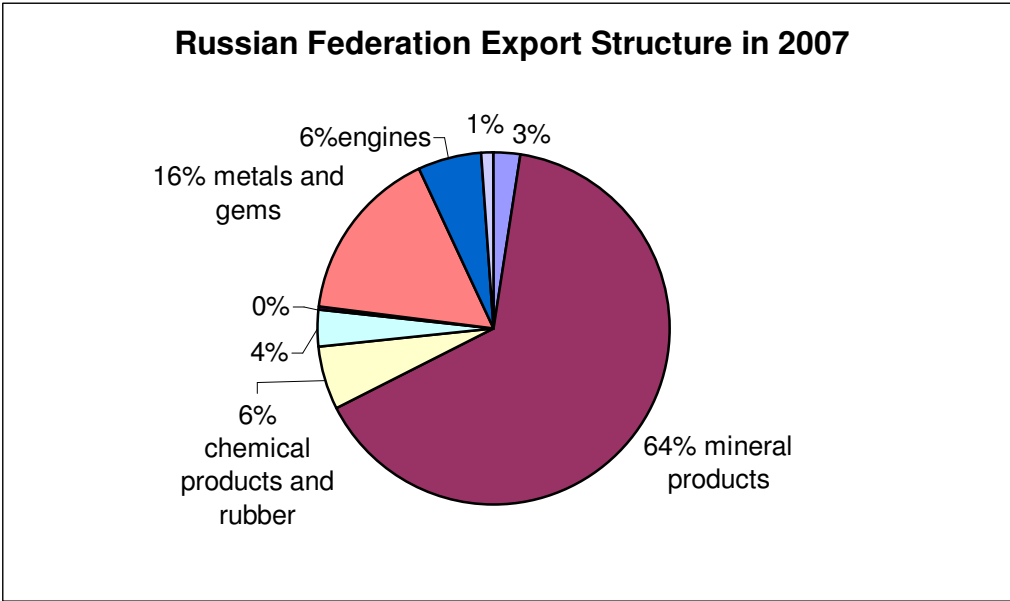
Trade structure shows the overwhelming importance of energy and reveals the neocolonial character of russian foreign trade.

### **A Neocolonial Trade**

The rent seeking economy is the model of Russian integration in the international division of activities. It promotes extensive growth.

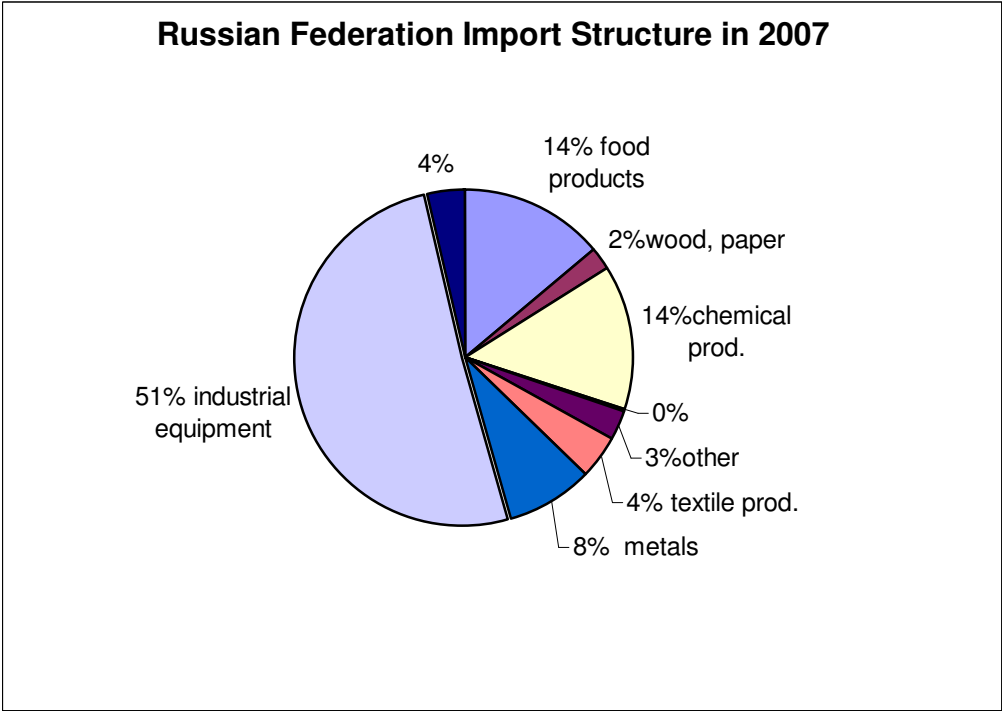
Two thirds of exports are represented by oil and gas incomes, whereas imports are half composed of goods (machines, engines and transport infrastructure). The share of mineral products in foreign trade continues to rise at the beginning of the 21<sup>st</sup> century: it represents only 42% in 1995 (OCDE, 2006). But one must precise that this growing share until 2008 reflects only the rising prices. The decreasing oil and gas production in volume is caused by insuffisant investments in exploration. Besides, the important exports incomes have caused the real appreciation of the ruble (see graph 4).

**Graph 2 : Russian Export Structure in 2007 (at current prices)**



Source : Rosstat.

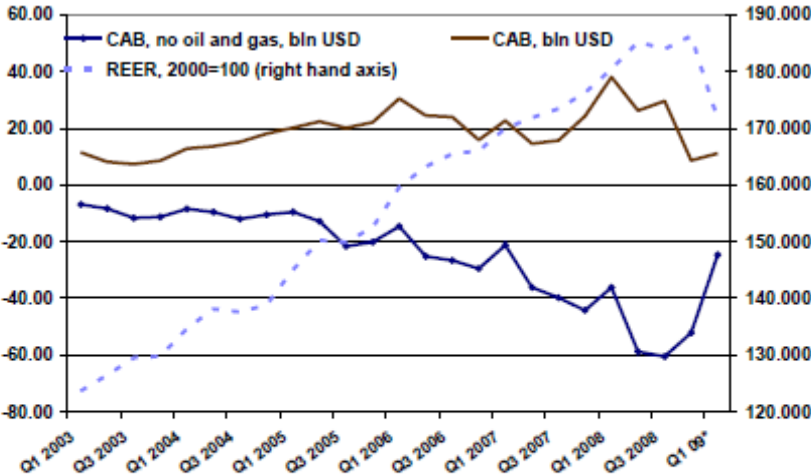
**Graph 3 : Russian Federation Import Structure ( at current prices)**



Source : Rosstat, 2009.

The collapse of oil prices from 140 dollars a barrel in August 2008 to 40 dollars a few weeks later only increases the deficit of foreign trade.

**Graph 4 Real current balances and the real effective exchange rate**



Source: World Bank staff calculations based on Rosstat and CBR data.  
 Note: Real effective exchange rates for 2009 Q1 include only January-February

World Bank, *Russian Economic Report*, n°19, June 2009.

The Real effective exchange rate grows continuously as graph 4 shows and represents a barrier to competitiveness in the manufacturing sector. Wood industry, paper, leather and textile industries are declining.

As graph 1 shows, foreign trade contribution to growth is negative before the crisis. Final consumption is the main factor of growth from 2004. Therefore, I would like to stress the particular importance of the contribution of the consumption to the crisis.

**The Domestic demand: an unsustainable growth**

Graph 1 shows that investment then consumption are sharply decreasing during the winter 2008.

From 2004, household consumption became the main component of growth, before foreign trade, in 2005, its contribution to growth was 90%. But, wages grow faster than labor

productivity, warns Andréi Illarionov, a liberal economist, previous adviser to Vladimir Putin. The official inflation rate is above 10% from 2007. The developing credit market favors sectors such as services and the building sector. The former benefited of a 6% growth per year, the latter twice as much between 2003 and 2007.

The crisis reveals the overheating in spendings, provoking a serious downsize in income. The average monthly real disposable income decreased from 738 dollars in December 2008 to 478 in March 2009. Households have cut their overall spendings and the consumption of imported goods. Therefore, they reduced the foreign trade deficit affected by a double cut in oil trade: in volume and in value.

Investment is usually very volatile in case of growth contraction. Investment flows are affected by a credit crunch, due to the connexion of the Russian banking sector to the international financial system. Foreign investments are also significantly cut and dependant on the world economy. Net capital flows to the private sector fell from +82 billions of dollars in 2007 to -132 billions of dollars en 2008.

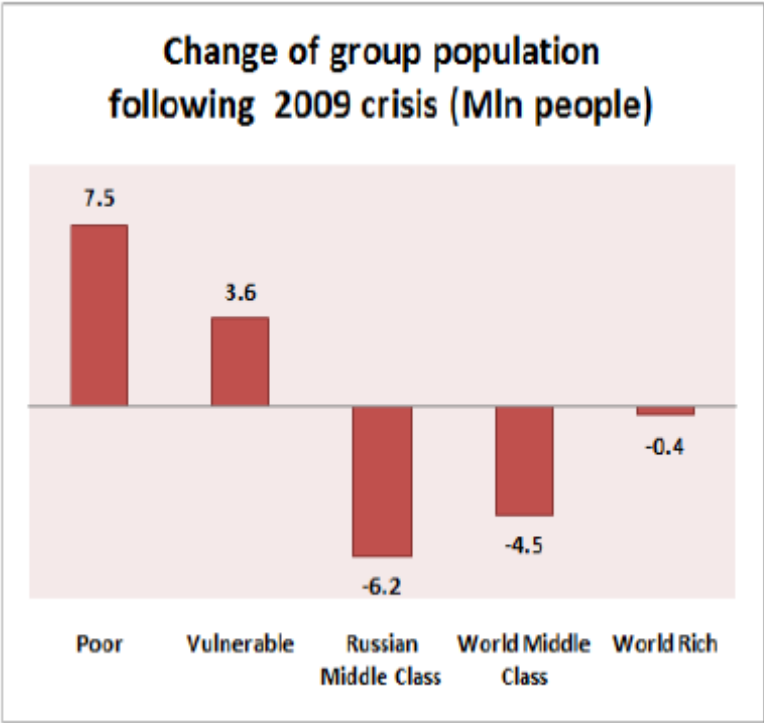
Russia suffers from Dutch disease symptoms (Oomes, Kalcheva, 2007). Social and financial instability are significant although the country has experienced almost 10 years of constant and rapid growth. Depressive trends are particularly acute throughout the social structure and the territorial composition of the Russian Federation.

### **Harsh Social and Territorial Effects: the Unstable Stability**

The Russian economy's structural imbalance is here twofold, social and territorial. This argument confirms the Dutch syndrome hypothesis. Besides, it is consistent with the sharp cut in final consumption and investments flows.

The sharp social effects of the crisis can be mesasured in terms of unemployment, income decrease but also in terms of declining social status. The unemployment rate is growing, from 7,8% in December 2008 to 10% in March 2009. The crisis concerns all groups but firstly poor people and middle class groups. According to the World Bank data, the poor group is growing by more than 7 million as we can see below, the vulnerable by more than 3 and the middle class by more than 10 million. Taken together, more than 20 millions of people – 15% of the global population- underwent a decline in their social status.

**Graph 5 Change of group population following 2009 crisis**



World Bank, *Russian Economic Report*, n°19, june 2009.

The territorial aspects of the crisis are becoming acute especially in mono-industry towns. The report published in October 2009 by the Ministry of Regional Development identifies 400 mono-industry cities in Russia. More than a quarter of the Russian population lives in these towns, they produce 40% of the industrial production of the Russian Federation. Among these cities, 20% participated in the wood proceeding industry, 18% in the machine building industry, 14% in the wood industry and 11% in the energy industry. The biggest among them, the city of Togliatti (700 000 inhabitants) hosts the giant Avtovaz employing more 100 000 workers. The plans to cut off more than 25% of the labor force provokes a tense social climate, acts of protest and strikes.

This regional feature of the Russian Federation is consistent with the depressive industrial trends noticed in many industries. For Andrei Illarionov, the industrial production collapse is upsetting and reveals internal inefficiencies. The production cut was 50% at the end of 2008 in such sectors as in metallurgy or construction materials. In monoindustry towns, the credit crunch is a major factor of the production crisis for businesses and plants, but also for households and farmers.

The Ministry of Regional Development addresses at last this problem in a federal plan targetting those cities: some of them face theoretically closure and resettlement.

The GDP collapse in Russia reflects the structural features of the Russian economy: the territorial imbalances and income inequalities have deepened the crisis. These features are inherited from the transition period. However, the Putin and Medvedev administrations have launched a development program, and many changes have affected the Russian industry. This orientation is consistent with the desire of Russian leaders to reinforce Russia's importance in the world economy. The highest ambitions have been expressed by Russian leaders, Vladimir Putin but also Dmitri Medvedev. The issue we stress in the next section is why this policy making had so little result ?

But the rent seeking hypothesis lies on rational behavior of economic agents therefore, it is neither able to apprehend the political dimension of change, nor the institutionnal settings of state and capitalism construction. Therefore a political approach is necessary to understand that lock-in. I argue here that the specific character of Russian capitalism and relationship between political elites and managers, that I call bureaucratic capitalism allows to understand the gap between achievements and goals.

### **The Failed Modernization of Russian Bureaucratic Capitalism**

The Russian Federation is far better off in 2009 than in 1998 after the krach on budget bonds. The federal budget has benefited from high excedents or almost 10 years. Taxes on oil revenu have been transfered to a stabilization fund, with more than 500 billions of dollars in 2007. The crisis program adopted in the winter of 2008 planned spendings of more than 5% of the GDP to reduce the depressive impact on economy and society.

Besides, the economic structure has underwent important structural change since 2006. Industrial policy is addressed by a programm targetting knowledge economy and innovation by 2020. Keys sectors have been identified: aviation industry, shipbuilding, energy, hydroelectricity and nuclear civil industry are traditional specializations inherited from the Soviet economy. Regional development must be promoted by the creation of free zones. Concentration has been strengthened in all sectors of the economy, especially in industry where public authorities have created conglomerates: Rosoboronexport in military industry but also in oil and gas with Gazprom and Rosneft. This process has allowed a significant increase of the federal state's influence in economy: his share was 35% in 2006 and only 20% three years earlier.

The state leading role is confirmed in this process: some economists talk about an authoritarian model of development, inspired by the Asian experience. After the 1998 krach, liberal anglo-saxon framework had been dismissed and deeply delegitimated. The purpose of these reforms is to create sustainable growth based on import substitution in heavy industry and in the military complex.

But the financial crisis has shown the reverse side of the Russian economy and the ineffectiveness of the reforms launched. In Russia, the Putin presidencies led to the strenghtening of bureaucratic capitalism over the oligarchic capitalism and state capture dominant during the Yeltsin era (Shevtsova, 2007). During the 1990’s, privatization had created a powerful business elite, able to support political leaders and thereby influencing public policy. In the 21 st century, the theory of weak state and state capture by oligarchs is denied by the facts. The Putin era has validated the bureaucratic capitalism analysis. The specific features of the bureaucratic capitalism are the important role of the state in economy, the existence of a numerous bureaucracy, an imperfect control of managers and shareholders on production and the ability of the state bureaucracy to dictate its goals to managers. The latter aims at productivity and profit, the former searches for continuity and power. The Yukos case had dismissed the oligarchic capitalism, the financial crisis has achieved the allegiance of oligarchs to the presidential administration. This “capitalism without capitalists” as Ivan Szelenyi has put it, is particularly difficult to reform (Eyal, Szelenyi, 1998). Indeed, the exertion of power over economic relationship is deeply influenced by a model of authoritarian power inherited from the Soviet Union. The search for power becomes its own goal, whereas in the western liberal tradition power is used in order to manage public affairs. Therefore the stable composition of the federal budget in favor of apparatus spendings is not surprising as shown in table 1: despite a decade of high and stable growth, military and administrative spendings dominate over social expenses (Oleinik eds., 2009).

Table 1 Structure of Public expenditures in selected countries in 2004 ( extract). (% in GDP).

	Health care	Education	Defence	Social Security (old-age, pensions)	Intesrest related to public debt
Russia	3,3	3,8	3,9	5,8	4,1

Brazil	3,4	4	1,4	9,8	11,4
China	2,0	n.a.	1,9	2,7	2,4
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Source : Gaman-Golutvina O., “The Changing Role of the State and State Bureaucracy in the Context o Public Administration Reforms: Russian and Foreign Experiences” Oleinik Anton Ed., *Reforming the State without Changing the Model of Power ? On Administrative Reform in Post-Socialist Countries*, Routledge, London and New York, 2009, pp38-54.

It can be argued that this model, similar to that experienced in China, is much more effective there. In Russia, bureaucratic capitalism is unable to produce incentives for innovation.

### **Innovation, the missing point**

In Russia, investment represent 20% of GDP in 2007. This rate is low for an emerging economy. Its growing trend cannot compensate for the first half of the decade, when it reached only 17%. In comparison, China’s investment rate reached 40% at that period and 20% for the Euro Zone (OCDE, 2006). The share of commodities with a high technological content is 4%, in Russia, in China, this rate is 25%.

The Russian gap in innovation and research is tremendous. This backwardness could be the result of the transition period. The restoration of the destroyed research potential takes time: many scientific centers have survived in difficult conditions, researchers have emigrated or moved to other professions. However, there are structural factors to mention: the top-down managment makes the system very insensitive to innovation. These features are not far from what has been described by Janos Kornai for the Soviet economy as an economic system working under pressure from the top (the administration) instead of working under aspiration from the bottom (the market) (Kornai, 1980).

This hypothesis has still to be confirmed in the field. For now, I sustain my point by giving the example of the most emblematic company of the Russian civilian industry ; the firm Avtovaz already mentionned previoully. Avtovaz is heavily indebted. It cannot compete with foreign automobile companies despite a 30% import tariffs.

A sum of 25 billions of rubles was already provided in state support to Avtovaz. The Industry Ministry deputy Andrei Medvedev has expressed an opposition to further support from the state, arguing it is useless.

But Prime Minister Vladimir Putin has declared that bankrupcy is unacceptable for Avtovaz. He has threatened to reduce the 25% share of the French automobile compagny Renault in enlarging Avtovaz capital in case Renault wouldn’t support the Russian car producer. Renault

is requested to pay 17 billion of rubles (400 million of euros) on the 70 billion of rubles necessary for Avtovaz to avoid bankruptcy.

In conclusion, the 21<sup>st</sup> century has consolidated the political elite's power over economy. This authoritarian model of capitalism assumed by the Russian authorities, has led to little result and to the triumph of bureaucracy. But as we have shown in the first section, the Russian economy is more and more dependent on international trade. So the public announcements about delayed accession for Russia to the World Trade Organization may not necessarily correspond to Russia's interests in the international division of work. In this context, the financial crisis is an opportunity that liberal leaders should use to promote deep reforms and ensure diversification from rent seeking activities.

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