

**Theorising transformation: the role of international  
financial institutions in forming a new mode of social  
regulation in Russia**

Thesis submitted for the degree of  
Doctor of Philosophy  
At the University of Leicester

by

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September 2002

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## Abstract

### Theorising transformation: the role of international financial institutions in forming a new mode of social regulation in Russia

Alexandra Wynn

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International Financial Institutions and various national governments, via their respective bi-lateral donor programmes, have sought to assist in the transformation of the Russian economy since 1991. Initially, the main aim of development programmes was to try and nurture the emergence of a free market economy and democratic society. This thesis argues, however, that too little attention was paid to the necessary evolution of a new mode of social regulation (MSR) that would support an adherence to free market principles. There was an assumption that a new MSR, constituted by social practices/institutions, would emerge spontaneously in response to the changes in the way capital was accumulated. But, IFIs and other donors failed to recognise the *embeddedness of social practices* and the evolution of *hybrid* modes of social regulation.

Through an analysis of two case study regions, Leningrad and Sakhalin oblasts, and work at the federal level, the thesis demonstrates the importance of understanding the current and fragmented mode(s) of social regulation and processes of governance when trying to theorise about transformation in Russia, as well as in assessing the impact of IFIs and other donors. It is shown that IFIs and donors need to recognise the dominance of *disincentives to change* and processes of *exclusion*, which impede the (re)creation of so-called 'appropriate' institutions. Furthermore, it is possible to discern an intensification of the process of uneven development as individual regions find their own way with coping with the exigencies of transformation. Explanations for these processes do not just lie in the regions' relationships with federal government, or on the industrial legacies of the Soviet era, but also on individuals, social networks and practices and the different geographies of regional economic regulation.

## Acknowledgements

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It is with the help of the following people that I have been able to successfully complete my PhD and keep smiling:

I would first like to thank Professor Michael Bradshaw for his constant supervision, advice and good humour throughout my PhD experience. I am grateful for his willingness to impart his almost encyclopaedic knowledge concerning all things Russian, and for helping me to complete within three years. The Staff and Postgraduate community of the Geography Department, University of Leicester have also been a source of support and inspiration over the past two years. Reading groups, seminars, presentations and pub outings have all played their part.

I am grateful to the University of Leicester for funding my field research as well as two years of study and to the University of Birmingham for awarding me a Departmental Studentship for my first year. I would like to acknowledge the excellent start that I was offered by the Geography Department of the University of Birmingham, as I undertook my research training and my Russian language training. Nick Henry deserves particular mention for setting me on my way with my theoretical deliberations. I am indebted to the Russian department for helping me to acquire the basic language skills that stood me in excellent stead for my fieldwork.

I would like to thank so many people for all their help and advice throughout my trips to Russia and the US. It is impossible to thank them all individually so suffice it to say a massive thank you to the seventy or so people in Washington, London, Moscow, Leningrad oblast, St Petersburg, Sakhalin and Vladivostok who have spared the time for me to interview them. A few individuals deserve more personal thanks for making the whole experience more enjoyable. Jonathan made sure that my Washington trip was a huge success and gave me my first taste of a real Thanksgiving. Elena and Henke became great friends in Russia and provided a home from home for me as I enjoyed a nomadic existence. Katarina kept me sane. Tatiana, Anna, Inessa and Tatiana were kind enough to help me out with temporary lodgings.

A huge thank you needs to be extended to my friends who have always shown a keen interest in my work, spurred me on and provided me with many opportunities for laughter. My family, in particular my parents and my sister encouraged me in the first place to embark on this journey. Their emotional support has been unswerving and greatly appreciated throughout and I hope that they didn't lose too much sleep, thinking of earthquakes and the like while I have been off on my travels.

Finally, I owe a huge debt of gratitude to Majk who has helped more than he can imagine, giving me constant support, the benefit of his critical eye, proof-reading, fiddling with formatting and above all for giving me fantastic reasons to keep smiling and the impetus to finish!





Troika (2001)

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## **List of Abbreviations**

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<b>ABC</b>	<b>American Business Centre</b>
<b>ACDI</b>	<b>Agricultural Cooperative Development International</b>
<b>ASEAN</b>	<b>Association of Southeast Asian Nations</b>
<b>BISNIS</b>	<b>Business in the Newly Independent States</b>
<b>CAS</b>	<b>Country Assistance Strategy</b>
<b>CBR</b>	<b>Central Bank of Russia</b>
<b>CEFIR</b>	<b>Centre for Economic and Financial Research</b>
<b>CIS</b>	<b>Commonwealth of Independent States</b>
<b>COMECON</b>	<b>Council for Mutual Economic Cooperation</b>
<b>CPSU</b>	<b>Communist Party of the Soviet Union</b>
<b>DFID</b>	<b>Department for International Development (UK)</b>
<b>EBRD</b>	<b>European Bank for Reconstruction and Development</b>
<b>EFF</b>	<b>Extended Fund Facility</b>
<b>EU</b>	<b>European Union</b>
<b>EWI</b>	<b>East West Institute</b>
<b>FDI</b>	<b>Foreign Direct Investment</b>
<b>FIAS</b>	<b>Foreign Investment Advisory Service</b>
<b>FIDP</b>	<b>Financial Institutions Development Project</b>
<b>FSC</b>	<b>Federal Securities Council</b>
<b>FSU</b>	<b>Former Soviet Union</b>
<b>FY</b>	<b>Financial Year</b>
<b>GATT</b>	<b>General Agreement on Trade and Tariffs</b>
<b>GDP</b>	<b>Gross Domestic Product</b>
<b>GOSPLAN</b>	<b>State Planning Commission</b>



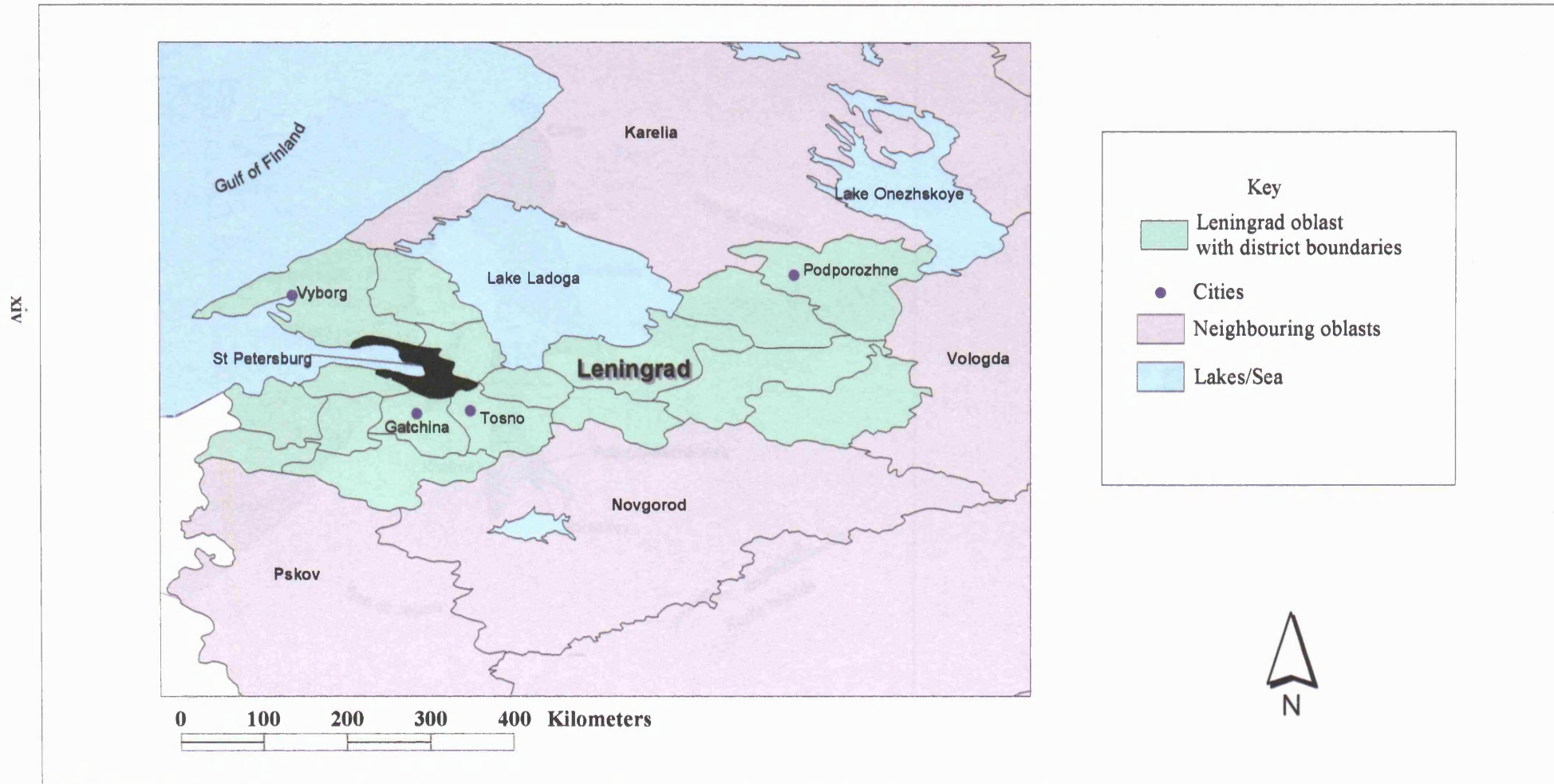
<b>GOSSNAB</b>	State Supply Organisation
<b>IBRD</b>	International Bank for Reconstruction and Development
<b>IDA</b>	International Development Agency
<b>IFC</b>	International Finance Corporation
<b>IFI</b>	International Financial Institution
<b>IMF</b>	International Monetary Fund
<b>LAFTA</b>	Latin American Free Trade Area
<b>MSR</b>	Mode of Social Regulation
<b>NAFTA</b>	North American Free Trade Agreement
<b>NEI</b>	Netherlands Economic Institute
<b>NGO</b>	Non Governmental Organisation
<b>NWA</b>	Northwest Association
<i>Oblast</i>	Regional administrative unit
<b>OECD</b>	Organisation for Economic Cooperation and Development
<b>OMRI</b>	Open Media Research Institute
<b>OPIC</b>	US Overseas Investment Corporation
<b>PCA</b>	Partnership Cooperation Agreement
<b>PSA</b>	Production Sharing Agreement
<b>RFE</b>	Russian Far East
<b>RRR</b>	Russian Regional Report
<b>SAL</b>	Structural Adjustment Loan
<b>SBA</b>	Stand By Arrangement
<b>SDA</b>	Sakhalin Development Agency
<b>SEIC</b>	Sakhalin Energy Investment Company Ltd.

<b>SIDA</b>	<b>Swedish International Development Agency</b>
<b>SME</b>	<b>Small Medium Sized Enterprise</b>
<b>SMNG</b>	<b>Sakhalinmorneftegaz</b>
<b>TACIS</b>	<b>Technical Assistance to the CIS</b>
<b>USAID</b>	<b>United States Agency for International Development</b>
<b>VAT</b>	<b>Value Added Tax</b>
<b>VOCA</b>	<b>Volunteers in Overseas Cooperative Assistance</b>
<b>WTO</b>	<b>World Trade Organisation</b>

**Map 1**  
**Fieldwork Locations in the Russian Federation**

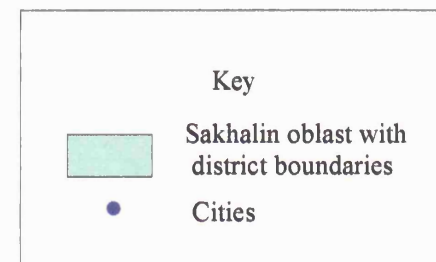
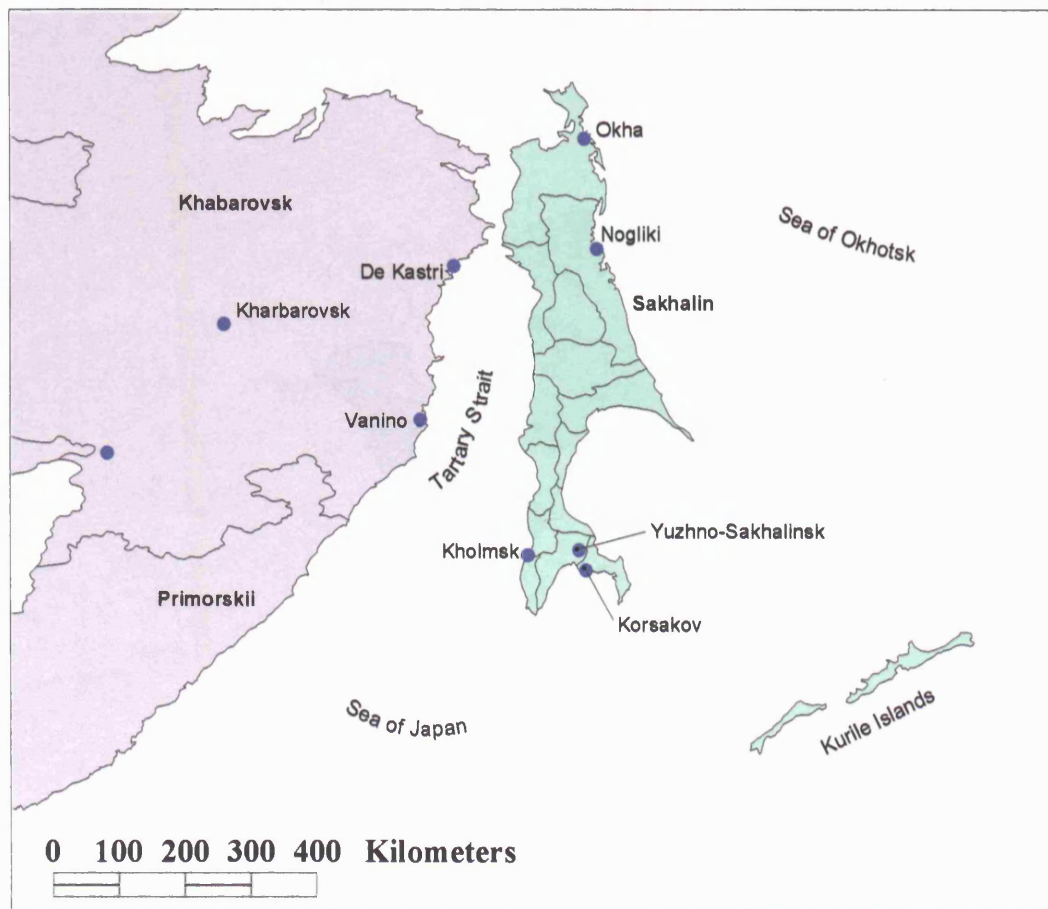


**Map 2**  
**Map of Leningrad oblast and surrounding area**



**Map 3**  
**Map of Sakhalin oblast and surrounding area**

AX

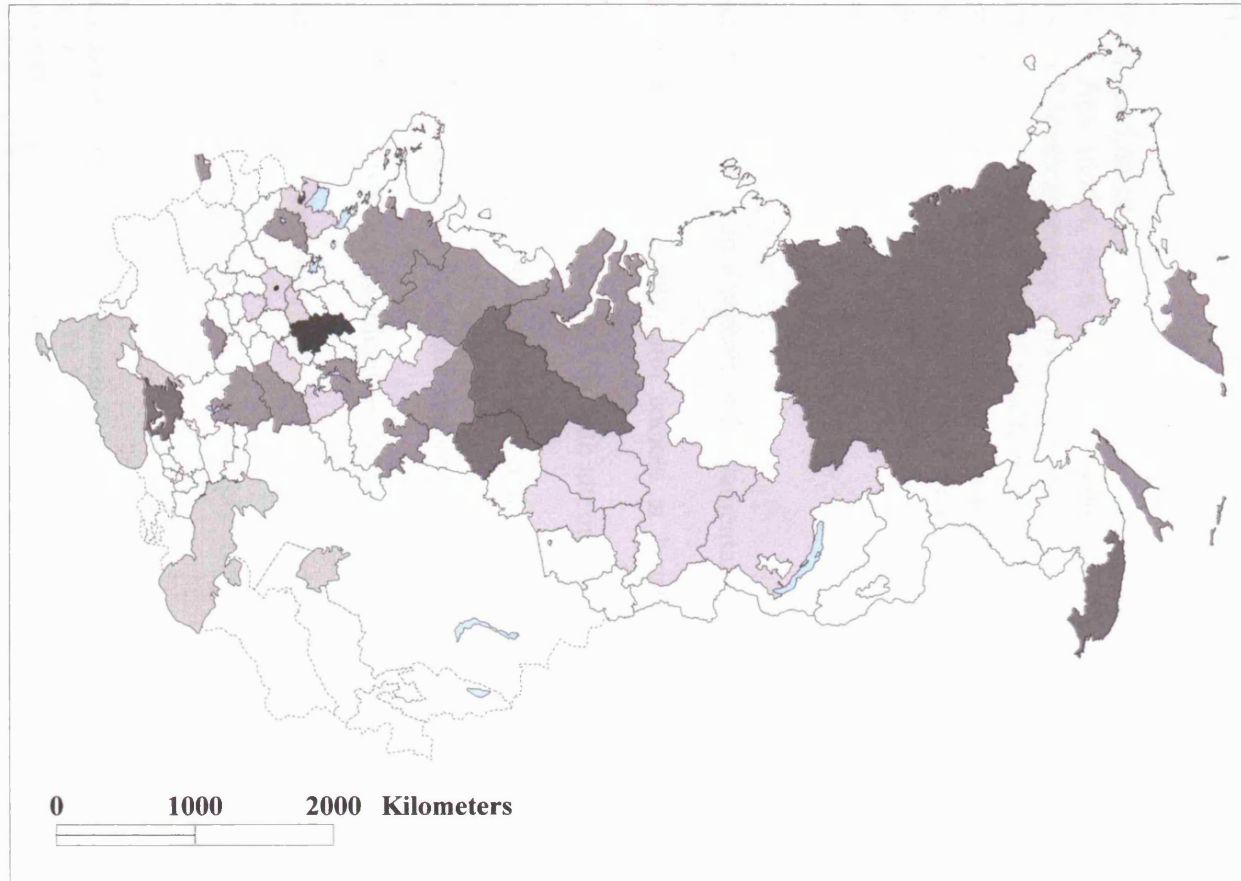


**Map 4**  
**The 7 Federal Districts of the Russian Federation**

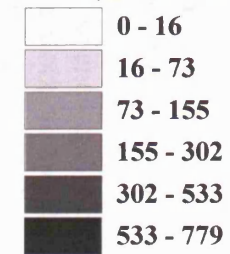




**Map 5**  
**Distrubution of EBRD Funding to the Russian Federation (1991-2001)**



**EBRD Funding by region**  
**(millions US\$)**



## Chapter 1

### Introduction

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‘A fundamental feature of the present-day world is the internationalization of the economy and society. And under these conditions the best world models become key criteria of success. Models in everything - in business, science and sports, in the rate of economic growth, the quality of the work of the state apparatus and competence of the decisions that we take. It is only when we will not just match the best models in the world, but when we will ourselves set these best models, it is only then that we will have a real chance to become wealthy and strong’ (Vladimir Putin, 2002<sup>1</sup>).

‘But please understand no country, no country, can repeat the reforms of another country. Any model, even a perfect model should take into account the face of development of a particular country, its possibilities, its economic possibilities and its social situation. Every country should conduct its own reforms, should develop its own model, taking into account the experience of other countries whether close neighbours or far away countries’ (Mikhail Gorbachev, 2002<sup>2</sup>).

### Introduction

Over the past decade there have been a myriad of fundamental systemic changes to the way in which the Russian economy, and society at large, functions and is regulated. Observers have concerned themselves with attempting to understand and analyse constantly changing and contested processes, and relationships, at a variety of scales from the global and federal, to the regional/local. The transformation process has been neither smooth nor predictable. In fact, Russia’s experience of managing transformation has demonstrated that the ‘models’ for transition, frequently advocated by Western advisors, are simply impossible to impose

---

<sup>1</sup> Excerpt from Annual Address by President of the Russian Federation Vladimir Putin to the Federal Assembly of the Russian Federation Moscow, April 18, 2002, available at: <http://www.russiaeurope.mid.ru/RussiaEurope/speech16.html>, last accessed 20.08.2002

<sup>2</sup> Excerpt from an interview with Mikhail Gorbachev conducted for the PBS television series ‘Commanding Heights: The Battle for the World Economy’. For a full transcript of the interview see: [http://www.pbs.org/wgbh/commandingheights/shared/minitextlo/int\\_mikhailgorbachev.html#1](http://www.pbs.org/wgbh/commandingheights/shared/minitextlo/int_mikhailgorbachev.html#1), last accessed 20.08.2002



effectively, given the increasingly hybrid nature of the Russian economy and the embeddedness of social practices and institutions.

International Financial Institutions (hereafter IFIs) and other international donors have sought to influence and fashion processes of change in Russia. Motivation for their involvement has been spurred by a desire to ensure global security. In order to fulfil this aim, IFIs and donors have been charged with the following tasks by the national governments that fund them: to integrate Russia in the global community, both economically and politically, to help stabilise the Russian economy, as it is transformed from a command to market economy, and to encourage the evolution of a democratic society. Between 1991 and 2000 assistance from the top five IFIs and donors amounted to over US \$35.8 billion<sup>3</sup>, considerably more than totals for sub-Saharan African states. One of the central aims of this thesis is to assess the impact that these IFIs and donors have had in mediating transformation processes, how they have gone about this, and how their efforts have affected processes of uneven development in Russia.

Considerable attention has been paid to international involvement in Russia at the federal level, but scant attention has been paid to the regional dynamics of assistance programmes. In fact, the latter is mainly uncharted territory. Yet, regional processes of change are critical to the integrity of the Russian Federation and in determining the path of large-scale economic and social transformations. Furthermore, the processes that intersect and impact on regions are not necessarily

---

<sup>3</sup> OECD (2002) statistics suggest that since 1998 Russia has received more net aid than the majority of recipient states, with the exception of China, though these statistics do not seem to include lending from the IMF. Russia has, however, consistently received more assistance than, for example, Poland. IMF lending statistics for the period 1991-2001 show that only Argentina has received more lending than Russia in this period (IMF, 2002).

homogenous through space, though they are often portrayed as such. In fact, given the legacy of spatial policy making during the Soviet period it is not surprising that processes can be spatially specific. These processes are founded upon specific sets of local institutions and social practices, which have evolved in response to: first, the exigencies of coping with the command system, and second processes of transformation, change and instability.

### **1.1. Contextualising international involvement in Russia's transformation**

By the beginning of 1991 the economic crisis in the Soviet Union had reached acute proportions and the official end of the Soviet Union in December 1991 was the culmination of the economic and political instability. Prior to that the first joint official reaction of western governments to the Soviet Union's requests for assistance with economic transformation came during July 1990 at the Houston Economic Summit of the Group Seven Countries (G-7). The G-7 countries commissioned a study of the current state of the Soviet economy in a bid to inform assistance efforts<sup>4</sup>. Detailed information concerning the state of play in the Soviet Union prior to this had, however, been available through Joint Economic Committee Reports<sup>5</sup>. All IFIs and donors seeking to be involved in Russia's transformation began providing assistance mainly in the form of loans or trade credits. In 1991 only a limited amount of technical assistance and financing came from the European Union (EU) and the European Bank for Reconstruction and

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<sup>4</sup> The 'Study of the Soviet Economy', known as the 'Joint Study', was compiled by the International Monetary Fund, European Bank for Reconstruction and Development, and the Organisation for Economic Cooperation and Development. It was published in three volumes in February 1991.

<sup>5</sup> Joint Economic Committee Reports were unclassified annual reports commissioned by the CIA and disseminated by or through the Joint Economic Committee of Congress. Details concerning the Soviet economy were first published in these reports from 1962.

Development (EBRD), the International Monetary Fund (IMF) and the World Bank.

It should be noted that the political context within which this assistance was granted was complex. The main political objective of policy leaders in the West was to try and promote stability in Russia. Instability was deemed highly dangerous, stability being a strategic necessity, not least in terms of control over Russia's nuclear arsenal. Leaders in Europe were also concerned that political and economic instability would lead to large-scale refugee flows. Such pressures, coupled with the opportunity to bring Russia into the neoliberal fold, created political pressure and the motivation for IFIs and donors to implement programmes to assist Russia as quickly as possible. Reformers, IFIs and donors had to react quickly to the somewhat spontaneous nature of some transformation processes, meaning that in many instances the imposition of models of 'best practice' was impossible from the outset.

## **1.2. Theorising transformation and the role of international institutions**

The involvement of IFIs and donors in trying to influence the process of transformation in Russia is a highly contentious issue. Any discussion of their work involves some discussion of the dominance of a neo-liberal agenda that informs their activities and networks of global regulation and governance. Processes of regulation and governance at all scales intersect, and can reinforce or challenge dominant global discourses of regulation and governance. In this thesis, I examine processes of regulation and governance in the Russian context, following the work of, for example, Grabher and Stark (1996), Hausner et al. (1995), Smith (1998) and

Smith and Pickles (1998), all of whom have looked at these theories in a post-socialist context. Russian reformers, IFIs and other donors have sought to introduce dominant global discourses of regulation and governance to Russia, but in doing so, have had to face resistance to change and the embeddedness of social practices and institutions at a variety of scales.

In order to examine the role of IFIs in 'institutionalising' new social practices I have opted to meld regulation and governance approaches, because they best fit the nature of what IFIs are trying to achieve; international actors are trying to manipulate and fashion the way that the Russian economy and society functions. A key aim has been to alter the way that capital is accumulated (the regime of accumulation) to a system more closely resembling an advanced capitalist economy, rather than a command economy. In turn, this is linked to the way that the economy is regulated (mode of social regulation) and the way that society functions. But, of course, Russia is no blank canvas, and Russian actors are the most influential in determining the nature of transformation and in accepting or resisting international involvement.

Unlike other transition countries, such as Poland and Hungary, Russia had no vestige of a democracy or a market economy, though economic relations with non-COMECON partners did expand during the 1970s through increased East-West trade. The Communist-era institutions that controlled the economy previously have been forced to adapt to different roles of oversight, mediation and regulation. Likewise, the social practices and institutions that were an integral part of Soviet life have also been transformed in Post-Soviet Russia. In attempting to influence

economic transformation in Russia, IFIs and other bi-lateral donors initially focussed on encouraging the emergence of a free market economy, but paid too little attention to the evolution of institutions and practices that would support free market processes. Using a regulation approach positively encourages a deeper analysis of the way that the economy is 'regulated', in its fullest sense, in terms of the social practices and institutions that define everyday life. These I argue are critical to understanding the hybridism of the Russian economy and help explain why IFIs, in many ways, have had a limited impact in Russia.

In assuming a regulation/governance approach the thesis also seeks to develop and extend the way in which regulation theories and governance theories can be used and applied. In linking area studies with geographical theories, as well as work of economists and transitologists, the product is the richer for doing so, though this presents some problems in terms of addressing multiple audiences. The dissemination of research requires some assumptions about the knowledge and interests of different audiences. I have tried to address an audience that is familiar with regulation and governance theories but which is perhaps less familiar with transformation processes, as well as audiences that are knowledgeable about transformation processes but who have not necessarily engaged with regulation or governance approaches, hence the structure of the thesis. This research contributes to work in both fields by relating work conducted in mainstream economic geography, which offers a diversity of interpretations of the evolution of economic and social processes, with those that focus on the FSU. Similarly, I have sought to draw attention to those who focus on geographies of the 'core', new interpretations

and processes that exist in the non-western world (for a further discussion of these issues see: Gibson-Graham and Ruccio, 2001; Potter, 2001; Smith, 2002).

### **1.3. Aims of the thesis**

In this introduction I have sought to introduce the background to, and motivation for, this thesis. There are two central aims of this thesis. The first is to highlight the importance of recognising the embeddedness of social practices and institutions when trying to theorise about, or in attempting to fashion, transformation processes in Russia. The second aim is to examine how processes of regulation and governance, mediated by IFIs, federal government and local government, are intersecting and affecting the uneven development of Russia's regions. In order to meet these aims I have set the following objectives:

- to identify the policy frameworks of IFIs which inform transformation efforts in Russia,
- to assess the impact and problems that IFIs and donors have had in mediating transformation processes in Russia,
- to identify 'obstacles' to change in the form of dominant social practices,
- to assess regional responses to international involvement in their transformation,
- and to see if IFI and donor activity could be actively contributing to increasing uneven development among Russia's regions

This thesis provides a predominantly qualitative analysis of the role IFIs and other donors play in mediating transformation processes. Datasets detailing regional IFI and donor assistance are not readily available either from Russian sources or from IFIs themselves. Data available at the time of writing was not sufficiently detailed to be able to break it down on a region-by-region basis. The fact that the IFIs, with the

exception of the EBRD, do not maintain such datasets is revealing in terms of their lack of a preoccupation with regional dynamics. Furthermore, qualitative techniques and analyses have provided new opportunities to examine trends and processes. I would argue that, more often than not, statistics used to demonstrate new trends and processes are not necessarily representative of reality in Russia because of the culture of misreporting. While useful in many instances, and more useful when triangulated with independently collected statistics, it would be unwise to rely on them for an accurate picture of the reality of everyday practices.

#### **1.4. The value of understanding ‘locally’ generated processes**

Developments in critical area studies are re-affirming the importance of examining trans-local processes and their relationship with, and role in fashioning, processes operating at different scales, such as the trans-national. Locales, which are understood as relational and contextual (see Appaduri, 1996) and generators of processes, therefore, become invaluable areas of study. Examining local processes offers the opportunity to go beyond seeing locales as merely products of global forces (see also Hayter, Barnes and Bradshaw, Forthcoming). Such a perspective is useful when thinking about the relationships within and between Russian regions and between the regions and federal (national) and global processes. It is demonstrated in this thesis, through the analysis of key processes intersecting in the case study regions of Leningrad and Sakhalin oblasts, that these relationships are not merely hierarchical but subject to constantly shifting scales of authority and control.

### ***1.4.1. Selecting the case study regions***

The regions that are the focus of this study (see Map 1) are by no means intended to be representative of all regions in Russia. No such average exists in the Russian Federation. While parallels have been drawn in some instances between Leningrad (Map 2) and Sakhalin (Map 3) oblasts, for the purposes of analysis and discussion of potential trends, a key aim has been to unravel the spatially specific responses to international involvement in Russia. Leningrad and Sakhalin oblasts were initially selected from the 89 federal subjects for four main reasons. First, both the regions have attracted considerable attention from international actors, both IFIs and bilateral donors, as well as foreign investors<sup>6</sup>, at least in comparison with other Russian regions. This fact alone has allowed me to look at the relationship between IFI and donor activity and their motivations to engage in transforming the business climate for existing and potential foreign investors from their member states.

Second, and related to the first point, Leningrad oblast is attempting, via FDI, to transform itself into a key region involved in processes of import substitution. For example, the Ford Motor Company has established operations in the region in order to supply the domestic market. In contrast, Sakhalin is focussed towards export-orientated activities, the long-term plan being to supply Asia-Pacific with oil and natural gas. Such a contrast is also useful for comparative purposes, in terms of responses to IFI and donor involvement in the two regions.

Third, the regions selected have enabled me to look at the different influences of European and Pacific/Asian actors in Leningrad and Sakhalin oblasts respectively.

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<sup>6</sup> Since 1997 both regions have been among the top ten regions attracting FDI in Russia.



Of course, Leningrad oblast is of greater interest to the European donors, for example, given its proximity to European borders. In the Russian Far East (RFE), US and Japanese donors show comparatively more interest in Sakhalin.

Fourth, given the different resource bases of the local economies and different political climates, the regions selected provide the opportunity for a useful comparison between a region that has sought to transform itself in order to attract foreign attention (Leningrad), and a region that has attracted foreign attention regardless of local processes of transformation because of its resource base (Sakhalin). In theory, this means that the regions could be differentially predisposed towards IFI and bi-lateral donor activity, which would affect the impact of projects.

### **1.5. Unpacking some key terms**

This section is aimed at unpacking some key terms that frequently appear in this thesis. In some cases, using descriptors or terms in preference to others is a direct consequence of the author's personal convictions. The following clarification and discussion of terms is by no means exhaustive. The issues flagged here in relation to the use of certain terms remain contentious. Further problems related to their use, and the dominance, in most instances, of ideologies that inform the use of particular terms are dealt with in more detail throughout the thesis.

#### ***1.5.1. Former Soviet Union***

The Russian Federation is often described as part of the 'post socialist' domain, suggesting that Russia was actually run as a socialist political economy and that socialism is now no more. Furthermore, to refer to Russia as being in the 'post-

socialist' world serves to reinforce a widely accepted dualism, especially in the context of the neo-liberal agenda, which suggests that there are only two alternative political economies – socialism and free market capitalism. I prefer to think of there being more than two possible or desirable systems. It is argued in this thesis that the Russian economy is predicated upon hybridism, path dependency and embeddedness (see Chapter 3). These are key factors determining the evolution of the Russian state. In short, the term 'former Soviet Union' is the least problematic alternative descriptor, as it only seeks to define the region in its geographical context and without alluding to different ideologies.

### ***1.5.2 Communism/ socialism/ post-socialist/ post-soviet***

In this thesis 'socialism' is most often found after the word 'state' to refer to the system of economic and political management that existed within the FSU. 'Socialism' and 'communism' are used interchangeably. However, 'Communism' and 'Communist', with capital letters are used to talk about the biggest political force in the FSU, the Communist Party of the Soviet Union (CPSU). 'Party' with a capital 'P' is the commonly used term for the Communist Party.

Descriptors such as 'post-socialist' and 'post-communist' are used to discuss processes occurring throughout the whole of the former state socialist bloc. These processes are evident in the FSU, East Central Europe and China. The term 'Post-Soviet' refers to experiences and processes occurring within the FSU. With these caveats in mind, which suggest that the terms 'post' and 'socialist' are problematic, it seems necessary to accept that there is a real problem in finding any alternative and less problematic descriptors to denote generic trends and processes. The terms

‘socialism’ and ‘post-socialist’ are therefore used freely in Chapter 2 as a means of comparing systemic changes from ‘Fordism’ to ‘post-fordism’, but I fully recognise that the latter term flags up similar issues with regard to the nature of change and the path dependency of it.

### ***1.5.3. Transition/transformation***

The term ‘transition’ is commonly used in reference to countries experiencing a shift from a system of state socialism to becoming a state with a free market economy and democratic society. The term ‘transition’ also implies a shift from one clearly defined point to another and has been largely favoured by IFIs and western observers throughout the 1990s. Use of the word ‘transformation’, instead of ‘transition’, is becoming more commonly used with respect to Russia as the word does not imply a shift to a certain, almost pre-determined point. This seems more appropriate for discussions concerning Russia, at least given the unprecedented evolution of ‘transition’ processes there. For a more detailed discussion of this issue see Chapter 3.

### ***1.5.4. Region/ Oblast***

The term region in this study is used in various forms. First, it is used to describe an administrative stratum in the Russian Federation, known as the *oblast* level. It can also be used to differentiate between the city and district administrations and that of the region/oblast. The bulk of case study work focuses on regional/oblast administrations, not those of the city or district because, as is common throughout Russia, the regional administration plays a pivotal role in defining the local modes

of social regulation<sup>7</sup>. Under the current system, individuals sitting on the Federation Council represent the interests of the regions in Moscow. Since 2000, Governors and regional legislatures must appoint their own representatives to the upper chamber of the federal legislature. The governor appoints his representative to the Federation Council by decree, while the regional legislature elects its representative (see Orttung, 2001).

The term region is also used to describe an entity that is not clearly delimited in geographical terms but that better represents ‘articulated moments in networks of social relations and understandings’ (Massey, 1994: 154).

## **1.6. Structure of thesis**

As previously explained, this thesis seeks to link several spheres of academic study. The first four chapters of the study focus on theoretical issues that constitute a major part of the thesis. Chapter 2 focuses on developing the theoretical framework and conceptual apparatus for this study. As theory and practice inform each other, attention is paid to the methodological character of regulation and governance approaches. Key ‘sites’ of ‘regulation’ to be examined are identified. It is demonstrated that institutions and social practices play a pivotal role in determining transformation processes through an analysis and comparison of Fordist, State Socialist, Post-Fordist and Post-Socialist systems. This naturally has implications for those seeking to instigate processes of change and helps provide an analytical framework for looking at the way that the Russian economy is being transformed.

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<sup>7</sup> For example, see Bradshaw and Hanson (2000) and their assessment of regional economic change in Russia and the importance attached to local elites as determinants of local transformation processes.

Chapter 3 goes on to explore the nature of transformation processes in Russia, which are of critical importance when examining the work of IFIs and other donors in Russia. Ideological debates concerning usage of the terms ‘transition’ and ‘transformation’ are tackled, and it is shown how the use of one or other of the terms influences the way that change is perceived, and how change can or cannot be mediated. This leads in to a critique of transition orthodoxy, and how the recommended four pillars to transition (liberalisation, stabilisation, privatisation and internationalisation) were applied. A key message emanating from this chapter is that the Russian economy is one that is predicated on *hybridism*, the dominance and persistence of the virtual economy being one of the greatest testaments to this. A further facet of Russia’s economic hybridism is the nature of change among Russian regions and differential processes of reform by local elites. The reality of different geographies of transformation and constantly shifting scales of control and authority pulls into focus processes of uneven development among regions; therefore, underlining the importance of examining the region as a locus for transformation processes.

Chapter 4 outlines the methodology for the thesis, highlighting the way the theoretical basis has informed the choice of techniques to examine sites of regulation and governance. The chapter also provides an opportunity to discuss issues and constraints encountered in conducting fieldwork in Russia.

Chapter 5 examines the policy frameworks adopted by the key IFIs engaged in Russia, as well as providing an overview of IFI activity in Russia since 1991. The chapter provides a crucial link between the previous chapters and the case study

chapters. The policy frameworks are for the most part informed, if not determined, by what is commonly known as the ‘Washington Consensus,’ and latterly the ‘Post-Washington Consensus’. Consideration is given to these policy agendas as well as the global economic regulatory framework within which they were conceived. The chapter goes on to explore the nature of IFI involvement in Russia since 1991 at the macro level and sets the context for the work of IFIs and other donors working in the regions.

The following case study chapters focus on identifying local processes of transformation, and regulatory change in the context of IFI activity in Leningrad (Chapter 6) and Sakhalin oblasts (Chapter 7). Chapter 8 draws together the previously identified themes from both the theoretical and case study chapters when looking at some examples of IFI activity at the Federal level. The *pervasiveness of disincentives to change* and processes of *exclusion* are shown to be critical factors in limiting the impact of IFI activity in the regions and at the federal level.

The final, or the concluding chapter, responds to the stated aims and objectives of the thesis set out in this introduction. It reiterates the claims that the *embeddedness* of social practices and institutions has been critical in determining the path of Russia’s transformation. This has meant that IFIs and other donors have had a limited impact in determining processes of transformation. Moreover, it is shown that processes of governance and regulation that are mediated and challenged at a variety of scales have not served to create a homogeneous mode of social regulation in Russia. This is because of the realities of uneven development across Russia’s regions.

## **Chapter 2**

### **Theorising Transformation: a critical engagement with regulation theory**

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'The regulationist project is more accurately viewed as a continuing research program than a completed theoretical edifice. It can provide geographers with an extremely valuable framework for analysing changes in the nature of contemporary capitalism' (Tickell and Peck, 1992:191).

#### **Introduction**

In direct response to Tickell and Peck's statement, it can also be argued that it is possible to use the conceptual apparatus of regulation theory to help in analysing the process of economic transformation within the Russian Federation, a newly emerging capitalist economy. Lying at the heart of this analysis is the desire to use the regulationist framework to highlight the pivotal role institutional practices and networks of social relations play in the transformation process. If institutional practices are shown to be so critical to any process of transformation, then this has important implications for those trying to influence the transformation process. So, a question that needs to be asked is: have IFIs and other policy makers taken due account of such influential processes?

Economic transformation has had a dramatic impact at the federal level within Russia, but the country is also witnessing the intensification of the process of uneven development. It is important to be able to explain what lies at the root of this. Individual regions are devising their own ways of coping with the realities of transformation. These agendas do not just depend on, for example, the regions' relationships with central government, or on the industrial legacies of the Soviet era,

but on individuals and the embeddedness of social networks, the ways in which regional economies are 'regulated'<sup>1</sup>.

Networks of social relations have developed over time in order to manage the exigencies of both the Soviet and Post Soviet systems. Social relations and local practices vary over the Post Soviet landscape (Rose, 1998) and until IFIs recognise this in their attempts to assist the transformation the economy can only be limited<sup>2</sup>. For example, in the early 1990s the Russian Federation privatised much of the industrial base, it has been argued that there was little consideration made for the way in which social groups would react to this process (Rose, 1998)<sup>3</sup>. Furthermore, individuals involved in this process have not necessarily made what neo-liberal economists term 'rational' decisions<sup>4</sup>. In reality, the more 'informal' networks of social relations dominated the process. For example, throughout the privatisation process, it was not uncommon for members of informal networks to try to protect their own interests, and to try to hold on to 'valuable' assets, even if this meant finding alternative means to do so other than those prescribed officially. Dominant social practices almost condoned this situation.

Typically IFIs have focussed on the need to transform the conditions of production and consumption within the economy without making sure that the socio-political

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<sup>1</sup> The intended meaning of the term 'regulation' will be explored in more detail in section 2.4 but, in short, it infers more than the regulatory powers associated with the state.

<sup>2</sup> My intention is not to suggest that all that IFIs do, or attempt to do, is necessarily desirable, for a more detailed discussion of this view, see Chapter 3.

<sup>3</sup> This argument would be countered by the work of Boycko et al (1995). See Chapter 3 for a detailed appraisal of the privatization process.

<sup>4</sup> The term 'rational' is necessarily problematic and is used here in a similar manner to the way it is deployed as a term in popular neo-liberal macroeconomic theory (for example an agent making a rational decision might be one who strives for optimal productive efficiency of their resources and/or capital). But of course rationality can also be understood in terms of making the perceived optimal decision given the past, present and predicted circumstances. Such a conception of 'rationality' does not necessarily match that of economic rationality as defined within economics.

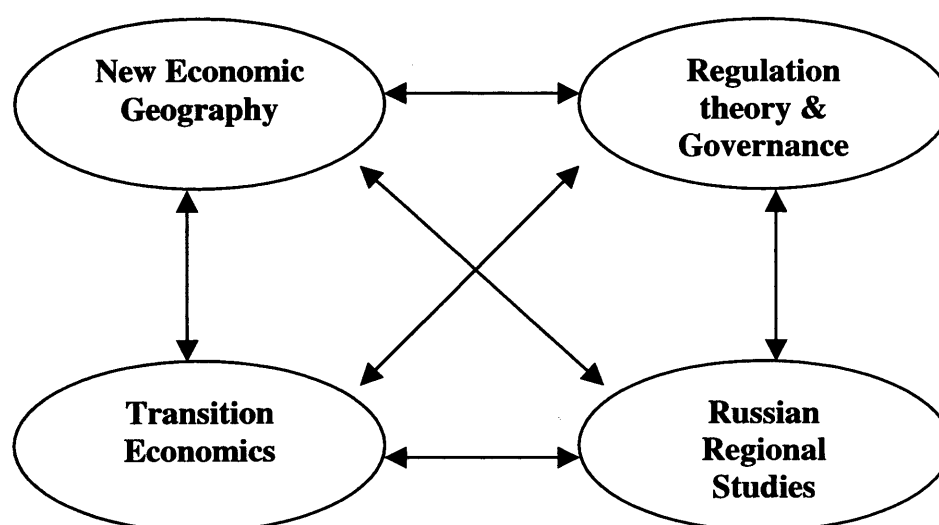


practices, or institutions exist to support these changes, and are themselves in a position to evolve over time in a way that will provide long-term support to these new economic practices. In using the regulation approach it is possible to identify and see how these socio-political and economic practices need to be mutually reinforcing to allow for stability within an economy.

## 2.1. Research links

A key task in this thesis is to link four areas of academic research in order to assess the relationship between IFIs and the transformation of the regions of the Russian Federation (Figure 2.1.).

**Figure 2.1. Bridging the gaps: Simplified diagram showing research links**



Established links between these areas of research vary in strength. Perhaps the strongest link exists between 'Regulation theory', 'Governance' approaches and 'new economic geography' (see, for example, work by Amin 1994; Amin and Robins, 1990; Brenner, 1998; Hay, 1995; Jessop, 1997, 1995, 1990; Painter and Goodwin 1995; Tickell and Peck, 1995, 1992). This work focuses on the nature of

the economy that now exists within the advanced capitalist countries following the crisis of Fordism, at the local, national and international scales.

Others have sought to explore the links between regulation and governance approaches with specific reference to the transition economies (for example, Grabher and Stark, 1996; Hausner et al. 1995; Smith, 1998 and Smith and Pickles, 1998). Their approach draws upon work that has emerged within 'new' economic geography concerning the ideas of the 'governance' of socio economic systems (for example, see Amin and Hausner, 1997; Cox, 1998, 1993; Herod et al. 1998; Hirst and Thompson, 1996; Jessop, 1997; Swyngedouw, 2000).

Theorists working with governance approaches try to divorce themselves from using concrete divisions between market, state and civil society, which has been implicit within mainstream analyses of modern society (Jessop, 1995; Painter and Goodwin, 1995). They further focus on the way in which institutions interact with each other, as well as trying to examine the commonality of local social and political practices and the way that these processes interact. Whilst Smith and Pickles (1998) use ideas that have been developed within the area of transition economics there are further links that can be made using the work of economists.

Economists working on the transformation process have tended to focus on the discernible macro-economic relationships that have evolved throughout the process of transformation (Hanson, 2000, 1995; Lavigne, 1999;) and, in my opinion, pay limited attention to the way in which these processes are affected by political and social networks of relations. There is, however, a wealth of information and analysis

(particularly empirical evidence) available within the body of literature concerning transition economics, which can be used to make important links between ideas emerging from economic geography and those working with the regulation and governance approaches.

## **2.2. A two-pronged critical engagement**

The aim of this chapter is to engage critically with 'regulation' at two levels. The word *critically* is also being used in two senses, that of importance, and second a scrutinising of the gaps that are left in the work completed within economic geography under the broad banner of the 'regulation' approach. This analysis shows that an engagement with regulation theory, and more specifically with the 'mode of social regulation,' a key concept within the theory, can offer a useful and valid platform from which it is possible to move in to theorising about the process of transformation within the transition economies and specifically within the Russian Federation.

International financial institutions, for example the IMF and World Bank, seek to dictate or at least play more than an incidental role, through their lending agreements, in stimulating the emergence and solidification of new ways in which the economy as a whole functions. This is in terms of the relationship between production and consumption and the allocation of capital between profit, reinvestment and consumption. Such changes, in the type of market, from 'planned' to 'free', necessarily involve changing the institutional practices that support the emergence of a free market.

The aim of the intervention is claimed to be the stabilisation of a national economy during the process of transformation, and it is now presumed that this is connected with securing a position within the arena of the international capitalist economy (Stiglitz, 1999). Over the years, priority has been given to turning around the way that the market functions with the expectation that a new support structure, with all the institutions and social relationships that it entails, will somehow naturally coalesce around this new market. Within Russia this has been seen not to be the case (Gustafson, 1999; see also chapter 3), the economy seems to be of a very hybrid nature and the role of the state has had, and continues to be, reconsidered.

The general trend, discipline wide, to focus on the way that capital is produced and reproduced stands to eclipse the important role that institutions<sup>5</sup> play in regulating the market, as they ultimately define the parameters within which the market can operate without it constantly lurching into periods of crisis (Tickell and Peck, 1992). Furthermore, little work has been done in attempting to use the distinction that regulationists make between the institutional structures, including networks of social relations and the processes of production and consumption outside analyses of the advanced capitalist economies. This research attempts to tackle both these issues. It demonstrates, via an analysis of the situation in Russia, an example of a Post Socialist country, just how vital the *embeddedness* and *evolution of socio-political networks* and institutions are.

Without taking into consideration the way in which the economy is regulated, attempts to proceed smoothly along the path of transformation are potentially

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<sup>5</sup> 'Institutions' are understood here to mean more than merely physical entities but rather processes that are constituted by social practice (see also Chapter 3).

severely hindered, if not doomed. Furthermore, this responds to the call made by Tickell and Peck (1992) to attempt to spatialise regulation theory by examining the ways in which market practices are emerging and the ways in which markets are being regulated within Russia. These processes can be delimited at several scales, including the national and the regional.

Whilst it is apparent that regulation plays a substantial role in this work, the reader should not be under the impression that this precludes a melding of other approaches. Rather, following the work, for example, of Smith and Pickles (1998) in their text *Theorising Transition*, and others looking at issues pertinent to advanced capitalist economies, the aim is to explore the relationship between regulation approaches and those that are primarily concerned with 'governance' as the key concept.

### **2.3. Facing the potential problems in applying Regulation theory**

The Regulation school did indeed emerge from Marxian economics in the 1970s, however, one should not presume that in using a regulationist approach any analysis is necessarily grand narrative in style or economically deterministic. Such criticisms, I would argue, are indeed valid when one considers much of the work that has been conducted under the heading of regulation theory, but in looking at the original 'régulation' work and the original definitions of key terms it is possible to see that such criticisms can be refuted.

'It is often forgotten nowadays that French work on 'régulation' arose in part in opposition to neo-classical economists' obsession with the market driven tendency towards general equilibrium - a process, which allegedly flows from disembedded economic change among pre-constituted rational economic actors... Its subsequent popularity has

much to do with a rejection of the taken-for-grantedness of the distinction between the economic and the extra-economic...[or,] 'integral economics' i.e. in the socially embedded, socially regularised nature of economic activities, organisations and institutions' (Jessop, 1995:309).

The word 'regulation' is itself the cause of many of the problems. The concept is readily confused with the familiar idea of judicial and political regulation. Such regulation is more closely aligned with the French word 'règlementation'. 'Régulation' is better understood as regularisation or normalisation (Jessop, 1995:309).

Furthermore, as is commonplace with respect to other theories, many of the criticisms are seemingly unfounded as they are actually based on a misreading, and therefore misunderstanding, of the original texts. As with many theories, the original conceptions differ greatly from later applications and understandings of them. It is important not to instinctively tar the original theory with the same brush as perhaps some of the work that stems from it.

A key objective of the original regulation work was, indeed, to differentiate between historical phases of economic development and to determine macro-economically consistent relationships of correspondence between the conditions of production and the economy (accumulation) and the socio-political relations that govern the way in which the economy can function (mode of social regulation) (Boyer, 1990). But this involves exploring, in great detail, the economic, social and political factors that have combined with each other to create networks of relations that we live, work and trade with. Some are apparently easier to discern in concrete forms while others

remain more nebulous through space and time and are subject to change. Goodwin and Painter clarify the issue further:

'While not denying the importance of necessary tendencies to uneven development, regulation theory focuses principally on the non-necessary relations that determine, which specific periods and places see what kinds of accumulation and economic growth. ... For now, the significant point is that regulation theory aims to develop a historically and geographically grounded account of the development of capitalism' (Painter and Goodwin, 1995:337).

By its very nature it is of course, a large project, but such analyses do not necessarily fall in to the trap of trying to explain phenomena by just looking at processes that occur on the national or international scale. Perhaps, one of the most attractive features of Regulation Theory is its ability to start an analysis without using arbitrary scales of reference. A factor which will be seen as critical when attempting to theorise about transformation as arenas of activity vary considerably through space and time (see Swyngedouw and Mouleart, 1992).

Many criticisms have been levied against the regulationist approach, but one must first give due consideration to the context in which the theory was conceived and second, to the way in which other theories have been used. Aglietta (1979) chose to theorise about the conditions of accumulation and the mode of social regulation, in advanced capitalist economies, which faced crisis in the 1970s. The focus of his work was on the American economy, developing ideas put forward by Antonio Gramsci in his work on American Fordism (1928/1971).

Since Aglietta's initial formulations, the increasingly pervasive forces of globalisation and regionalisation have served to alter radically the economic

landscape. These changes do not, however, necessarily invalidate the usefulness of the relationships that were conceived by Aglietta, nor the analytic tools that were utilised. They can still be used to good effect. Any theory is written within a specific historical context and geographical space. Just as those working with the Marxist project have continued to extend the discourse, they continue to use the original concepts. So too can social scientists continue to develop and use the regulation approach.

Perhaps more importantly, in stressing methodology it is possible to focus on regulation theory as a 'perspective and a form of analysis that is in principle distinct from the substantive claims made about particular structures and processes by individual regulationist writers' (Painter and Goodwin, 1995:337). Regulation theory can be used as an approach without necessarily having to endorse all historical accounts developed under its heading.

The goal here is not to attempt a wholesale lift of 'western regulation theory' and dump it on to an increasingly confusing map of the post-socialist world. Rather, the intention is to utilise the key concepts of the approach, the regime of accumulation and the mode of social regulation in an attempt to unravel the processes of uneven development that are affecting the Russian Federation, which combine to undermine the emergence of a stable economy.

There are the obvious similarities between the productive practices, which typify the era that we understand as Fordism, and that of the period under the leadership of Stalin in the USSR, when five-year plans became the motivating force behind



production. The bureaucratic regulatory system was clearly defined and managed by the Communist Party within the Soviet period and as such the regulatory system was strictly controlled in order to maintain the Soviet status quo. At the most basic level of understanding, the demise of the Soviet system can be explained by the breakdown in the relationship between the processes of production and consumption and the way in which they could be managed by the existing regulatory framework which was steeped in principles of 'State Socialism'<sup>6</sup>.

It is important to try to understand how such a previously tightly regulated economy<sup>7</sup> can manage the transformation process with little or no experience of managing a free market economy. The collapse of the Soviet system has left the transition economies, and particularly the Russian Federation, which lay at the heart of the system, with a paucity of social institutions from which collective and strategic action could emerge to help manage the transformation process (Smith and Swain, 1998)<sup>8</sup>. It is by making the distinction between the regulatory framework and the processes of production and consumption, which intersect at every level, that we can unpick the processes that are combining to cause the uneven development of the regions of the Russian Federation.

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<sup>6</sup> The term state 'socialism' is used with reference to the ideological principles that guided the evolution of the Soviet state. The state, in principle, and for the most part in practice, was to guide all aspects of economic, social and cultural realms. Of course the application of the term is problematic in many ways, not least because it implies that the state did in fact control all aspects of life, this was not the case. There was at least a burgeoning second, or shadow economy that almost helped to prop up the formal economy and ensure that demand etc. was met.

<sup>7</sup> See also footnote above. To a greater extent the economy was tightly regulated, especially in judicio-political and planning terms. However, it would be misleading to assume that the whole economy was under strict control.

<sup>8</sup> I would argue that using the word 'paucity' is only appropriate in the context of describing the lack of institutions needed for transformation to the supposedly most 'desirable' blueprint system, but not if one considers transformation processes to not have a predetermined end point.

## 2.4. Regulation theory: the basics

Michel Aglietta's '*A Theory of Capitalist Regulation*' is central to the work of the Regulation School. He clearly states in his text that the theory, which he has produced, seeks: 'to answer the question as to whether a new phenomenon is a change in form of the determinant relationships, or instead the emergence of relations, which can if they develop, transform the mode of production itself' (Aglietta 1979:37). For example, the mere introduction of a universal banking system does not necessarily mean that all people are going to look to open personal bank accounts. The decision to do so or not will be determined by the evolution of social practices and therefore perceptions related to the positive or negative benefits of having a bank account or not. If a large proportion of the population opts to have a personal bank account then a new way in which capital can be accumulated will become widespread.

Perhaps more simply put, he *rejected* the idea that the reproduction of economic relations involves 'modes of coordination between the *predetermined* and *unalterable*<sup>9</sup> behaviour of subjects' (Aglietta, 1979:13). He thus proposed to study regulation in terms of the 'transformation of social relations as it creates new forms, which are both economic and non-economic, that are organised in structures and themselves reproduce a determinant structure, the mode of production' (Aglietta, 1979: 16).

A Marxist interpretation of the evolution of capitalism argues that any regime-type has a limited life and that because of the inherent contradictions within the system,

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<sup>9</sup> Own emphasis added

it cannot last. Therefore, new fixes are constantly needed to resolve the tensions that are generated by the internal dynamics of the regime (Harvey, 1982). Theorists, such as Michel Aglietta, writing in the 1970s, rejected Marx's idea of the linear development of capitalism and tried to develop a theoretical framework encapsulating and explaining the paradox of capitalism and its inherent instability. This involved looking at its ability to coalesce and stabilise around a set of institutions, rules and norms, which serve to secure a relatively long period of economic stability.

'Without regulation, it is argued the process of capital accumulation would collapse through its own contradictions. If stable, or expanded accumulation occurs, it does so in part as a result of a process of regulation *that is not presupposed by the accumulation process itself...*(.) Continued accumulation depends upon a series of social, cultural and political supports that are only contingently co-present. Moreover, there is not just one possible pattern of regulation, but, at least in principle, many alternative contingent combinations of 'non' economic factors that might operate to support accumulation, with varying degrees of effectiveness' (Painter and Goodwin, 1995:337).

A series of intermediate concepts have emanated from the work of the regulationists that try to uncover what lies at the root of the movement from regular growth to stagnation and economic instability, they are, of course, variable through space and time. The key to understanding the regulationists' view of capitalism is the belief that it is the desire of capitalists to maximise opportunities of surplus profit that disrupts the proportionality between the means of production and consumption. Aglietta (1979) claims that new investment speeds up the accumulation of the means of production and if the increased output is to be consumed, wages must be increased. This requires an increase in productivity to stabilise profits, for there is no reason that wages as a cost to capital should be reconciled with wages as a source of consumer demand, therefore the system needs regulating.

Aglietta (1979) identifies three key processes and their related structural forms, which interact to influence the growth or stagnation of a national or regional economy. The first concerns the developments of the process of labour, the wage relation and relationship of wage determination with the development of individual and collective consumption. The second is the nature of capitalist competition and the emergence of large corporations. The third is the role of money, credit, finance capital and inflation.

#### ***2.4.1. Key concepts: regime of accumulation and mode of social regulation***

The two central tenets of regulation theory are that of accumulation and regulation (Aglietta, 1979). These concepts are used to help explain the systemic coherence of individual phases of capitalist development. In simple terms, a regime of accumulation can be understood as a systematic organisation of production, income distribution, consumption and exchange of the social product (social product can be understood as the difference between the social benefits and costs arising from the use of some factor of production or from some form of economic activity). It is, therefore, a form of surplus value production and realisation supported by particular types of production and management technology. In less technical terms this means that it is:

‘...the form of the distribution of surplus between capital and labour required in each period in order to coordinate production with social demand. It covers the essential economic conditions for the operation of the productive system (technology, organisation of the labour process, relations between the departments of production)’ (Mavroudeas, 1999:313).

Furthermore, the concept of a regime of accumulation incorporates the types and methods of organising production, as well as the economic conditions for the reproduction of labour power and capital. For example, this might involve, currency devaluation strategies to reduce inflationary pressures and/or boost the export market (these alter the structure of the economy, notably the ratio between the producer and consumer goods sector). But also wage conditions, consumer models, class structures and the relation between the capitalist and non-capitalist sectors in society, and the mode of integration into the international market, are of importance (Lipietz, 1987).

Regulation, or the mode of social regulation (MSR) can be said to define the rules of the game by trying to guide and stabilise the process of accumulation. The term can be used to describe the way in which a system as a whole functions. The system functions around the conjunction of economic mechanisms associated with a given set of social relationships of institutional forms and structures (Boyer, 1990). The mode of regulation therefore refers to the institutional ensemble and the complex of cultural habits and norms, which secures the regime of accumulation. These formal and informal rules codify the main social relationships within an economy (Nielsen, 1991:22). As will be apparent in Chapter 3, it is possible that the mode of regulation can fail to support effective accumulation and in the Russian case such a form of accumulation has been dubbed 'crony capitalism' (see Gustafson, 1999 and Chapter 3).

Regulation may be imposed, at one level, by enacting laws and leaving their supervision to the normal processes of law, by setting up special regulatory agencies

or by encouraging self regulation, and in some cases delegating powers to non-state bodies. But, as previously noted, *régulation*, implies more than just that stemming from judicial or political processes, though in many instances these reinforce '*régulation*'. Its broader meaning spans that of the variable pattern of cultural, political and economic institutions.

It would be misleading, however, to conceive a mode as a 'completed' system. It is one, which is in a constant state of evolution and flux (Painter and Goodwin, 1995:340). The pace and scale of changes of course vary through space and time. It is common amongst critics of the concept to argue that the idea of modes of regulation overemphasises the functionality, stability and coherence of processes and relations, therefore not taking account of change and conflict. A more sophisticated understanding of the concept does, however, allow for such processes to be taken in to consideration. I would argue that a common misconception follows the logic that a change in modes of regulation signifies some kind of sharp discontinuity. It can be, but does not have to be the case, and more often that not is subtler than a radical, or very visible change.

It is also common, within some studies using the regulation approach, to imply that conflict and human agency only become important, or apparent, during periods of upheaval or crisis. To do so is to show an inadequate understanding of the original conception of the term. Modes of social regulation evolve constantly and human agency plays a fundamental role in this at all times.

I would concur with Painter and Goodwin (1995:342) in suggesting that the *process* of regulation is the product of material and discursive practices that generate and are then conditioned by cultural and political institutions. But more than this, regulation remains *tendential*, rather than being achieved or established.

'There are tendencies towards effective regulation that are partly, but not entirely, the products of strategic action undertaken by individuals and institutions. Equally there are counter-tendencies operating to disrupt the reproduction of the capitalist order. The regulatory process is the product of the interaction of these forces... A regulation theory that treats regulation as process, is able to deal rather more subtly with temporal and spatial variability' (Painter and Goodwin, 1995:342).

The terms 'regime of accumulation' and 'mode of social regulation' might have been devised and defined with the advanced capitalist economies in mind but there is no reason why they cannot be applied to the economic development of the Soviet economy and now, the Post-Soviet states. In developing this conceptual apparatus regulationists acknowledged that *régulation* fashions a system but the form and process of *régulation* cannot be predetermined (Amin, 1994). Important for this work, is the belief that while regulation theory identifies the economy as the object of regulation, the regulatory processes, institutions, practices and norms that constitute *régulation*, *cannot be identified a priori*.

*Régulation* is also a process without one clear central subject, and therefore cannot be reduced to being just state regulation, for example. This means that the IFIs, if they are going to attempt to force transition or transformation in one direction, must consider that their work has to extend beyond that of the state, though of course, changes to state regulation can codify changes to cultural and institutional *régulation*. In addition, and perhaps most obviously, regulation theory allows the

reversal of the 'causal arrow'. 'The 'success' or 'failure' and stability or instability of the accumulation process is held to be, if not wholly determined, at least heavily influenced, by institutional organisation, social forms, political processes and cultural norms' (Painter and Goodwin, 1995:338).

#### ***2.4.2. The methodological character of regulation theory***

As processes of regulation are constituted through unevenly developed social practices they need to be investigated via empirical research. This is imperative because processes that define or are identified as constituting 'abstract' modes of social regulation must arise in concrete terms in reality (see Sayer, 1984). Moreover, as regulation is complex and varies temporally and spatially such differentiation must affect regulatory processes in real terms, whether that be what kind of regulation, or how much regulation.

A regulation approach can help to explain why and how capitalism is different in each country (Boyer, 1990) and perhaps even different within countries. It can do this, because the differences are not necessary and not presupposed by the abstract accumulation process. Therefore, the regulationist perspective, of a sort of historical materialism, can be used explain the differences.

So, as a method of analysis, regulation theory begins with the pretext that the reproduction of (capitalist) social relations cannot be determined and therefore not guaranteed by the abstract relations that define a capitalist mode of production. Consequently, it is concrete institutional processes and discourses that create 'kinks', or 'crises', in the reproduction process. It further suggests that there is no



such thing as 'perfect' regulation, both in the sense of there being a mode that adheres to some kind of predictive blueprint, nor that there are periods of 'good' or 'bad' regulation. Regulation just 'is'.

A key methodological aim is therefore to examine the generation of regulation, as organised through *sites* of regulation. Each set of social practices that constitute regulation, have their own key sites. The interactions are therefore interactions through space. The spatial dynamics of regulation are integral to the character of it, its effectiveness, or lack of it.

This can be put into more concrete terms, with direct reference to this research. Practices are institutionalised, while institutions are constituted through social practice. Practices are 'situated' in institutions therefore becoming 'sites' of regulation. Therefore, at the international scale, IFIs, the physical beings, are constituted by sets of institutional processes, most of which emanate from practices associated with those of advanced capitalist economies pursuing some kind of neo-liberal agenda<sup>10</sup>. Such institutions naturally shape the physical institutions, which stand as a concrete materialisation of them in some way. The institutions are thus sites of regulation<sup>11</sup>.

Each Russian region and its regional administration also embodies set(s) of institutions/social practices. These vary considerably through space, hence the multitude regional responses to the pressures of transformation. The regional

<sup>10</sup> See Tickell and Peck (1995) for a more detailed discussion of the relationship between the crises of Fordism and the emergence and evolution of a neo-liberal agenda.

<sup>11</sup> Sites of regulation are not just confined to the economic and business realms, they can also include, for example, the home, social meeting places, schools, places of worship and more political orientated social meeting points.

administrations do not alone constitute some mode of social regulation within the region. There are other sets of institutional practices emanating from spheres such as local businesses and business associations as well. They are all sites of regulation.

Methodologically speaking, it is important to identify certain sites of regulation relevant to this project and to try and access the sets of institutional practices that constitute them. Cultures will of course vary throughout them, some being sites of resistance and disruption. Even within a regional administration, for example, different departments will possess different institutional understandings of their political and economic worlds, as will different individual and groups of businesspeople. Of course there are also differences within and between IFIs and other bilateral donors. The added complication is that practices vary not only through space but time as well. In this study, sites of regulation include: regional administrations, business associations, IFIs and bi-lateral donors with representative offices in Russia and abroad and Russian partners.

Discourses influence the construction of modes of regulation. They play a fundamental role within for example, the work of IFIs working within Russia, as they do within Russia and Russian regions, not only in terms of the construction and perpetuation of discourses but also in the challenging of them. Such 'structures of feeling' (Williams, 1965:64) therefore also need to be identified wherever possible. Readings of such discourses and structures of feeling are necessarily complicated and problematic (see also Bourdieu, 1994; de Certeau, 1984). Any study of regulation needs to try to identify both dominant discourses which are perpetuated, created or challenged at sites of regulation. Whilst regulation theory supports such

an aim, the melding of governance and regulation approaches allows for a more nuanced analysis as governance mechanisms stand to support, develop or challenge modes of regulation. The two approaches tackle the critical issue of structure and agency.

## **2.5. Melding 'Regulation' and 'Governance'**

The increased use of the term 'governance,' as opposed to 'government,' can be associated with the rise of non-state institutions governing territorial development (Painter and Goodwin, 1995). Theories of governance are primarily concerned with a wide range of social co-ordination, not just a narrower notion of political modes of social organisation. Social co-ordination is understood here to refer to the manner in which, disparate but interdependent social 'agencies' that interact and meet some form of objective. It has been suggested that many approaches to governance share a rejection of the conceptual trinity of the market-state-civil society, which has fairly dominated mainstream analyses of modern societies (Jessop, 1995: 310). This is reflected in the boom of studies looking at an ever-increasing range of economic governance mechanisms (see for example, Grabher, 1993; Hollingsworth et al. 1994).

'The new institutional capacities include a conceptual reorientation of the economic role of governance; the ability to generate and apply knowledge across a broad range of policy areas; fashioning new mechanisms and approaches to leadership and decision making; redesigning systems and strategies for getting results; and creating more effective means of performance assessment and accountability' (Fosler, 1992:4).

Within the sphere of international relations too there has been an increase in the interest in the conventional distinctions between domestic political hierarchies that

exist within a sovereign state and international political hierarchies and interstate relations. It seems inappropriate then to confine research to looking only at the top down nature of state power. Therefore, this reorientation of academic work is commonly understood to signify a shift from a concern with government to governance. Analyses, might for example, involve examining issues such as 'governance without government' (Rosneau and Czempiel, 1992).

Such work has, among other things, highlighted the growing role of associations, private interest government and processes of self-regulation. The issue of corporate governance has also risen to the top of the agenda for many institutions, and in particular IFIs, such as the World Bank, who have now identified this process as essential to their work in recipient countries. Top down planning, no longer seems to be the preferable option in affecting change within countries like, for example, Russia. Therefore, more generally issues of governance, especially corporate governance are now of great interest to such insitutions, 'think-tanks', policy advisors, as well as academics.

Jessop (1995) argues that many regulation theorists have shown an interest in theories of governance either in passing or through a more intensive and sustained engagement. Similarly, some theorists of economic or political governance have shown more than a casual interest in regulation theory (for example: Grabher, 1994; Hollingsworth et al. 1994). Such interests are not just confined to reasons of similarly timed paradigmatic shifts in both area of academic interest, namely the so-called crisis of 'Fordism' within the advanced capitalist countries.

Both sets of theories tackle debates concerning structure and agency and the processes that ultimately stimulate changes to the structure and organisation of society through space and time. Both involve looking at the embedded nature of institutions and social practices. Jessop clearly explains one of the key overlaps between the two approaches:

'We find a strong interest in (a) the self-organisation of systems concerned in the first instance with their own self-reproduction rather than with their impact on other systems; and (b) problems related to the external 'steering' (governing, guiding, managing) and/or strategic co-ordination of complex systems that are resistant to direct intervention or top-down management but none the less coexist and co-evolve in complex ways with other systems with which they are reciprocally interdependent' (Jessop, 1995:314).

Furthermore, just as regulation theorists claim that the objects of regulation do not fully pre-exist the process of regulation, governance theorists commonly recognise that the 'objects of governance are only known through their attempts to govern them' (Hunt and Wickham, 1994:78). Therefore, the processes of regulation and governance constitute the objects that actually come to be 'regulated' or 'governed' in and via some sort of mode of self-regulation. Similarly, as already seen with regulation, there only exists a specific or particular mode of governance, there is no 'general' governance that should be comprehended as a totalising form. Such realisations further highlight the need to study the different processes of the constitution of such objects of governance and regulation, as they vary through space and time<sup>12</sup>.

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<sup>12</sup> Of course, in addition to the overlaps between the two approaches there are differences. For example, governance is often related to problem solving whereas the regulation approach seeks to observe and explain. More importantly, regulation theorists tend to assume more of a top down approach to economic analysis but conversely governance studies tend to start from the micro or meso-scales. I would argue that such differences actually enhance the benefits of trying to use both approaches as certain weaknesses of each approach are at least tackled.

Tickell and Peck (1992) argue convincingly that regulation theory, and much of the subsequent work stemming from it, fails to acknowledge the spatiality of political-economic life, as well as focussing too heavily on the 'economic' mode of social regulation. Mouleart (1997) further contends that the original conception of the mode of regulation, being heavily biased towards the state, neglects other dynamics. However, for a more effective analysis it is possible to link 'governance' approaches with regulation work.

If one agrees that regulatory processes are territorially institutionalised as 'bundles of social practices' or as network relations in place (Smith and Swain, 1998) then these ideas can be developed in order to examine the causes of uneven regional development. 'Local' social practices can be seen to be operating in the former Soviet Union, interacting with each other to produce modes of regulation that act as the glue holding regional economies together. These are not determined from the outset. They are the product of a long-term adjustment of practices materially and discursively constructed within arenas of struggle competition, stabilisation, and transformation at the local, national and international scales.

This argument stands to contest the belief that the IFIs can use their programmes to force a speedy transformation of the Russian economy, as we have seen to be the case since 1991. Time plays a crucial role in the evolution of new modes of social regulation. The Soviet regulatory system did not furnish the emergent economies with a tradition of regulatory practices that would facilitate an easy or quick transition.

A key question to be answered in this research is: to what extent is the regional institutionalisation of regulatory processes defining the uneven development of Russia's regions, and on the national scale, a fragmented mode of regulation which might or might not be sustainable? Having tackled this question, it is then possible to analyse whether in fact involvement by Russia's regions on the international stage is stimulating the emergence and solidification of a mode of social regulation that can support the regime of accumulation that the Federation is expected to achieve, by the IFIs of the advanced capitalist countries. Just as Jessop concludes then:

'Whether a solution for governance problems can be linked to new modes of regulation depends on how far (integral) economic concerns can find expression in the discursive construction of the problems of governance and secure a social basis among the political actors involved in resolving this problem. Likewise, whether an emerging mode of governance is subsequently linked to a new mode of regulation will also depend on the nature of the structural coupling between political and economic processes i.e. on the appropriateness of the mode of governance to integral economics as well as governability problems' (Jessop, 1995:322).

## **2.6. Practical application: advanced capitalist and state socialist experiences**

Having looked at the theoretical background to regulation theory and some concepts of governance, it is now important to examine the concrete nature of processes and institutions that have actually existed. As regulation theory is based on the analysis of advanced capitalist countries from Fordism to the current day it is useful to look at key trends within this period. This provides the opportunity to compare and contrast the Soviet experience from state socialism to the current day. Looking at the sites of regulation within Fordism, and whatever form it has taken today, gives a clearer and more practical understanding of how a regulation approach can be applied to the Russian experience.

Due to limitations of space, the following analysis only pivots around key processes. Sites of regulation are considered in more detail with respect to Russia and more specifically the regions being studied in the following chapter and within the case study and analysis chapters. The aim here is to see what in particular characterised the regime of accumulation and the mode(s) of social regulation in the Soviet period. This then provides a clearer picture of the evolution of processes and institutions over time to the present day. After all, such change is path dependent and helps to explain the reality of concrete current conditions. Moreover, this analysis of the Soviet and Post Soviet conditions highlights the importance of recognising how a mode of social regulation is constituted and how this fashions the regime of accumulation. This argument is central to the thesis that without due recognition of this 'causal link', attempts to manufacture a regime of accumulation are unlikely to unfold in the predicted manner.

### **2.6.1. Fordism**

The original focus of regulation work, using the two concepts of the mode of social regulation and the regime of accumulation, was to try to explain the phenomenon of 'Fordism' and its subsequent demise<sup>13</sup>. Fordism is used as a shorthand term to represent a dynamic and contested set of economic and social processes that characterised the post war period in advanced capitalist economies (Amin, 1994). The underlying factors heralding the transformation of capitalist production and the regulation of the working class that invoked the switch from extensive to intensive

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<sup>13</sup> There is much debate as to whether Fordism has actually experienced its own demise or, if in fact, what exists now is merely a crisis of Fordism rather than a 'Post' form of it. See section 2.6.3. for a further discussion of this.



regimes of accumulation were seen to be the new productive processes inaugurated and typified by the practices of Henry Ford.

Regulationists identified four principle objectives of Fordism. First, to rationalise production times through a high degree of mechanisation, involving the synchronisation of production flows. Second, to organise the strict hierarchical division of design, production, organisation and sales. Third, production was not governed by demand it was assumed that goods produced in bulk at low cost would always find a buyer despite mediocre quality, given this, relative prices were reduced to stimulate mass consumption. Fourth, large companies kept the stable portion of demand for themselves (monopolistic competition) (Aglietta, 1979; Boyer, 1990).

Fordism, as a regime of accumulation, was based upon the constant upheaval of the labour process by the incorporation of know-how into the automatic systems of machines. This regime was, therefore, based upon the joint growth in the productivity of labour and the volume of fixed capital per worker. This grew out of national systems of collective bargaining, limiting inter-capitalist competition to technological and organisational factors because of the inability, for example, to use cheap labour inputs. The precondition to this type of accumulation was seen to be the systemisation of the actions of craftsmen by the 'scientific organisation of labour' – 'Taylorism'.

The crisis of Fordism, as documented by the regulationists, clearly sets in, during the 1970s. Taking account of the fact that capitalism relies upon the continuous

growth of the economy and thus the continuous expansion of buying capacity in the economy, one can imagine that there are many possible factors that might be attributed to a breakdown in the system causing it to 'combust.' Commentators have indeed discussed many such factors, their inclusion and omission in explanations and the relative weighting that they have received has continued to fuel the debate surrounding the end of the Fordist era.

Factors pertinent to making important links with the former USSR and its own predicament will be mentioned here. First, the productivity gains that had accompanied mechanisation seemed to slow down. Second, as the link between productivity and wage rates was broken, this in turn led to crisis with the maturation of the inherent structural conditions. Any reduction in popular buying power resulted in direct recession, any increase led to the accumulation of profit. Investment and capital intensification in production for consumption slowed down while at the same time real wages continued to increase due to collectivised bargaining structures. Firms experienced a squeeze on profits and this coupled with the macro economic shocks of the 1973 oil crisis meant that the crisis of the production model could no longer be concealed (Amin 1994). The mode of social regulation could simply not contain this crisis. The USSR was isolated from these particular pressures due to its very limited engagement in international markets.

Therefore, in addition to domestic pressures, there were processes occurring at the international scale, which had repercussions for the functioning of domestic markets within the advanced capitalist countries. Advanced capitalist countries linked by international flows of financial capital found their future success tied with the

functioning of the gold standard. The exchange rate of the dollar being linked to the value of gold became a fundamental unit of exchange within the international economy and as such the US Federal Reserve found it difficult to control the flows of dollars out of the country and therefore to maintain its rate of exchange. With the collapse of the gold standard, the 'global' mode of regulation was going to be forced to change. The financial system inevitably became more speculative as the Euro dollar market grew making national economic management more difficult because of the increase in the amount of international financial flows.

A well-cited criticism of regulation theory concerns the issue of accumulation crises and what led to the breakdown of the Fordist system. Frequently 'crisis' is portrayed by regulation theory as a single totalised event. Therefore, it can be argued that traditional regulation theory does not allow for the possibility of incremental, state driven restructuring and transition and a steadier evolution of the regime of accumulation and mode of regulation. But such an attack fails to acknowledge the attempt by the theorists to identify a number of different points of crisis. Some of which, the smaller internal crises, can be managed by adjustments within the existing mode of social regulation. Others, either internally or externally generated, might send shocks to the system, which can then be diffused through tinkering with the mode of social regulation.

The role of geography can become particularly important in this form of crisis management, for example, in the need of nation states to change, either individually or collectively, their scales of reference for their economic activities for example, needing to focus on regional programmes of generation within the bounds of the

nation state). On the other hand serious shock waves can and have caused a breakdown in the relationship between the mode of accumulation and the mode of social regulation. It can therefore be argued that the theory is not overly rigid, but allows for flexibility and thus the recognition of historically specific phases of activity.

It could be easily argued, as Harvey (1989) has suggested, that commonly accepted explanations made in attempts to account for the crisis of the Fordist system could be seen to give the history of the sequence of events some logical coherence that in reality it hardly ever seems to possess. This is a fair point. What regulation theory does do is offer a vital insight into the key macro and micro economic relationships, which cause instability and therefore dramatic change in the way in which economies are organised and function. In addition to this, regulation theory gives us the opportunity to understand the regulation of economies and crisis resolution as a complex intersection of forms of accumulation and institutional structures of regulation (Smith and Swain, 1998).

### ***2.6.2. State Socialism***

Having discussed four of the principle objectives of Fordism it is important to compare them with the economic objectives of State Socialism that existed within the Centrally Planned Economies. The following discussion is focussed around the institutional complexes that constituted the mode of social regulation: the wage relation, the money form, competition and state and international regimes, all of whose control ties into the objectives of building a system of 'state socialism'. It

will be shown just how the regulatory conditions determined the regime of accumulation.

In Socialist countries, productive assets were state owned, in industry, trade and services, prices were fixed and there was no preoccupation with the term profit (Nove, 1977). The Soviet system was characterised by the dominance of central planning. Instead of the market, the plan was used as a co-ordination mechanism. The plan should be seen as a set of techniques, used to determine what action should be taken in the future, to achieve objectives that have been previously set. The plan was to be fulfilled with maximum efficiency and coherence within the structures that were set up by the state. The decision makers involved in this process were political authorities, almost without exception members of the Party<sup>14</sup>. The plan was used as a mechanism that had the potential to allow for the management of everything under socialist ownership and party control (Pallot and Shaw, 1981). This economic system was then based upon stronger state regulatory control than the Fordist market system.

GOSPLAN and GOSSNAB, two pivotal state agencies, were responsible for the co-ordination of production processes, and controlled all flows of goods, fixed capital and labour that were important within the economy. In the absence of a free inter-enterprise market, the state had to bring together the suppliers of the means of production and the users of these goods (Lavigne, 1999; Nove, 1982; Pallot and Shaw, 1981). Not unlike Fordism, there was a strict hierarchical division of design, production, organisation and sales. This was deemed as essential not only in terms

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<sup>14</sup> Where the 'Party' is referred to the reader should take this to mean the CPSU when referring Soviet history.

of managing the sheer scale of managing such a large economy but also in terms of keeping a tighter reign on enterprises to ensure that targets and demand were adequately met. The state planners' aim was to synchronise the production and distribution flows within the economy between all the enterprises in attempts to make contracts (state orders) comply with the provisions of the plans. Each enterprise was accountable to the planners through the extensive hierarchy within the economy whilst the state bureaucracy frequently exerted petty tutelage over them (Nove, 1982). Again it is possible to see the stronger element of control in the Soviet economy than that of the Fordist economy.

Furthermore, through the imposition of the five-year plans, in Stalin's time, producers were forced to try to rationalise production times both through an increased degree of mechanisation, and through increased labour productivity<sup>15</sup>.

Whilst then the labour force faced constant pressure from the demands of the government to increase productivity this was limited by the fact that under the system of State Socialism there was the desire to maintain full employment (Nove, 1986). Such a desire was an essential objective of the implementation and maintenance of the system of state socialism. This coupled with the fact that wages were not directly related to productivity could help to explain why the system was prone to stagnation as the link between wages and production was missing (Hanson, 1995). The commitment that might have been felt by the workers to the socialist

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<sup>15</sup> This is perhaps best illustrated by the phenomenon known as the Stakanovite movement. The movement arose out of the exploits of one individual named who managed to mine coal well above his quota for the day. He had managed to rationalise his work so as to gain a dramatic increase in his output. Publicly recognised by the government and he was held up as a hero of the Motherland and from his actions others were encouraged to emulate his endeavours. In truth, officials selected the heroes of such stories beforehand and their 'performance' was set and completed using better supplies of equipment and through the help of others (Lavigne, 1999).

cause cannot be ignored, but it would be hard to argue that this alone encouraged the workers and producers to make productivity gains their priority. On the one hand, there was a dominant discourse revolving around collective input and productivity, but on the other, discourses also arose to challenge such notions. Discourses of disinterest have been documented as particularly prevalent at all levels within the economy and enterprises (Rose, 1998). Therefore, it is possible to conceive of at least two fairly dominant discourses running in parallel to each other throughout the Soviet period with respect to work practices and commitment to the socialist cause.

Many expected a socialist regime to grant large management rights to the workers who should, under a system of socialism, be the collective owners of the means of production with the party itself purely being the vanguard of the workers' class (Lavigne, 1999). However, this was not the case in the USSR<sup>16</sup>. Worker participation remained indirect despite there being formal channels for involvement. The official transmission belts of the Party were the official trade unions and as such became important sites of regulation. But even though they had significant functions, the trade unions had negligible influence in the sphere of management. Yet they could claim that they really did represent the people with the majority of the population being members. Unlike the party, which remained more elitist with only 12-15 per cent of the total population being members (Lavigne, 1999).

The trade unions in the USSR did not attempt to bargain about wages. Their remit was instead: to campaign for guaranteeing job security, managing social security

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<sup>16</sup> Yugoslavia was the only socialist state that organised all economic activity on the basis of direct self-management.

and were therefore seen more as a welfare organisation. The relation between wages and productivity as is understood within the capitalist economy was not there. Increases in productivity did not stimulate increases in wage levels (Nove, 1982), nor levels of consumer consumption.

The system of virtual 'monopolistic'<sup>17</sup> competition further hindered any sense of competition within the economy. The priority of producers was to fulfil the quotas that had been set. A blind belief in the benefits to be gained from exploiting 'economies of scale' meant that the enterprises were bigger than comparable ones in the West, for example, in terms of the number of workers. There might be only one or a handful of enterprises that manufactured a given good.

Any enterprise that enjoyed a position within the military industrial complex might have been under considerable pressure from the hierarchy to perform to maximum levels, but the executives and employees received higher wages and bonuses, and access to shortage goods, as well as being advantaged in planning procedure, a contradiction to the way in which other workers were remunerated. Such enterprises received higher quality supplies and attracted higher calibre workers than light industries. Executives were not just economic agents they were often very active political ones as well. For example, directors of enterprises were politically appointed and throughout their period of office they were directly accountable to the Party (Granick, 1954). Such networks of social and economic relations are enduring

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<sup>17</sup> It is important to not that the term 'monopolistic' cannot strictly be used to describe a socialist economy the buyers. There is none in this case. It is however the most recognized term used to describe the position of the state enterprises within the Soviet economy. Because to deserve the descriptor there would by definition have to be a market in which the seller(s) faced



and constitute a very important factor when considering the sites of regulation that have become increasingly apparent since 1991.

The military-industrial complex was regarded as the propulsive sector within the Socialist economy. As such, this complex included defence industries and almost all heavy industry (i.e. mining, steel, fuel, machine building and automotive industries) (Noren, 1994). Most attention was focused on this complex due to its critical importance within the Socialist economy. Other sectors such as the consumer sector therefore received a comparable lack of attention, showing a bias towards 'producer' rather than 'consumer' goods<sup>18</sup>.

Unlike in a capitalist economy, the planners controlled any form of integration between enterprises, and decisions were not based on competition or market criteria such as profitability. Enterprises were allowed, however, with their limited powers of autonomy in the area of investment, to expand in to sectors different from their main scope of activity. They could, for example, manufacture 'complimentary' goods with spare resources. Many enterprises in the military industrial complex therefore took to manufacturing consumer goods on the side of their other operations. Of course, such control did not preclude enterprises making informal agreements with each other relating, for example, to supply and fulfilling quotas. A culture of 'unofficial' activity was also burgeoning in this sphere.

The existence of such titans, which had internalised most of the suppliers, maintenance units and subcontractors, meant that there was a paucity of small and

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<sup>18</sup> For a detailed discussion of the problems of transforming the military-industrial complex see Noren, 1994

medium sized enterprises within the economy. Much of the internalisation was completed in order to avoid the possibility of shortages in supply and quality of goods. Large inefficiencies within the production processes abounded as enterprises tried to be self-sufficient entities.

Production was, like the Fordist system, not governed by demand. The emphasis within the Soviet economy was on quantity, not necessarily quality. In fact, during the Soviet era there was a saying passed amongst the Russians that warned against buying a television that had been produced on a Friday. The better bet was to try and ensure that you purchased one that had been made earlier in the week!<sup>19</sup> This is explained by the fact that weekly targets were set for the quantity of goods to be produced and as the week neared its conclusion there was pressure to fulfil these targets. By Friday considerations of quality would be overshadowed by the need to produce the numbers required, a phenomenon known as 'storming' (Lavigne, 1999: 34).

The plans focussed purely on the quantity of goods produced and the time that the process had taken; there was little accounting for quality. Again, not unlike the Fordist system then, the economy for a time thrived on producing goods that could be sold at a low price encouraging mass consumption. This process was kept stable by enterprises securing a large portion of demand for themselves. Another factor to consider when thinking about Soviet 'quality' was that production was predominantly to be for the internal COMECON market. Therefore, the producers were not only under pressure to provide adequate quantities for the large market,

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<sup>19</sup> Anecdotal evidence shared by a group of Russians living in St Petersburg, August 2000

which they often failed to do, but also they were not exposed to internal competition. Therefore, there was also lacking the incentive to improve quality or production practices as firms enjoyed mainly monopolistic competition. Furthermore, the innovation process was severely hindered under the system of central planning.

Of course, one fundamental difference between Fordism and State Socialism was the existence of money. At the beginning of the Soviet regime money was seen as a symbol of capitalism and something of an anachronism. When planning was first introduced targets were set in kind, the metric tonne being the most heavily used unit for commodities and manufactured goods. Within the materials balance system of accounting money was only used when the materials balance was totalled into a global macroeconomic balance and then only as a unit of account. Reformers did try to introduce 'markets and money' as instruments to lead to a better fulfilment of the plan. The words, prices, profits, monetary policy, credit, became more commonly used, but the meanings that they conveyed were not necessarily the same as the ones that are understood within capitalist economies.

Money did not play an active role within the economy as prices continued to be administered, and plans still focussed on the volume of output. Enterprises did not need to make profits to secure their survival but had to be talented in negotiating targets with the planners. The Central Bank was the only credit institution within the economy and it issued money. Its main tasks, however, were those of accounting. Local branches of the central bank monitored the activities of the enterprises at the local level, holding their accounts and acting as intermediary for all its payments.

Under the system of State Socialism individuals were allowed to have a savings account and all payments had to be made with cash, either banknotes or coins. Whilst the limited flows of cash and non-cash money were not necessarily technically incompatible with planning procedures, they were limited because it was felt by the planners that the dominant mode of regulation could not accommodate such changes without upsetting the status quo (Grachev, 1995). This of course meant that there was not the same conception of capital during the Soviet period, though of course this changed even before the collapse of the Soviet system as those in control of enterprises began to start operating in a different more 'capitalist' manner. Whilst such perceptual and actual changes occurred within the productive sector, so too was there a shift within the consumer side of the economy.

Generally speaking there was a dominant discourse of state control that pervaded every facet of Soviet life, running parallel to this was also a discourse of 'working' the system, along lines which did not conform to principles of 'state socialism'. As 'disincentives' to work at optimally efficient levels did not exist and unemployment did not pose a real threat, many workers within the system adopted a somewhat more flexible work ethic, than that promoted in the advanced capitalist countries. This naturally has implications for the transformation process, as expectations and attitudes to work, employers and the state need to change radically *if* a neo-liberal, democratic system is to be successfully introduced, *if* this is both possible *or* desirable.

It clear to see there were marked similarities between Fordism and State Socialism and of course there were dramatic differences not least for the fact that within the

Socialist system there was no market mechanism and the market for goods was to a greater extent 'contained', limited to being COMECON. The aim here is not to suggest that the two systems mirror each other, but to illustrate the manner in which the regulatory systems were configured in association with the dominant regime of accumulation. These systems were able to contain tinkering in certain areas but not larger scale alterations. The conceptual apparatus of regulation theory can be used within the post socialist context despite the differences in the regimes of accumulation and the modes of social regulation. Within the USSR the official rules of the game had been defined more clearly, perhaps than anywhere else, but the system could not function without the existence of the shadow economy, therefore the 'unofficial' rules of the game were as pivotal in determining the nature of the Soviet economy.

### ***2.6.3. Post Fordism***

The term Post Fordism is used widely within economic geography, yet debates continue as to whether or not we have witnessed the emergence of a stable Post Fordist mode of regulation, or if it is inappropriate to even conceive of such a thing as 'Post' Fordism, rather than continued crises of Fordism (Tickell and Peck, 1995). It is valid to ask whether (Post) Fordism is a transitory state in itself. There has been comparatively less work completed concerning the function and form of regulatory measures in this time of flexible accumulation (Tickell and Peck, 1995). One of the foci has been examining the move towards 'just in time' and flexible modes of accumulation. Such discourses of 'flexibility' of production run concurrently with discourses of the annihilation of space and time in this era.

The term 'just in time' refers to a form of production management in which companies do not obtain stocks of components until they are actually needed within the production process. Traditionally, under the Fordist system, companies kept large quantities of parts ready for use. Just in time management operates effectively when there are no problems with delivery of parts. If there are delays and the production process is held up it is expected that this occurrence will reveal which parts of the production process are going wrong most often.

When corrected the process will be performed more efficiently. Production costs are lowered using this system, as the cost of maintaining stocks of parts is reduced. In advanced capitalist economies this concept has been applied at all levels within production processes and the success of its application relies upon there being a comprehensive and smoothly functioning infrastructure which supports the rule of law and the regulation of the financial system, at all scales, the regional, national and global (Amin, 1994).

This form of production process is accompanied by more flexible modes of accumulation. The economic conditions for the reproduction of capital and labour are now much more flexible, for example, firms are able to employ more workers on temporary and short term contracts, in direct response to the demand that they have from others for their goods and services.

The growth in number of transnational corporations and their increased ability to move capital freely around the global economy further illustrates the change in the regime of accumulation on the international scale. One of the most obvious ways in

which accumulation is more flexible, in this context, is the way in which corporations are able to exploit the comparative advantages of spatial variations in labour costs. Uncertainty necessarily accompanies the transition from one regime of accumulation to another and it is, thus, inevitable that opportunism and experimentation are prevalent within economic and political spheres. The international economy is characterised as being more volatile and prone to crisis as economic decisions and productive practices in one region, or country, have visible knock on effects elsewhere (for example, the widespread impact of the Asian financial crisis in 1997). Of course, the annihilation of space through time also has implications for the role of the state and the politics of scale (see sections 2.7. and 2.7.1.).

#### ***2.6.4. Post Socialism***

Capitalist systems are characterised by contradictions around the wage relation, which requires regulation through the management of the market. Soviet systems, however, pivoted around the contradiction between the production, appropriation and redistribution of the surplus product (Clarke et al. 1993). This system was regulated and internalised by the state authorities, it required the fusion of socio-political and economic institutional spheres.

By the 1960s, as the performance of the economy seemed to falter considerably, the bureaucrats attempted to reform the planning mechanism by introducing some elements of the market. But the existing mode of regulation could not contain this. The mechanism did not allow for the market and plan to exist together in the same system. This was not just because of the different mechanisms that the two involved

but because of the system that central planning was an intrinsic part of. The party needed to maintain the monopoly of power. Strictly speaking central planning can only function under a system of quasi-military discipline. It was only after the collapse of the system that it was recognised that the system could not be reformed (Åslund, 1989). Of course the plans never effectively regulated the economy totally. It was unable to control every detail, partly because of the scale of operations not to mention the physical distances involved in monitoring progress. Managers of enterprises had no qualms about fixing the information that they were sending back to the planning authorities. If targets were fulfilled or even over fulfilled then an enterprise could guarantee that the quota in the following one or five year plan would be increased without them gaining any real reward for their increases in productivity that could be passed on to the workers or to the management.

By the end of the Soviet era GOSSNAB employed approximately one million workers. Its collapse severed inter-enterprise links before new ones could be established through the market. In the era of Post Socialism it is not uncommon to find enterprises trying to use previously existing links within the economy despite the fact that they might not be the most cost effective and efficient. This highlights the fact that in Russia social networks from the previous era are still shaping the transformation of the economy. Many enterprises that are suffering from the still depressed economic environment are trading with contacts along systems of barter and exchange (Braguinsky and Yavlinksy, 2000).

Whatever attempts there were made at reform, the Party still claimed to ultimately keep the economy in tutelage in order to allow for the continued industrialisation of



the Soviet economy based on extensive forms of accumulation (Lavigne, 1999). But the inability to intensify production even with the aid of foreign loans to purchase advanced western technologies in the 1970s and 1980s coupled with the ideological exhaustion of a way to state socialism resulted in the undermining of the hegemonic power of the Communist Party (Smith and Swain, 1998). It has been argued that, 'socialist systems collapsed... because the institutions of society were insufficiently flexible in adjusting to crisis tendencies that had been concealed for too long' (Altvater, 1993:23).

What is clear is that the regime that has emerged is unstable and prone to crisis and that any current mode or modes of social regulation that exist cannot support the regime. A detailed discussion of the realities of the current situation within the Russian economy is presented in Chapter 3. Furthermore, with the collapse of the Soviet system came a heightened fragmentation of modes of regulation and geography began to matter even more. Of course, increased exposure to the international arena has also served to draw Russia further into the melee of the world economy, forcing it to cope with both the politics of rescaling and the volatility of capital and commodity markets.

## **2.7. Spatial Scale and Regulation**

A discussion of the politics of scale is currently high on the agenda within the field of economic geography, as it should be for those looking at the processes of transformation. Swyngedouw (1992; 2000) has criticised approaches, which have in the past, limited scale to a binary division of the global and the local when it is more helpful to see them in *relational* terms. He further claims that scale is socially

constructed through arenas of conflict, compromise, domination and marginalisation, transformation and stabilisation, just as modes of regulation and governance are too. Following this argument one can postulate that it was the scales of Fordism and the subsequent changes to them, which helped undo the system. Typically the scaling of the Fordist era has been misrepresented as seemingly static in nature when in reality, and through reading the work of Aglietta (1979; 1982), for example, it can be seen as a process revealing the continuous re-articulation of 'nested scales' (Swyngedouw, 1992).

In its original form, regulation theory was applied at the scale of the nation state. As most economies were governed by the state this was perfectly logical. This scale of reference is perhaps even more pertinent when examining the system of state socialism as the mode of social regulation and regime of accumulation were strictly monitored in a conscious bid to maintain the integrity of the USSR. The USSR represented a single economic space and was centrally planned as such. But it is possible to level the criticism that regulation theory fails to recognise uneven regional development within the delimited boundary of the nation state even within the period of Fordism. It would also be misleading to presume that, though tightly bounded in one sense, the Soviet system did not experience processes of uneven development, it certainly did. It is just that the manner in which the differences were 'controlled' gives rise to the opinion that it should be seen as a totally coherent and homogenous territorial unit.

In undertaking this (re)examination of the USSR under the system of state socialism, the importance of uneven development and fragmentation is highlighted

even more; suggesting that there is indeed a gap within original regulation theory and the attention that is paid to such processes. In the Russian Federation it is possible to see different regional responses to the problems posed by the transformation process, different ways of managing the local economy and different local regulatory practices that support these new hybrid markets. The complex geographical legacy of the USSR, which has been bequeathed to the C.I.S., is proving to be crucial in terms of the transformation process (Bradshaw, 1993).

There was a distinctive structuring of space and organisation within the Soviet system. Every region was connected to the centre by the planning mechanism. The spatial implications of this policy were crucial to Moscow in terms of controlling the regions' economic performance, their political relations with the centre, all maintaining the balance of power in favour of central government. All-important decisions were taken outside the region regardless of the resources, skills and identities of the regions concerned (Smith, 1995). In essence then, the USSR was not regulated/planned by region.

Formal regional institutions, enterprises and local authorities just acted as mediums through which decisions made outside of the regions were filtered. Furthermore the institutions within the same region were isolated from each other as all formal relations between them were mediated via the central government authorities. Local informal networks between local and regional authorities and state enterprises developed in response to the imposed system. These networks became increasingly important in ensuring the functioning of the system at the local level, whilst undermining the integrity of the national system. But the informal networks were

established on the basis of trying to deal with the planning system not by a strategic and collective vision of local economic development (Smith and Swain 1998).

With the new system, regions and regional enterprises, now find themselves left without the previous formal networks of connections and planning that they had benefited from under the old system<sup>20</sup>. It is clear to see that regional units have become increasingly important within the political economy of the Russian Federation. Proof of this came when President Putin, obviously aware of this fact, introduced a new level of political control at the federal level, which is aimed at exerting more control on the actions of political and economic agents within the regions (Brown, 2001)<sup>21</sup>.

As Fordism depended upon the spatial integrity of capitalisms organised primarily at the scale of the nation state, then the intensification and proliferation of the internationalisation of exchange and competition, as documented within regulation literature, led to a rescaling. What seems to have emerged out of this crisis is a contested reconstruction of scales (Swyngedouw, 1992), which are more global than national, yet at the same time more local than national (see also Cox, 1997). In response to this the intervention of the state has had to be rescaled to either the international level, (e.g. NAFTA, EU) or down to the region or city. It is apparent that in the Post Socialist context, the demise of the Soviet system, and therefore the collapse of the dominant regulatory order, resulted in the need for a re-articulation of scale, perhaps along similar lines to those of advanced economies, as the former centrally planned economies enter the global arena of capitalism.

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<sup>20</sup> See chapter 3 for a discussion of the 'regional dimension'

<sup>21</sup> For a discussion of the regional dimension see Chapter 3.

The interaction of the global economy, the nation state and the region is a very complex one and one that varies over space and through time. Starting from the point of looking at the mode of social regulation and regime of accumulation might provide a valuable way in which to examine the processes through which scales are reconstituted, especially with regard to the Russian Federation and its process of transformation.

### ***2.7.1. Globalisation and regionalisation***

In any discussion of the shift from the system of Fordism to Post Fordism or the Soviet system to the Post Soviet, it is crucial to acknowledge the issue of globalisation, the restructuring of the global economy and the process of regionalisation. The concept of globalisation is commonly understood to describe the trend of increasing global economic and political integration, which has, and is continuing to result in extensive alterations to the frameworks for international politics and economics (Cox, 1997; 1993; Gordon, 1988). Goods, services, capital and ideas have always moved across national boundaries, but it is argued that the acceleration of this process over the past twenty years marks a clear quantitative and qualitative change from before (Ohmae, 1995).

Some have characterised the 'triadisation' of the world economy (Ruigork and van Tulder, 1995), while others have placed greater emphasis on the role that IFIs play in shaping and regulating economic development processes (Hirst and Thompson, 1996; Boyer and Drache, 1996). Internationalisation, however, also seems to be accompanied by co-existing local and globalising forces, which fuel the uneven development of capitalism (Grabher and Stark, 1997:16). The global-national-

regional nexus consequently plays a role in the development of uneven transformation.

Therefore, processes of regionalisation have been seen to be accompanying the intensification of the processes of globalisation. The process of regionalisation can be understood to mean the transfer of power from the centre to the regions (Amin and Robbins, 1990). This occurs at different scales. For example, at the international level effective trade blocs have been secured within Europe (EU), the Americas (NAFTA, LAFTA) and Asia- Pacific countries (ASEAN), to name but a few. The process is also happening within national boundaries challenging the central state's monopoly of power. Here the processes of regionalisation involve the disintegration and decentralization and ensuing reorientation and reintegration (Bradshaw, 1994) of the geographical and political area, of the economy and of the legal and military power structures. This is what is occurring within the Russian Federation.

Thrift and Amin (1994) see these global forces as 'fields of action' producing a differentiated geography of opportunities both positive and negative as well as new territories internal to the global political economy. They further argue that the ability of nations and regions to become or remain self-regenerating growth poles will depend on their success in internalising knowledge to competitive ends and to upgrading institutional capacity. This then refers to the need to focus on the mode of regulation to manage transformation, not just the regime of accumulation.

Some might see the tendencies of increasing globalisation and regionalisation as a long-term crisis that has lasted for at least two decades. Tickell and Peck (1995) use

regulation theory to discuss the role of the states in the construction of social regulation as a stable form of governance during the Fordist period. However, they still acknowledge that as yet regulation theory, in its more original form, has not been used to offer an explanation of the processes of transition (Smith and Swain, 1998). In fact the question still remains as to whether or not we have really witnessed the emergence of a relatively stable mode of regulation through both space and time.

It has been possible, however, to observe in the advanced industrialised capitalist countries a hollowing out of the practices of 'taylorisation' since the 1970s. New solutions have been found to deal with the slump in productivity gains, in amongst other things, new forms of vertical integration, disintegration and quasi integration. Through the internalisation of production local, regional and national production sites are put into a position of mutual competition. If the processes of globalisation and regionalisation become dominant, as they seem to be, then this calls into question the level of national intervention and regulation and competencies, something the Russian state must take into consideration as well, something it is having to consider in its continuing negotiations with the WTO for membership. Obviously the scope and extent of national regulation is changing and new institutionalised and organisational specifics will develop. Political and social regulations draw on the socio cultural traditions that govern agency.

The new political economy that is emerging recognises that economic systems are socially and discursively constituted, yet, they are still governed by socio-political institutions. Further to this, Grabhner (1993) argues that systems depend upon a

variety of organising principles and mechanisms. Of critical importance to theorists of transition is the recognition of the path dependency of systems (Putnam, 1993; Hausner et al. 1995). Regulation theory can be comfortably set along side more contemporary debates concerning the 'social embeddedness' of economic actions. The objective of both of these theories is to engage with social relations and institutions, which 'regulate' or 'govern' the economy (Smith and Swain, 1998).

All the major IFIs, including the IMF, have been involved in trying to influence a speedy transformation process in East Central Europe and the former Soviet Union. The premise lying behind this was that a system of capitalism could be imposed successfully on the Post-Soviet landscape. The thinking was that as the capitalist regime of accumulation pervaded the newly exposed economies it would stimulate the emergence of the necessary institutions, regulations and practices. Of course, any transformation that has/does occur is variable through space and time and this can be attributed to the social relations in which the activity is embedded. Smith and Swain (1998) have summarised the claims of those adhering to this alternative view. Socio-economic change is in this case, driven by agents, who are in negotiation with formal and informal institutions. Change is path dependent, which acts to restrict but not preclude strategic choice, it can therefore be path shaping.

## **2.8. The mode of social regulation under the spot light**

With the start of the transformation process came expectations of a sweeping away of the old mode of regulation which was to be replaced with a new market inspired, globally influenced mode. The reality has been somewhat different (Hanson, 2000). Change had seen the emergence of 'open,' 'virtual' and 'shadow' markets, but little



clarity in terms of the 'complementary' formation of a new and stable mode of social regulation (Gustafson, 1999)<sup>22</sup>. In fact, many of the regions, in a direct response to the exposure of the Russian Federation to the global economy, have endeavoured, often with the aid of IFIs, to create an independent identity on the global stage. This has become almost axiomatic in the regions' need to compensate for the failings of the Russian federal system.

Stimulating the emergence and solidification of a new and stabilising mode of regulation will not be easy for Russia. Particularly if what is expected is too alien to the previously existing social relations. Time will be a key factor in this process. But what does this process of forming a new mode of regulation entail on the ground level? It must involve defining central-regional relations, some form of local reconstitution and probably some liaison with IFIs.

## **2.9. Conclusions**

This chapter has set out to explore the conceptual apparatus of regulation theory and to link it with approaches to governance in order to set up a theoretical framework for this research. It has been argued that an understanding of the concept of the mode of regulation and its application to understanding the post socialist situation is very useful when trying to examine the process of transformation. Considering the mode of social regulation necessarily involves an analysis of the processes of governance within the Federation.

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<sup>22</sup> See Chapter 2 for a discussion of the markets that have emerged.

A grasp of the *complexities* of the networks of social relations and the *embeddedness* of them is vital when considering the decisions concerning the giving of advice and financial aid which IFIs make. One thing that will become clear through this research is that there might *not* be a case for suggesting that there is only one all encompassing mode of social regulation that exists within the bounds of the nation state. Furthermore, it is important to consider that through the different articulation of the modes of social regulation and/or governance that they will be configured differently through space and time. There can, therefore, be no blueprint for change. Moreover, the objects of regulation (the regime of accumulation) do not fully pre-exist the process of regulation just as objects of governance are only known through attempts to govern them.

## **Chapter 3**

### **Problems with ‘transition’: hybridism, embeddedness and institutions**

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#### **Introduction**

This chapter examines notions of ‘transition’ and ‘transformation’ in semantic, theoretical and practical terms. Understanding the reality of the transition/transformation process is critical when examining the work of IFIs working in Russia, as it provides the background to the nature and way in which projects have been managed since the collapse of communism. The problematisation of the above terms helps to provide a frame of reference within which to look at the key transition/transformation processes that have occurred in Russia since 1991, as well as providing the context in which policy decisions were made with regard to Russia. I argue that the danger in abiding by the notion of ‘transition’, and adhering to a belief in so-called ‘transition orthodoxy’, is that one is blinkered to the realities of the evolution of Russian economic, political and social networks/institutions.

This has implications for those actors, who from the outset, believed in this orthodoxy and tried to (re)produce a system based on an unrealistic blueprint for economic and political transition along western capitalist lines. Until 1998, transition orthodoxy and its four related golden ‘pillars’ (liberalisation, stabilisation, privatisation and internationalisation) dominated policy decisions made internally and externally to Russia with respect to its ‘development’ and went fairly

unchallenged<sup>1</sup>, at least within the policy making communities. It was at this point that the financial crisis exposed the fragility of the new Russian state as it supposedly matured along its 'predetermined' transition trajectory. At this juncture reassessment became essential and as a result 'transition logic' became widely challenged. The question, 'who lost Russia?' became asked more frequently by academics, policy makers<sup>2</sup> and politicians.

Some observers have recognised, even prior to 1998, the evolution of a hybrid system (Altvater, 1998), which possesses an influential 'virtual economy' (Gaddy and Ickes, 1998a; 1998b; 1999), hitherto unexplored theoretical territory for economists working in western capitalist economic systems. It is also possible to identify important differences in terms of the intrinsic nature and way in which Russian 'institutions' are evolving over time. Therefore, the way in which the economy is regulated and capital accumulated is not as expected. The oft-quoted concept of 'path dependency' (Putnam, 1993) does hold much merit, but it should not be relied upon to offer a complete explanation of the Russian predicament. The embeddedness of institutions is indeed a critical explanatory factor in understanding the transformation process, and the point at which Russia stands today. However, so too are the highly variable intersections of spatial and temporal forces/processes which affect any location. The path of transformation, it can be argued, is to some extent determined by the range of options available in any given space and time.

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<sup>1</sup> Of course there was debate within organisations concerning the merits of transition orthodoxy and its prescriptions but these are not well documented. Interview evidence suggests that the debates prior to 1998 focussed not on whether or not these four pillars were essential but rather how and at what speed they should be implemented.

<sup>2</sup> Predominantly those policy makers based in Washington D.C.

### 3.1. Transition or transformation?

The debate surrounding the use of the term transition or transformation continues. However, interested parties naturally fall in to two groups, one group accepting the term transition and the other faction preferring transformation. But it is not as simple, or black and white as this, there are of course any number of ways in which people have accepted the use of one or the other term, in a more active or passive manner. Moreover, it does not seem uncommon that, for example, different disciplines or audiences commonly accept one or the other term. But before entering into a discussion of why these differences matter, the terms need to be 'unpacked' in more detail.

'Transition' implies that some form of 'ideal' end state, or ultimate destination, exists and that there is also a defined path along which that destination can be reached. It is possible to see transition as being a twofold process that of endogenous modernisation and of exogenous opening up to external markets and of integration within the capitalist world system. Janos Kornai is explicit in stating the values, as commonly perceived, of the transition process:

'It would be desirable for the structure of society to resemble in its main features the structure of the most highly developed capitalist countries. A broad stratum of independent, autonomous business people and entrepreneurs should emerge... All this transformation in the structure of a society should be coupled with the modernisation of production and other activities of society, through the spread of up to date technologies and life styles' (Kornai, 1992:33)

I argue that the term is not usually used with reference to the multiple and contested changes affecting on Russia, it is not nuanced enough to be suggestive of the multiplicity of changes that occur in reality, unlike the term transformation.

Both terms imply an acknowledgement of the move away from state socialism, but the difference is perhaps strongest in suggesting what path to follow and what that destination might be. Transition suggests a move from something to another along a predetermined trajectory. 'Transformation', however, seems to leave some more room for manoeuvre, suggestive of the change from one state to another, but not implying that this proceeds along a specific path, it conjures up images of multiple transformations occurring in any number of directions. Furthermore, it is debateable as to whether the existence of some kind of final state is implicit in the term transformation. Yes, there is change from one form to another but I would argue that this does not imply that the process of change is over. The existence of any 'state' of a system is transitory in nature. Nothing is static.

By simply making either of the terms plural one could acknowledge any number of transformations that are occurring spatially and temporally. Change can then be acknowledged to occur in multiple spheres at multiple scales. While the concept of a 'triple transition' has been explored (see Bradshaw and Hanson, 2000 and Offe, 1991), I would argue that the term transformation lends itself better to the acknowledgement of the multiplicity of changes both spatially and temporally mainly because of the undetermined nature of paths of change.

'... Across the region, we are seeing a multiplicity of distinctive strategies; within any given country, we find not one transition but many occurring in different domains – political, economic and social – and the temporality of these processes are often asynchronous and their articulation seldom harmonious...' (Stark, 1992: 301)

It might just appear to be a matter of semantics but the IFIs as well as many academics, particularly economists, and political scientists, have widely accepted

the term transition mainly because the term was generated within these communities. It would not be unfair to suggest that the usage of either one of the terms implies an individual or community is assuming some kind of ideological position with regard to the 'development' of the so-called transition economies.

Largely speaking, use of the term transition might suggest some kind of belief in the merit of neoliberal economic and political policies but the same can be said for many of those that prefer to refer to transformation. The fundamental difference lies perhaps in the approach to the 'development' of these economies. The appropriateness of the prescriptive nature of policy advice and its implementation and an acceptance of the complexity and multiplicity of changes, which have combined to form what I argue, is a hybrid system.

It was widely accepted between 1991 and 1998, by the policy-making community, that some kind of transition for Russia was both necessary, one could in fact argue it had already started,<sup>3</sup> and desirable. The optimal end state was a democratic political system operating in conjunction with an economic system run and regulated along western capitalist lines. This belief translated itself into some kind of transition orthodoxy, which supposedly would help all concerned follow the appropriate transition trajectory.

Looking at the notion of transition orthodoxy and briefly, at some of the key issues that have arisen from its attempted implementation, provides the background to the work of IFIs trying to influence the transformation process in their role as external

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<sup>3</sup> For a discussion of the economic decline of the Russian Federation see Åslund A (1991) *Gorbachev's Struggle for Economic Reform*, Ithaca, NY: Cornell University Press; Easterly, W. and Fischer, S. (1995) 'The Soviet Economic Decline', *World Bank Economic Review* 9 (3): 341-71.

agents (see Chapter 4). It is also obvious that there is not such a clear-cut distinction between internal and external agents involved in the reform and restructuring process. The two are closely intertwined, which again raises some interesting issues with regard to the imposition of beliefs from external agents.

### 3.2. Transition orthodoxy

In short, 'transition orthodoxy' represents the notion that there are specific changes that post-socialist states need to make in order to move towards becoming a fully functioning market economy. The work of international financial institutions, such as the IMF and World Bank, as well as that of many economic advisers to Russia, following the demise of communism, typifies the adherence to this so-called 'orthodoxy' (see Åslund, 1992; Blanchard et al. 1991; EBRD, 1996; Lavigne, 1991; 1999; Stiglitz, 1998a; World Bank, 1996; 2002a).

Åslund (1995) in his book, 'How Russia Became a Market Economy', details four processes that Russia needed to adopt in order to become a market economy. Åslund was not of course the only individual to believe that these changes were essential to secure the transition, but he himself played a key role in offering advice to Yeltsin's government and worked extensively in Moscow and Washington D.C. with other advisers, academics and institutions in forming the reform agenda. The four changes are: monetisation of the economy, introduction of hard budget constraints, de-politicisation of ownership and depoliticisation of allocation. To facilitate these changes four 'pillars' have been identified: liberalisation, stabilisation, privatisation and internationalisation. If implemented in the right



manner and the right sequence, then the conclusion is that the transition to a market economy will be successful.

Before looking at the four pillars individually, the following box details the main points of the Russian Memorandum of Economic Policy, launched January 2, 1992. The team of reformers who put the proposal together were certainly doing so in an attempt to curry favour with the IMF, but they also held a belief in the appropriateness of such measures for Russia's transition to becoming a market economy.

**Figure 3.1. The four pillars**

**Chasing the four pillars: Memorandum of Economic Policy**

- Liberalisation of prices: Gaidar frees prices on the majority of goods and services, excluding energy, rents, medicines and some basic food items (90 per cent of consumers prices and 80 per cent of producers prices).
- Liberalisation of domestic and foreign trade, excluding energy carriers, which were regulated via a quota system.
- VAT introduced at 28 per cent, later reduced to 15 per cent
- Stringent monetary policy announced: based on the maintenance of high interest rates, budget expenditure cuts, minimum wage and pensions regulation. Incomes policy is stopped.
- Privatisation programme is to be officially started
- A single fixed exchange rate for the ruble is to be introduced by 1992

Source: Lavigne (1999)

### **3.2.1. Liberalisation**

Liberalisation: involves the abolition, or reduction, of regulations and restrictions imposed on economic activity, on trade and prices, production and enterprise. Yegor Gaidar and his team, working in collaboration, with amongst others, staff at the

Harvard Institute for International Development and other organisations such as the IMF, identified the liberalisation of prices to be crucial in the reform process, and a key catalyst to the economy to commence its transition to a market economy. Gaidar and his team of reformers perceived the freeing of prices to be technically straightforward. It was shown that prices could be freed overnight stimulating producers and consumers to rely on market mechanisms to guide their activity.

Under the Soviet system, prices had been tightly controlled and 'distorted' to help fulfil non-market driven goals. The connection between prices, supply and demand was not present under this system as it is in a market economy. Production and trade priorities were set by the state, predominantly via the state planning machine, GOSPLAN. The prioritisation of producer goods over consumer goods was commonplace and a significant sector of the economy was devoted to what is known as 'purely socialist production'.

Given this background, it is obvious that the liberalisation of prices was inevitably going to cause massive upheaval within the economy, as both consumers and producers faced the implications of the imposition of the 'new' pricing mechanisms. Producers, for example, were faced with the harsh reality of market logic. Labour, capital, raw materials and the means of production cost more as their 'real' value became apparent. Of course, one of the biggest problems that enterprises had to face was that supply was now to meet demand, and therefore some sectors of the economy faced decline while new ones emerged, particularly in the service sector (for example; the explosion in the number of currency exchange offices).

In order for the new actors to compete effectively, theory says that it is critical that the state withdraw from productive and distributive activity as much as is practicable. The optimal speed at which to do this remains controversial, those preferring shock therapy tactics would encourage this to be done as fast as possible. Privatisation is a key part of liberalisation but so is the removal of state subsidies for economic activity.

Implementing hard budget constraints<sup>4</sup> has been shown to be one of the failings of the liberalisation policy in Russia since 1991 (Hanson, 2000). Transition orthodoxy also suggests that the state should be removed from the process of the allocation of the means of production and goods and services. Instead, markets and prices should fulfil the allocatory function.

Reality, of course, teaches us something else and whilst prices were liberalised in the early 1990s and liberalisation was declared complete, its early completion remains questionable. Soft budget constraints remained prevalent, as did state activity in some sectors of the economy. Prices became free in the sense that they are no longer determined arbitrarily, unlike under the Soviet regime, however, the state has not withered in terms of its role in production and distribution activity as much as might have been hoped<sup>5</sup>. 'Hoped' that is, according to the rules of transition orthodoxy, whether that was ever possible or desirable is another issue, which will be tackled later.

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<sup>4</sup> Hard budget constraints can be understood as the circumstances in which an enterprise faces the full force of market mechanisms without the 'protection' of soft budget constraints, such as subsidies, either in the form of direct capital transfers or, for example, in terms of the acceptance of payment for goods or services received in non-monetary form.

<sup>5</sup> For example, the state is still involved in pricing and subsidising

### 3.2.2. *Stabilisation*

Stabilisation is closely related to the process of liberalisation. Advice from institutions such as the World Bank and IMF was for the Russian reformers to concentrate on achieving macro-economic stabilisation first, and then to think about privatisation. But putting brakes on the almost spontaneously occurring process of privatisation was going to be difficult. However, stabilisation did remain a priority of the Gaidar team in the early 1990s.

The term stabilisation is used within transition orthodoxy to refer directly to the reduction in government spending and tightened money supply. In freeing prices the economy is exposed to a price-wage inflation spiral, which can run out of control. The likelihood of such a spiral occurring is higher when a monetary overhang, dating from a period of suppressed consumer demand exists within the economy<sup>6</sup>. Such an overhang was prevalent within the Russian economy immediately following the demise of communism. Whilst the liberalisation edict stresses the importance of the reduction of state intrusion in the economy, at the same time, inflationary pressures can put more pressure on a government to continue to maintain the existence of soft budget constraints, via subsidy and soft credit and in some instances non-monetary exchange. This was very much the case in Russia.

It is necessary for an economy trying to implement a stabilisation programme to tighten the money supply, so that firms become more market orientated: interested

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<sup>6</sup> Monetary overhang refers to the excess of actual money holdings by households and enterprises over the desired amount. An overhang can develop only when the general price is controlled and the parallel goods market (black market) is circumscribed. If prices are free they could increase to reduce the real stock of money to the desired amount. If capital flows are uncontrolled then excess is exchanged for foreign currency. In this case there can be an increase in assets without there being an increase in consumer prices.

in profits, competitiveness and market shares; as well as being a crucial factor in trying to keep a lid on inflationary pressures. Another feature of a stabilisation programme is to introduce a coherent tax system that will help government to increase its income, and in theory, therefore, increase its potential spending power to help alleviate some of the most urgent affects of systemic transformation and the predicted transition recession. Experience showed, however, that transition recession would bite long and hard before the Russian government could increase its revenues to help alleviate the situation.

### **3.2.3. Privatisation**

Privatisation is perhaps the most important pillar of transition orthodoxy, the Russian case was certainly no exception and the manner in which the process was 'managed' has been the subject of much controversy and criticism. The process of privatisation and the Russian experience will be tackled in a little more depth in comparison with the other three pillars as many interesting points, and most obvious points of relevance to this discussion have arisen from it. Via such a discussion, it is possible to highlight, the complex nature of transformation and the problems associated with trying to impose a 'transition orthodoxy'<sup>7</sup>, which is not necessarily going to provide the 'desired' end result.

Neo-liberal economics attaches great importance to well defined property rights as a determinant of economic success. Logic suggests that when property rights over a productive asset are clearly defined, and the person who decides to employ this asset bears the full costs and at the same time is able to enjoy full benefits, the asset

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<sup>7</sup> 'Transition orthodoxy' has been imposed in 27 different economies to date.

is then deployed in the most productive manner. 'This argument provides the ultimate rationale for relying on private property as the basis for the efficient organisation of economic activity in society... Conversely it is commonplace to blame "poorly defined" rights for bad economic performance, including that of communist Russia' (Boycko et al. 1995: 19).

Of course, privatisation is not just about the promotion of profit motivation, (and therefore, the promotion of efficiency and capacity restructuring) but also about the de-statisation of the economy. As was the case for liberalisation and stabilisation, logic dictates that the state should withdraw from control over economic life, as it distorts and interferes with the functioning of the free market. Full privatisation would, therefore, require the disengagement of the state in all sectors of the economy, including, eventually, the public economy of education, health, housing, utilities and welfare provision. Before privatisation can reach this point however, there needs to be the existence and fair and enforceable property rights.

In the spring of 1992, Anatoly Chubais<sup>8</sup> pushed through government and parliament a mass privatisation programme, which was based on giving vouchers to purchase shares in Russian industrial firms to their managers, employees and the public. Maxim Boycko, who played an instrumental part in the process, working in the State Ministry, claims that by the time that the programme officially ended on July 1, 1994, two thirds of Russian industry was privately owned and apparently some 40 million Russians owned shares in privatised firms and mutual funds.

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<sup>8</sup> In 1991 President Boris Yeltsin appointed Anatoly Chubais to run the newly formed State Committee on the Management of State Property (known by the Russian acronym GKI)

In their book 'Privatising Russia', Boycko, Shleifer and Vishny (1995) identify three fundamental beliefs held by the people that put the privatisation programme together; they themselves were involved in this process. They are as follows.

First, Russian people, like other world citizens, were 'economic agents' who responded rationally to incentives. The privatisers, they claim, rejected the widely held view that Russians lacked entrepreneurial ability and were unusually suspicious of wealth. They go on to suggest that this belief implied that Russia did not need a third way of organising its economic activity, such as market socialism or heavily regulated capitalism to 'compensate for its alleged cultural specificities and deficiencies' (Boycko et al. 1995: 9).

This appears to have been an idealised view and whilst it would certainly be wrong to say that Russian citizens acted 'irrationally', in reality many of them might have been seen to be, when looking through the lens of western economic theory. But did the reformers really think that people's mindsets would change overnight? Does this rather naïve belief in itself, support the argument that from the outset those constructing the transition agenda were misguided in their judgement?

I would argue, 'expected' responses by citizens to the reform process do not adhere to 'perfect' economic logic. First, because of the shock of reform at the time and second, because of the legacies of the past. Furthermore, nor were the privatisers ever likely to have the tight control over the process that they might have preferred mainly due to the scale of the operation and the fast crumbling economic system. The entrepreneurial ability some Russian citizens have displayed throughout

transformation has certainly been impressive. But perhaps the privatisers were looking for 'perfectly legal and rational' entrepreneurship, but how so given the inadequate establishment of institutions to support these market reforms in the way that was supposed to make the Russian economy more akin to that of one in the advanced capitalist world? Expectations on the parts of both the reformers, and those attempting to affect on the transformation process, and those living the multiple transformations do not necessarily concur, therefore this issue of 'expectations' is returned to in later chapters.

Second, the team believed that political influence over economic life was the fundamental cause of inefficiency and the principle objective of reform was, therefore to depoliticise economic life. They upheld the belief that when enterprises are subject to political influence they engage in inefficient practices. Boycko et al (1995: 11) in fact argued that 'Russian privatisation succeeded because the privatisers focussed on this primary objective and were prepared to compromise on less important issues'. It was a political goal to make reform irreversible.

The inefficient productive practices that prevailed during the Soviet period have been well-documented<sup>9</sup> and political influence inevitably continued to have an impact on such practices. If Russia was to become a market economy, then this system needed to change. However, it is clear that Russian privatisation was not an unqualified success, and that privatisers focussed on this primary objective of depoliticising economic life. The debacle at Gazprom in 2001, and President Vladimir Putin's personal intervention concerning the appointment of a new

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<sup>9</sup> See, for example, Braguinsky, S and Yavlinsky, G (2000) for a detailed discussion of the political economy of the socialist state including aspects such as models of innovation and incentives and producers behaviour.



Chairman to the energy giant's board, lends support to the theory that economic life is not really depoliticised<sup>10</sup>. In fact, the overlap between political and economic life seems more pressing in Russia today especially when one considers the influence that so-called oligarchs have held in the Kremlin, though this is less the case under Putin than was the situation with Yeltsin.

Third, the consensus amongst the privatisation team was that the Russian Government did not really own the assets that needed to be privatised.

'Various "stakeholders", including the managers and the employees and the local governments, exercised substantial control over the allegedly public assets and could stop privatisation if they chose to. In return for their agreement to privatise stakeholders demanded significant payoffs...(.) In designing the programme, the privatisers consistently and generously recognised stakeholders' claims, and thus ensured their eventual support for privatisation' (Boycko et al. 1995: 13).

Some might read this last statement as being contradictory to the first, given who the stakeholders were during the start of the official privatisation process. If, in some cases at least, stakeholders were bought in order that their eventual support for privatisation was secured then this might be problematic, when simultaneously trying to depoliticise economic life. While many individuals made the move from a more politically orientated to business life, the connections to government and old networks of course remain, suggesting that the break between the economic and the political realms would be at best problematic. In effect, the voucher privatisation scheme of 1993, despite its widely proclaimed target of 'people's privatisation', amounted to handing over the assets formerly owned by the state to insiders<sup>11</sup>.

<sup>10</sup> See articles in Pravda, The Russia Journal, the Moscow Times, St Petersburg Times and Economist July 2001 for details and discussion of this affair.

<sup>11</sup> For example, Aoki writes: 'Insider control... appears to be a generic potential in the transition process, evolving out of the inheritance of the communist regime... The gradual retreat of the central

Much of the privatisation that has taken place has been 'spontaneous'<sup>12</sup>, leading to ambiguities of ownership. Problems of legal uncertainty have been further compounded by the limited development of a market infrastructure, and legal frameworks in particular. While workers and managers often own the majority of shares in a privatised enterprise, responsibility for survival still seems to reside with the state. Of course, such attitudes to ownership accompanied with the persistence of soft budget constraints have served to hinder the Russian economy from functioning fully as a market economy.

The case of the privatisation process underlines perhaps one of the key issues with transition orthodoxy, as understood in this piece of research, that inadequate attention was given to 'institution building', prior to, and during the reform process, which would then support the transformation process. In other words the sequencing of reform processes did not work.

#### ***3.2.4. Internationalisation***

Matters are further complicated for reformers as they try to apply the fourth pillar: internationalisation. This fourth pillar has a large impact on the other three and (re)enforces the need for their implementation, and in the Russian case, it made the consequences of the other prescriptions more severe and painful. For example, an economic system/state wishes to engage in more economic activities in the international arena, via trade, investment and lending then it is necessary for that

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planning authority ended with its sudden dismantling. The managers of the SOEs [State Owned Enterprises] who had already carved out substantial control rights from the planning apparatus further enhanced their rights in the vacuum created by the collapse of the communist state' (Aoki and Kim, 1995: 7-8).

<sup>12</sup> See Slider (1994) for more details concerning the privatisation process, and in particular the allocation of shares.

entity to possess a convertible currency, and preferably a stable one. This of course has implications in terms of needing to suppress hyperinflation, and to keep the money supply tight.

In Soviet times, all foreign economic activity was controlled by the state. It set quotas and awarded export licences. Foreign economic activity was related to domestic policy goals. The decision making process was controlled by the state not by the enterprise. During this time trade was mainly orientated towards other socialist countries, particularly members of Comecon, though there was some expansion of East-West trade as early as the 1970s.

In order to become a fully-fledged market economy, transition orthodoxy suggested that the Russian economy, as others, needed to experience competitive pressures associated with international trade, investment and finance activities. There was, and still is, pressure to reduce tariff and non-tariff barriers to trade so that access to Russian markets is possible. The other side of the coin is that internationalisation, coupled with the imposition of a system of hard budget constraints, should force Russian firms to be more competitive, both domestically and internationally. Russian firms must also be able to engage in foreign economic activity and to attract foreign investment, and amongst other things, establish joint ventures with foreign partners. This should in theory, all be done with minimal interference from the state, though the latter naturally has a regulatory role to play.

Another key issue for the Russian government has been seen to be the need to implement the rules and standards of international regulatory systems. The reasons

for this are twofold. First, the government has been under pressure to improve standards to international levels, in light of the conditions it has needed to fulfil in order to receive assistance for reform and restructuring. Second, in seeking membership of institutions such as the World Trade Organisation (WTO) these reforms are essential.

The Russian economy has been opened up to foreign firms, the activities of international financial institutions, other bi-lateral donors and international organisations. As will be demonstrated in the following chapter, there was a boom in the provision of policy advice and institutional activity with regard to Russia and the challenge of managing the transition. The activities of international actors and reformers within Russia, forced the realisation of the fourth pillar of transition orthodoxy, that of internationalisation.

### **3.3.The real experience: not transition but nomenklatura privatisation?**

'There is of course the view that what was happening in Russia was not really 'transition at all'. The Soviet system had never really vanished; it was taken over and adapted. The old nomenklatura became the new owners, and behind the façade of privatisation they stripped the best assets of the former Soviet economy and extracted rents from the remainder. Russian politics became the story of powerful business clans doing battle for the control of state favours and subsidies, united only in opposing any changes that might weaken their power, while society sought refuge from taxmen and Mafiosi by withdrawing into the shadow economy' (Gustafson, 1999:14).

Observers such as Gustafson (1999) and Stiglitz (1998a; 1998b; 1999) do not contest the fact that Russia had come a long way to operating along free market lines, but would disagree with Åslund's (1995) belief that Russia had become the type of market economy prescribed by the majority of western advisors and IFIs at

the time. What Russia in actual fact possessed/possesses is some form of 'crony' capitalism.

'The very things that were positive in the transition narrative were negative for those who rejected it. The new institutions were little more than fronts; the new skills mainly serviced Western speculation and the laundering of mafia profits; the middle class was a pseudo-class, enjoying a one-time bounty from exports of non-renewable commodities. The apparent stabilisation of society and the turnaround of the economy were largely statistical artefacts, while the suppression of inflation and the strengthening of the ruble by 1997 were achieved only by a massive withholding of pensions and wages by the government. Transition was not simply wrong; it was a hoax' (Gustafson, 1999:14).

Of course, the danger lies in maintaining this perception beyond its period of validity. Today, the situation remains complex and there are multiple factors that can be used to try to explain Russia's seemingly awkward position, somewhere between a rock and a hard place. Perhaps what looms largest in the memories of analysts and investors is the financial crisis of 1998, which underlined the fragility of the 'real' progress of transition. This continues to inform today's cautiousness with regard to assessing Russia's so-called 'progress'. Despite an apparent economic recovery, there is still concern that this is due to helpful exogenous factors rather than real qualitative change.

### ***3.3.1. August 1998: a reality test***

The financial crisis in August 1998 can be seen as a critical test because it revealed the deep flaws in the transition narrative<sup>13</sup>. Alongside other factors, the internationalisation of the Russian economy meant that, like other internationally

<sup>13</sup> For Western accounts of the crisis see 'The Russian Crisis', in European Bank for Reconstruction and Development, Transition Report 1998, London: EBRD pp12-19. For Russian perspectives on the crisis see Ivanter I, Kirichenko N and Beletskii I (1999) 'Schast'e v dolg ne voz'mesh', Ekspert, January 24; Illarionov A (1998) 'Kak byl organizovan rossiiskii finansoi krizis', Voprosy ekonomiki. Vol. 70, No. 11, pp20-35

exposed economies, it was vulnerable to the knock-on effects of the Asian crisis. But months of falling oil prices and the exit of capital from the economy also served to severely weaken the public and private sector in Russia. Commentators have pointed to the immediate cause of the crisis in Russia to the Federal Government's simultaneous devaluation and default, caused by the government's short term borrowing in order to offset its chronic budget deficits and the ever-increasing burden of debt service. At the time of the crisis debt servicing swallowed approximately one third of all government revenues.

The government had failed to curb spending and raise revenues, which caused tension within the government. The weakness of the state in combating tax evasion was also highlighted as an explanatory factor for the low revenues. So too was the continued ability of enterprises to make payment in barter form. The rest of the economy, the virtual economy, and the cities and regions outside of the financial centres, were less affected. This in itself illustrates the concentration of wealth in certain cities and regions, namely Moscow and St Petersburg, suggesting that transformation whilst occurring throughout the national economy, was not perhaps benefiting the majority.

Russia's very vulnerability to world commodity price fluctuations does bear witness to how open the economy had become. In this sense internationalisation had been achieved. But what underlay it was not so stable. Many enterprises in the virtual economy<sup>14</sup> had purchased government bonds but in response to the crisis, rather

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<sup>14</sup> See section 3.4.1. in this chapter for a more detailed discussion of the virtual economy.

than folding, they behaved in a 'market' like fashion and following ruble devaluation increased their level of exports and/or filled import gaps.

### ***3.3.2. Real problems: tunnelling, corruption and anti-competitive practices***

Analysts observing Russia and her economic transformation have always noted that 'tunnelling' has been a pervasive problem. Tunnelling can be defined simply as the legal expropriation of income and assets belonging to minority shareholders (Johnson, La Porta et al. 2000). The most common forms of tunnelling that have occurred in Russia include the diversion of cash flows, transfer pricing and asset stripping. It is common for the managers to be the ones engaging in the process, usually at the behest of key shareholders. Tunnelling is subtly different from rent seeking, another oft quoted process to have besieged the Russian economy since 1991. Rent seeking instead refers to the attempts of enterprises to bargain for some kind of advantages via privileges or subsidies granted by the government. Rents have been extracted in the Russian case over a wide cross section of society, whereas the impact of tunnelling is on a few shareholders, or the state if the latter is a shareholder in the enterprise.

It is then clear to see that this widespread process causes instability and further fosters a lack of trust within the economy, especially given the less than consistent legal system which could not offer protection. But more importantly, it acts not only as a potential barrier to foreign investment, but also goes some way to explain the infamously high levels of capital flight. The call from analysts and IFIs is that the government must act to curb this, but of course questions remain as to who in fact is benefiting from such a practice, and therefore, in whose interests it would be

to change the laws. This is a frequent problem when discussing reform processes in Russia, because those responsible for implementing change are the ones benefiting the most from the current situation.

Anti-competitive practices and corruption stand to mar the investment climate both for potential domestic and for overseas Russian and foreign investors. Taxes and regulations in Russia are consistently quoted as being among the most important impediments to expansion by new enterprises (World Bank, 2002a: 59)<sup>15</sup>. Much research now being conducted by analysts working for IFIs suggests that corruption<sup>16</sup> remains one of the biggest obstacles to growth of all enterprises as is access to infrastructure services which, in many situations, are controlled by regional or federal authorities (Hellman et al. 2000a; 2000b).

Johnson and Kaufmann et al. (2000), produced evidence suggesting that in a comparison of cross country averages it is possible to see that managers in Russia and the Ukraine experience a more difficult situation than their counterparts in other 'transition' countries, including: Poland, Romania and Slovakia. For example, they face higher effective tax rates, worse bureaucratic corruption and a greater incidence of mafia protection<sup>17</sup>, as well as having less faith in the court system.

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<sup>15</sup> See the results of the Business Enterprise Survey conducted by economists working at the World Bank for an assessment of the way in which enterprise behaviour and performance was related to and affected by enterprise environment and business conditions see: [www.worldbank.org/wbi/governance/datasets.htm](http://www.worldbank.org/wbi/governance/datasets.htm)

<sup>16</sup> Corruption is defined as an abuse of state power for the attainment of personal gains. Corruption goes beyond just taking bribes. (UN definition). It includes therefore, nepotism, appropriation of public property for personal gain, as well as deliberate concealment of full information during the decision making process.

<sup>17</sup> See Frisby (1998) for a discussion of the rise in organised crime in Russia.



Luneev (1996) reveals in his study of state involvement in corrupt practices that 'in the structure of corrupt officials, there is a great predominance of those working in the institutions of state power (66.3 per cent) and law enforcement (27.4 per cent); of the latter, 95 per cent or more are workers in the organs of internal affairs' (Luneev, 1996: 88)<sup>18</sup>.

The government is, therefore, not seen as being entirely credible, as it fails to constrain oligarchs and insiders. In order to redress this, Putin claims he is making strides with the backing of his administration<sup>19</sup>. This requires the strengthening of the role of the state rather than rolling it back, or 'hollowing it out' (Jessop, 1997). Is it the case then that the transitologists idealistic view of a minimal role for the state is in fact undesirable if their ultimate goal is to be secured? If it is to succeed, must Russia have a strong federal government?

### ***3.3.3. Has Russia failed?***

Russia's economy has been transformed dramatically over the past ten years, mainly in terms of the mass transference of property rights from the state to the private sector and the liberalisation of markets. Transitional recession dogged the Russian economy until the end of the 1990s. But since the financial crisis the economic climate has experienced an upturn.

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<sup>18</sup> Translated from Russian.

<sup>19</sup> July, 1 2000, in an address to the nation, Putin stated that in order to assure economic growth and social justice the country needed a strong centralised state. "We have to recognise that the State itself was largely responsible for the growing strength of the unofficial shadow economy, the spread of corruption, and the flow of great quantities of money abroad... Our economic policy is very clear: less regulation and more business competition. We should not be supporting a select group of businesses but private businesses on the whole'.

Following seven consecutive years of output decline real GDP was calculated to be approximately 64 per cent of 1990 values in 2000 (World Bank, 2002b). Private sector growth as a percentage of GDP has risen from 5 per cent in 1990 to 50 per cent in 1994 and 70 per cent in 1999 (EBRD, 2000). In terms of stabilisation inflation remained high until 1995 and fell to a single digit annual rate by late 1997, there was an increase in 1998 with the onset of the financial crisis, but the rate has subsequently been stabilised at around 15 per cent per annum. These macro-economic statistics suggest that the Russian government and CBR have made considerable headway in stabilising the economy. However, economists such as Hanson (2000; forthcoming) have suggested that the headway made is not as impressive as it might have been and that Russia is still under performing in terms of its economic potential.

Federal government is spending approximately 40 per cent of GDP whilst it collects 30 per cent.<sup>20</sup> The recent increase in the percentage of revenue collection can be accounted for by substantial gains made from oil revenues and a simultaneous devaluation of the ruble from 1998-2000. However, these gains are not likely to occur on a permanent basis. Foreign investment between the period 1992 until 1995 stood at US \$3.9 million (0.3 per cent of GDP) and between 1996 and 1999 the situation had improved to US \$11.9 million (0.9 per cent of GDP)<sup>21</sup>.

However, Russia, according to economists, and in comparison with other transition economies, has not performed as well as it might (Hanson 2000). There are four well-known theories that have been proffered to try to explain Russia's poor

<sup>20</sup> This figure is likely to rise within the financial year given the tax reforms of July 2001.

<sup>21</sup> World Bank staff estimates and country statistical office data published in 2002 and UNCTAD data, 2001.

performance. Åslund (1999) suggests that incomplete liberalisation is to blame. Stiglitz (1999) prefers to dwell on the premature scheme of mass privatisation as being a key factor. Blanchard and Kremmer (1997), on the other hand blame 'disorganisation' associated with the inheritance of long supply chains. Rose (1998) too focuses on inheritance issues, but in relation to social capital associated with 'anti-modern' society, which has impeded market friendly institutional change.

All of the above theories suggest, implicitly or explicitly, that something has gone 'wrong'<sup>22</sup> in the transition process, rather than perhaps seeing that preconceived notions of transition were flawed and therefore never really attainable<sup>23</sup>. The first three also imply that the type of medicine that was prescribed was not necessarily wrong, rather the way in which, and speed at which, it was taken were at fault. Therefore, the policy failures were in this sense avoidable. I would argue that transition orthodoxy is fundamentally flawed, as scant direct attention is paid to the specificity of transformations and the central role that institutions play in evolutionary processes.

Bad management is frequently cited as a key explanation for Russia's poor transition performance (Blasi et al. 1997). The argument that the managerial cadre have failed to recognise the need for fundamental change in their behaviour and their attempts to preserve their own personal power and wealth at the expense of the marketisation of their enterprises is well known. But should we view the situation in

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<sup>22</sup> Shleifer and Treisman (2000) uphold the view that failure is directly attributable to the way policy advice was implemented. They justify this by arguing that the prescriptions worked in other transition economies. The difference each state experienced and therefore the explanatory variable is political constraints.

<sup>23</sup> Rutland suggests rather forcefully that ideas of the orthodoxy are 'immune to falsifiability' (Rutland, 1996: 266) as policy failure is interpreted as the result of poor policy implementation or inappropriate social and cultural institutions.

such simplistic terms (Hendley, 1998)? The issue of incentives is relevant to this discussion, but again, so too is the environment in which enterprises and managers operate. Levels of instability and the asymmetries of information available to economic actors are also crucial factors. It is not unreasonable to try to examine the way actors adjust to external factors acting within some kind of bounded rationality that is also open to evolution. This naturally affects their capacity to change.

Key questions that need to be examined include: does/can transition orthodoxy take account of these factors?; and are its rather dogmatic prescriptions appropriate?

### **3.4.Critiquing 'capitalism by design'**

It has been argued that those involved in the transition process have sought to implement a form of capitalism by design (Stark, 1992). These criticisms that have been levelled at such a scheme should necessarily be seen as ideological ones. The criticisms are focussed at the idea of a blueprint form of 'ideal' capitalism. Such beliefs raise epistemological concerns.

Stark (1992) has postulated that western advisors and commentators have actually served to recreate fallacies of Leninism, suggesting that social systems can be radically transformed in a short period of time, by simply imposing change on a number of institutional and structural features (Stark, 1992; Grabher and Stark, 1996).

Transition orthodoxy suggests that the process of transition is one ruled by a binary logic. Modernisation theory distinguishes between inefficient socialist systems and

efficient modern market capitalism and the transition from one to the other. There is no room in this equation for the possibility of a third way, a mixed economy between capitalism and communism<sup>24</sup>. In fact, Altvater (1998) argues transition is no more than the implementation of market mechanisms and of the functioning mode of money, the building of political institutions of the nation state for making democratic participation possible and last but not least, the development of a pluralistic society. But the structural heterogeneity that exists within 'peripheral' societies is too pronounced to permit the establishment of economic, social and political systems that are coherent and fulfil the prerequisites of modernisation (Altvater, 1998: 592).

Therefore, structural heterogeneity acts as some kind of obstacle to modernisation and development. A negative fact if one sees modernisation, along a transition trajectory as the optimal goal.

'Often, even sober empirical analyses contained normative assumptions, mostly unaware of the specificity of transition with regard to the time-space coordinates in which it (and still takes) place. Modernization theory was (and still is) the most often used guideline adopted by the great majority of works concerned with the historical transition to a socio-economic and political system with the modern (and partly, already, post modern) image of the OECD world' (Altvater, 1998: 591-2).

It seems inappropriate in this context to conceive a simple transition trajectory following a binary logic. Instead there are 'complex articulated transformation[s] of social, economic and political forms not to mention individual changes of habits, social culture and the social relation to nature (Altvater, 1998: 595). It is also vital to

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<sup>24</sup> There has been debate concerning the appropriateness of Scandinavian, Anglo-American and East Asian forms/models of capitalism (Moltz, 1991) but the discussion has failed to tackle the issue of whether or not Russian capitalists, have, can or will pick some kind of existing blueprint.

consider that the geographical scale of transformation processes is global. Any given country is thus exposed to the spatial-temporal processes of global markets and power relations. So the path of transition is never the result of a free choice of autonomous political actors. The choice depends upon options available at a given spatial and temporal nexus of transformation processes

Ignoring the multiple forms of capitalist economies and the constitution of a new system through cultural and social contexts in different spatio-temporal contexts is dangerous. So too is the failure to acknowledge the 'specificity of the Soviet experience and the enormous obstacles to development' (Burawoy, 1994: 774). Such an argument can take on ideological overtones, suggesting that any belief in the possibility of a communist society crumbled with the collapse of the Soviet Union. Perhaps more helpful for the purposes of this analysis, is the acknowledgement that the point of arrival, from actually existing socialism depends on the point of departure<sup>25</sup>.

Furthermore, it is not helpful to think of the political, economic and social transformations as being independent processes. They combine to form transformations with numerous contradictory and asynchronous elements. To be able to come close to understanding the economy then, it is important to simultaneously look at the social and cultural practices that underpin it, and the context through which it is constituted.

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<sup>25</sup> Burawoy and Krotov (1994) commence their analysis of the Russian political crisis in the 1990s with a simple model of the state socialist economy as one based on the central appropriation and redistribution of surplus. The institutionalisation of property rights in the transition process is understood to be the most critical process as it determines how public property can be transformed in to private and what the mode of appropriation is.

### ***3.4.1. Institutions and transformation in a virtual economy***

The general problem with many of the proposed measures for improving the situation in Russia is that they presuppose the existence of an already functioning institutional framework (Braguinsky and Yavlinsky, 2000; Brezinksi and Fritsch, 1997; North, 1997; Stiglitz, 1999). This is of course easier to understand if one sticks to the notion of institutions as being the rules of the game in a society rather than organisational entities (North, 1990; Smith and Pickles, 1998). Therefore, an institutional framework consists of those formal and informal rules that de facto are used by a set of actors. Institutions being the 'legal administrative and customary arrangements for repeated human interpretations... the prevailing institutional framework in a society consists of formal and informal rules' (Pejovich, 1998: 23).

Therefore, the institutional framework of a society is composed of a large number of institutions, and consideration needs to be given to whether or not there is a dominant institutional set-up; a set-up that is to some degree persistent and consistent through time and economic space. While there might be a dominant set-up, there can coexist any number of institutions, but somehow they combine to maintain some sense of coherency to the functioning of the economy. Institutions, one can argue, make the world a more predictable place, at least in theory, and they certainly affect on strategic choice and the behaviour of individual actors (Gaddy and Ickes, 1998a; 1998b; 1999).

'Although formal rules may change overnight as the result of political or judicial decisions, informal constraints embodied in customs, traditions and codes of conduct are much more impervious to deliberate policies' (North, 1990:6).

I would further add to North's observation that, the issue of trust is also central to the process of institution building. The process of reform, as well as institution building, therefore, needs the support of the people. The evolution of institutions takes time, over which ideas and practices can be regularly reinforced, perhaps challenged, and through a process of (re)negotiation reinforced again, in the mindsets of the people. Kiser and Ostrom (1982: 209-210) have suggested the following process by way of explanation to understand the way in which institutional practices can materialise:

'Constitutional decisions establish institutional arrangements and their enforcement for collective choice. Collective decisions, in turn, establish institutional arrangements and their enforcement for individual action... Constitutional choices precede and constrain collective choices'.

The lack of institution building, of the 'appropriate'<sup>26</sup> nature, which has seemingly characterised the transformation process in Russia, is demonstrated via the identification of the virtual economy that pervades economic activity in the country. Gaddy and Ickes (1998) have examined why managers and other economic agents have chosen not to restructure their activities. They suggest that these actors are in fact acting rationally and that the environment induces them to postpone or avoid restructuring.

'The new system can be called Russia's virtual economy because it is based upon an illusion about almost every important parameter: prices, sales, wages, taxes and budgets. At its heart is the pretence that the economy is much larger than it really is. The pretence allows for a larger government and larger expenditures than Russia can afford. It is the real cause behind the web of wage, supply and tax arrears from which Russia cannot seem to extricate itself' (Gaddy and Ickes, 1998: 1).

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<sup>26</sup> 'Appropriate', that is, according to transition logic.



The emergence and growth of the virtual economy should not necessarily be seen as a detour within the transformation process. Of course, it will inevitably be considered as that by those that perceive transition to be possible and desirable along a predefined trajectory.

Just as Carlsson et al. (2001), suggest, I would concur and propose that available evidence shows that social responsibilities, associated with running firms, are explanatory factors in terms of managers running their operations, not necessarily with profitability at the top of their list of priorities, though this does remain near the top. The lack of effective bankruptcy and arbitrage systems indeed postpones the process of creative destruction of firms. In a perfectly performing market, the first option would theoretically be to invest in making production more effective and efficient but again, according to Gaddy and Ickes (1998), Carlsson et al. (2001) and evidence from my own interviews, the preferred option appears to be to invest in 'relational capital'. In other words, to perform, for example, services for the local authorities and to negotiate for privileges. The aim of this is usually to survive in terms of business and/or to provide an opportunity to seek personal gain.

Thus, again, the issue of cooperation comes to bear. If the system is to grow out of its 'virtuality', then an alternative dominant equilibrium needs to prevail. The Russian state has not long had its tenth birthday and the present situation has been characterised by a sort of 'prisoner's dilemma' (Carlsson et al. 2001). To stimulate changes in behaviour there needs to be as long as possible shadow of the future to offer security to actors in terms of them putting trust in new set of institutional norms. The virtual economy does, however, seem to be entrenched within Russian

society. Part of the reason for this is that public authorities are themselves inextricably linked with the virtual economy. As they constitute an integral part of the system, it seems unlikely that they are going to jeopardise their position, 'and take independent decisions that would undermine their position.

'Building institutions takes time and market institutions are not built from above. However, political authorities might provide an institutional framework that enables a market economy to be established. The authorities should ensure that those who are among the first to act in 'proper' ways do not have to pay a disproportionate share of the burden by being, for example, extensively taxed. Consequently the most important task is to reduce the payoff from investing in relational capital' (Carlsson et al. 2001: 860).

This discussion then brings us back to the issue of the reform process and the need for the Russian government to implement effective reform packages. For example, the implementation of a comprehensive and fair tax system to name but one factor, as well as the need to ensure that the agencies and ministries that constitute federal activities act themselves in a just and 'proper' manner.

### ***3.4.2. Rethinking the state***

The story of Russian transformation would suggest that the process of rethinking new economic functions had to compete with the pressing business of day-to-day survival and management. It is true that the state no longer owns most of the economy. Its direct control over the main economic levers – prices, taxes, investment and ownership of property – is much reduced. It is debateable whether the decision to role back the state was a conscious one on the part of the

government<sup>27</sup>. Conscious decisions were of course made to reshape the Central Bank, and to create anti-monopoly and other watchdog committees. Much of the 'old' state apparatus and committees were also disbanded leaving seemingly weaker administrative bodies with predominantly coordinating functions. In this respect, Gorbachev has been held responsible for much of this in his attempts to dismantle the Soviet system without creating a viable alternative.

It seems that much of the withdrawal of the state was due to attrition (Gustafson, 1999; Boycko et al. 1995). As a result, the extent of state restructuring has not been thoroughly thought through. Most of the powers it appears to wield today are of a negative nature, employing blocking or delaying tactics rather than always facilitating for example investment. One question that needs to be answered is whether there has been a comparable shift in the structure and mentality of the state and those working for it, as it has become a hybrid form of a market economy? On the other hand, is the hybrid nature of the system partly the result of the continued dominance of state structures and attitudes?

But of course, yet again, the situation becomes more complex when considering a potentially differential role of central government over the 89 federal subjects and the subjects' reactions and relationship to it. The sheer scale of the transformation process highlights yet another problem for transition orthodoxy. How do geographical conditions and relations affect systemic changes?

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<sup>27</sup> Yeltsin made a conscious decision to compromise and role back the state in many ways to stay in power.

### 3.5. Russian regional (re)integration

There is of course a complex geographical landscape, which provides the context through which transformations take place and through which the state mediates a role. As has been discussed earlier, the very nature of the Soviet system created its own particular geography. The impact of Soviet development policies on local and/or regional economies and their interaction with each other indicates that the patterns of regional development in Russia are complex. So too is the relationship of these factors to the path and nature of transformation processes (see Bradshaw, 1991; 1997). The adoption, or otherwise, of the prescriptions associated with the four pillars has been handled differently by the regions suggesting that by examining regional experiences it is possible to shed more light on transition/transformation issues.

Much of the regionally orientated work concerning Russia specifically addresses centre periphery relations (Solnick, 1998), and the asymmetrical nature of federal relations (Lynn and Novikov, 1997), as well as the promotion of local self-government at district and municipal scales (see Mitchenok, 1997; Solnick, 1996; Treisman, 1998). Bradshaw and Treyvish suggest that 'a region's relative position and strength in the federal structure does appear to be an important factor affecting its ability to attract federal support and retain income generated on its territory' (Bradshaw and Treyvish, 2000: 22). This obviously has implications for a region in terms of its own transformation. Taking the point one step further it will be shown that a region's relative position in the federal structure also has implications for the attention it receives not only from federal government but also from investors, international financial institutions and other bi-lateral donors.

Through space and time it is possible to discern three inherently geographical changes that are of relevance here, within Russia. First, change that is mediated by inherited geographies and histories. Second, the former, along with current conditions, influences the differential implementation of reforms by local elites. Third, there is a constantly changing political economy of scales of interaction (fields of action). Transition orthodoxy, to its own detriment, fails to fully take into account these processes, and their heterogeneity, which are played out spatially.

### ***3.5.1. Differential implementation of reform by elites***

A common theme running throughout the literature on regional economic development is that, between 1991 and 1999, there was considerable variation in the policies and practices of economic management undertaken by different regional units within Russia (see Bradshaw and Hanson, 2000). The willingness of regional elites to engage in the reform process, and to build relations with the federal centre relates closely to political processes and processes of democratisation (see Gelman, 1999; Hahn, 1997; Stoner-Weiss, 1997).

Olga Kryshтанovskaya (1996) estimated the proportions of different contemporary elite groups that derive from the Soviet era nomenklatura elite: presidential circle 75 per cent, party leaders 57.1 per cent, regional elites 82.3 per cent, government 74.3 per cent and business elites 61 per cent. The percentage of regional elites is strikingly high, and goes some way to explaining the manner in which the regions behaved throughout the 1990s. Both their established personal contacts and new powers/freedom enabled members to assert themselves within newly emerging business and political circles, as well as being in a position to extract rents from

local assets. Regional political elites have become closely involved with managerial and business leaders within their locales (see Kirkow, 1995). This is presenting an even more pressing issue today to the Kremlin, which now potentially faces two sets of foes who are building alliances with one another.

Increasing decentralisation, or reduced centralisation of federal control seemed to offer the regional elites the opportunity to act relatively independently, at least in terms of the writing, implementation and enforcement of certain areas of legislation. Since the election of Vladimir Putin to the position of President, the power divested to the regions has gradually begun to be clawed back, in attempts to redress the balance of power in favour of central government again (CEFIR, 2002: 25). Regions seem to have lost power both to federal authorities and also to big businesses.

However, for the greater part of the 1990s control over spending and personnel and the lack of supervision of regional legislative programmes meant that local and regional elites were able to determine, to quite a large degree, the pace and nature of reform. Policies such as privatisation, liberalisation, stabilisation and internationalisation were legislated upon at the federal level, and in this sense action at the regional level in these areas could potentially be seen as minimal. But there have been many examples of regional authorities manoeuvring around federal policies, in some instances to manage their own regional debt problems, controlling prices in some ways themselves, taking control of previously state owned enterprises, and also sustaining local enterprises by maintaining systems of soft budget constraints.

There is so much potential for variation between regions in terms of the way that they might respond to and influence transformation, maybe in terms of managing the region's economic/social predicament internally, for example, protecting the region's economic integrity by propping up failing but key enterprises in the region. Regions have also pursued the tactic of launching themselves and their location/natural resource/labour/investment potential advantages on the international stage. Regions also maintain different relationships with federal government and vice-versa.

Examining all of the above conditions specific to the regions goes some way to help to explain the deepening economic and social cleavages within Russia, and the uneven patterns of development across the country. Of course, the policy decisions made within the regions are related, first and foremost, to the regional administrations' own attitudes towards transformation, and the regions' position within the Federal structure and allegiance to Moscow.

Throughout the 1990s there have been many different examples cited within the press that testify to the regions' pursuing independent strategies to manage transformation<sup>28</sup>. For example:

- Exerting price controls over basic household goods, foodstuffs, public transportation and communications;
- The use and official/unofficial approval of local alternative currencies and barter relationships;
- The non payment of wages;
- The creation of protectionist measures, protecting local producers from competition and bankruptcy and local consumers from an influx of cheaper lower quality products.

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<sup>28</sup> The examples were compiled from a search through the archives of the following newspapers: Pravda, The Moscow Times, and St Petersburg Times in the period 1991-1999

Those pushing for Russia's speedy transition to a market economy have construed most of the above examples, in negative terms. As such, such policies have seen to stand as obstacles to transition and therefore have retarded if not distorted the process. Conversely, however, policies pursued by more pro-active reform minded regions have attracted vocal approval from Western economists<sup>29</sup>, especially those who have sought to enter the international economic arena. Policies to this end have included, for example: the establishment of bilateral, foreign economic links, the creation of tax concession and free economic zones to attract foreign and domestic investors.

Some regions are inevitably deemed strategically more important than others by federal government and are therefore accorded more privileges, or perhaps watched more closely in terms of the activities they are engaging in, and in bi-lateral agreements they are making with foreign actors. For example, many border regions fall in to this category, as do those housing lucrative natural resources and/or key military installations. Many regions negotiated different tax concessions with Moscow in the early to mid 1990s and have signed bilateral agreements. But of course having agreements and federal legislation has not ensured that regions have always fulfilled, for example, their tax obligations.

Regions have also sought to influence federal decisions, either transparently through democratic institutions or alternatively in a more underhand manner by using bribery and influence, perhaps in relation to the control of lucrative natural resources. The differences between the actors involved in such processes and the

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<sup>29</sup> The reform minded Governor Boris Nemtsov, was fairly exalted by western analysts in his and his administration's attempts to make Nizhny Novgorod a 'darling' of the transformation process. See Hanson (1994).



issues at stake of course vary considerably over space and time. Some of the laws passed within the regions between 1991 and 2000 actually contradicted those passed at the Federal level. Much is being done at this time to reverse this process and to standardise legislation over the whole Russian Federation.

### ***3.5.2. Constantly changing scales of control and authority***

Differentiation in policy making and implementation at the local and regional scales has been made possible by the decentralisation of authority within the Russian Federation. The collapse of the centrally planned economy and the privatisation of ownership have meant that the radical shifts in the locus of authority and control have been a key part of the transformation process. The shifts have occurred both spontaneously and been legislated for.

Russia is a Federation of 89 administrative units, including 21 republics, 55 *oblasti* and *kraya*, 22 smaller autonomous formations within *kraya* and two cities that have been accorded Federal Status (Moscow and St Petersburg). The authority of these subjects was clarified in three Federation Treaties signed in 1992 and later confirmed in the 1993 Constitution. The constitution signed under Yeltsin's Presidency has aroused much controversy, mainly because of its deficiencies and apparent vagueness and loopholes granted in a bid to appease strategically important local elites who threatened to destabilise the integrity of the nation state. Nicholson states that:

'Russia's constitutional framework is weak and inherently flawed and the balance of political power between the regions is ill defined. In the absence of firm constitutional settlement, regional elites have

consolidated power restricting the growth of local democracy and frustrating attempts at grass roots economic reform' (Nicholson 1998: i).

Approximately 46 power sharing agreements had been signed by 1999<sup>30</sup>, as well as hundreds of bi-lateral agreements at lower levels, most of which were kept more secret in order to stop the competition for favours getting out of hand (Nicholson, 1998). In June 1999, Yeltsin signed legislation confirming the primacy of the federal constitution and federal laws over individual agreements made with the regions to try to regain much of the control that had been lost over the regions. Just as economics decisions were frequently made on a day-to-day basis to stem collapse, so too did the constitutional basis of Russia evolve as a series of compromises reached amid continuing political crisis. The two key problems that typify the past ten years are that of the asymmetrical nature of federalism and the relationship between the centre and the regions, which has been poorly defined.

Local and regional powers within Russia were very much practiced on the basis of top down centralisation, not dissimilar from that system employed within the Soviet period. Whilst the regions have taken control of some areas which affect on their own destiny, it would be wrong to think that central government, though weakened for most of the 1990s, did not seek to exert its influence wherever and whenever possible. For example, Yeltsin appointed regional administration heads but did not balk from removing them from office or publicly engaging in a dispute with them if they defied government policy, even if the latter was not so successful<sup>31</sup>.

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<sup>30</sup> No more such agreements have been signed. This phase therefore appears to be over.

<sup>31</sup> Yelstin famously removed governor Vitalii Mukha from office in Novosibirsk and battled with Nazdratenko, the governor of Primorskiy kray (see *The Federal vs. the regions: an uneasy balance*, IEWS Regional Report, 17.07.1997

As has already been mentioned briefly, it is important to note that Russian central government was forced to adopt a different role following the demise of communism and that has not been an easy process, exactly because there is no blueprint for managing such change. Restructuring the massive organs of the state requires time, but also cooperation and compliance, a problem that has dogged Russian reformers and frustrated transitologists.

Since the collapse of communism Russian Federal agencies have faced in many cases funding shortages, however, considerable spread over the territory of the FSU has been maintained. Federal agencies still employ more citizens outside Moscow than do the sum of all regional administrations. But funding remains a real issue. Regions are often in conflict with Federal authorities as both sides attempt to share out fiscal revenue flows. Fiscal federalism is one of the most contentious issues within Russia and has consequently received a lot of academic attention (see Kouznetsova, Hanson and Sutherland, 1999).

The term fiscal federalism refers to the sharing of budget revenues and its redistribution to the regions via the Federal Fund for Support of the regions<sup>32</sup>. Regions are themselves interested in maintaining adequate shares of these revenues that feed in to their own budgets. In the past it has been suggested that there were incentives to engage in negotiations with federal authorities to receive preferential treatment or on the other hand to misreport and/or receive tax returns in non-monetised forms (Lavrov, 1998). In return the Federal authorities are expected to try

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<sup>32</sup> FFPR is the Russian acronym for the Federal Fund for Support of the regions (FFPR)

and reduce the uneven distribution of incomes amongst the regions and to act to promote efficient resource allocation.

This role suggests that the state should not be rolled back too far so that it can fulfil these obligations. But does this contradict the policy advice of transition orthodoxy, if the state has to 'interfere' within regional economies, perhaps maintaining some system of soft budget constraints in a bid to level the incomes of the regions? But of course processes of fiscal federalism impact upon a region's own trajectory for change. Popov (2001) in his analysis of the relationship between reform strategies and economic performance of Russia's regions has concluded that initial conditions (perhaps resource advantages) and institutional capacity<sup>33</sup> are important explanatory variables. However, he suggests that there is no evidence to show that economic reforms have led to better output and investment dynamics. But when trying to understand per capita income change amongst the regions reform progress is an important explanatory factor, and income level of course controls federal-regional financial transfers. This evidence suggests then that it is not possible to make a binary division between pro-reform and more 'obtuse' regions when trying to explain why some regions seem to be fairing better than others.

Such brief points illustrate again the diverse economic terrain of the Russian Federation and the different ways in which regions respond to central government.

This naturally has implications for the transition/transformation process and

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<sup>33</sup> Such understandings of institutional capacity are based on an economist's view, and are consequently measured in such terms. For example, Popov (2001) cites the traditional method of measuring the number of newly created enterprises in the region and their contribution to the regional economy. The assumption underpinning this method is that stable and non-corrupt administrations would be conducive to the process of new business start-ups and that new entrepreneurial activities would contribute to better economic performance. I argue that this is an overly simplistic and even naïve way of measuring 'capacity' that is inevitable given the definition of institutional capacity used in this example.

suggests, yet again, that institutions within regions can be viewed as being embedded and heterogeneous. This evidence further supports the claims that notions of transition along one predefined trajectory are misguided. There is so much scope for difference.

### ***3.5.3. Geographies of Transformation***

Having looked at the changing politics of scale (Chapter 2), and for example, differential processes of reform and relations with the federal centre, it is clear that spatiality matters and demands real consideration when thinking about the processes of transformation. Issues of geographical differentiation should not therefore be viewed as of secondary importance, or simply an outcome of transformation processes. Just as notions of 'institutions' and 'culture' have been conveniently tacked on to explanations of systemic transformation, as and when, they have been popularly deemed relevant, so too has geography. But these variables are of great importance and in glossing over them transition orthodoxy comes unstuck.

Massey (1984) has argued that, 'it is not just the spatial that is socially constructed; the social is spatially constructed too' (Massey, 1984: 6). It was common to believe that a region's geography could be explained by the playing out of a variety of social, political and economic processes. Therefore, geography is seen as an outcome. But, just as Massey suggests, turning the concept on its head is as important, 'the geography of a society makes a difference to the way that it works' (Massey, 1995: x)<sup>34</sup>. The spatiality of processes of transformation and the way in which they occur in and through spaces is critical and should be 'theorised

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<sup>34</sup> See also Gregory (1978) and Soja (1989)

conjointly' (Thrift, 1983: 31) with elements of what make those places what they are (institutions, culture and history).

The region stands as a site through which transformation is mediated. But it is also important to look at different scales (such as the federal) as 'a large proportion of those relations, experiences and understandings [which influence the structure of places] are constructed on a far larger scale than what we happen to define for that moment as the place itself' (Massey, 1994: 154). The specific context through which investment is constituted can be local (for example, Caterpillar choosing to start operations in Leningrad oblast). However, the space/time structures, which define that context, operate on a variety of scales<sup>35</sup>: international investment climates, management of international firms, operations of international financial institutions, relationships with bi-lateral donors and trade missions, national policy agendas, interests of local politicians and business elites, and the working lives of men and women in the region.

Each of the above structures has a different geography and is constantly affected by other structures and their geographies but they come together in particular combinations in places to form the setting/framework through which structures and processes are mediated. Looking at the work of IFIs at the regional and federal level and their impact on the transformation process necessarily involves then an acknowledgement of the complex interaction of processes and structures at a variety of intersecting scales.

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<sup>35</sup> See also back to section 3.4 and the discussion of the nexus of spatial and temporal processes

### 3.6. Transactors

Chapter 5 focuses on the way in which IFIs have tried to help promote transition orthodoxy through their policy frameworks. But it is interesting to note that transition orthodoxy, whilst supported by a wide range of individuals, from academics, politicians to policy makers, has been most doggedly promoted by those most closely involved in actual reform and direct policy advice. The distinctive method of conducting policy advice and reform initiatives has been accorded the term 'transactorship' by Jane Wedel (2000a) in her paper 'Tainted Transactions: Harvard, the Chubais clan and Russia's ruin'.

The term transactor in itself conjures up multiple images of people engaging in business, over borders and between institutions. The paper does nothing less than attack the way in which individuals, both Russian and Western, who were associated with the Harvard Institute for International Development performed multiple roles within managing the transformation process. In some cases, it was suggested to their own advantage, and possibly to Russia's detriment<sup>36</sup>. The point in discussing these issues is not to discredit particular individuals, nor to cast aspersions on the nature of transactions that have occurred<sup>37</sup> but rather to draw attention to the simple fact that it is clear that throughout the transformation process there has been a limited number of actors working together to meet particular aims and objectives. This either replicates, or is replicated within Russian society in

<sup>36</sup> The Russian sociologist Kryshchanovskaya (1997) believes for one that 'Chubais had what no other elite group has, which is support of the top political quarters in the west, above all the USA, World Bank and the IMF, and consequently, control over the money flow from the West to Russia. In this way, a small group of educated reformers led by Anatoly Chubais transformed itself into the most elite clan of Russia in the past five years'.

<sup>37</sup> Various individuals either currently or formerly employed by the Harvard Institute for International Development are currently under investigation by the US General Accounting Office on charges related to the misappropriation and misapplication of US funds given in good faith to aid Russia's transition. See US General Accounting Office website for further details <http://www.gao.gov>

terms of the wealth of the nation seemingly distributed among a disproportionately small group of powerful business people.

The intention here is certainly not to back some kind of conspiracy theory<sup>38</sup>, but merely to indicate that transition was imposed by a combination of internal and external agents working in collaboration with each other. The IFIs such as the IMF and World Bank are not excluded from this circle. This seemingly small point, however, adds further weight to the argument that one of the key problems has not only been to see transformation from a 'transition' perspective but also to have failed to engage the Russian people in the institution building process necessary to support the evolution of a fully functional market economy and democratic society.

Wedel (2000a) argues persuasively that one of the problems of vesting so much power and confidence in a relatively small team of people and institutions who are not willing to look outside of the box that they prefer is that they actually exclude would be other reformers who might seek to engage in mediating transformation processes. The inclusion of other, and not necessarily completely like-minded, reformers might stimulate wider discussion and debate about the ideological principles as well as the epistemological ones involved in trying to manage transformation. Such issues will be further highlighted in the chapters concerned with evidence gathered in Leningrad and Sakhalin oblasts where perceptions of IFIs and foreign assistance are discussed.

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<sup>38</sup> See the reply from Sachs and Åslund in response to Wedel's article in Wedel J R (2000b) 'Tainted Transactions: An Exchange', *The National Interest*, 60 pp 98-110



### 3.7. Conclusions

This chapter has demonstrated that, 'a revolution has indeed happened but the processes of change have not yet run their course. Yet the main legacy so far is a weak state, a private sector deformed by the manner of its birth, an economy stuck half way between the command economy and the market and an unsettled ambivalent relationship between state and society' (Gustafson, 1999:36). The above observations are not welcome to those who sought transition orthodoxy to hold the answers. Maybe it is the case that the policy prescriptions were inappropriately applied but it has been demonstrated that the lack of attention paid in theory and practice to, existing and evolving institutions, the possibility of hybridism, and heterogeneous transformations has been to the detriment of transition orthodoxy. Expectations held by the proponents of transition orthodoxy have therefore been misguided.

Understanding the notion of institutions, in its fullest sense, rather than just seeing them as organisational entities, and the nature of their embeddedness is important. After all the rules of the game define to a great extent the way in which a system will function. Geography matters too. It is important to try to take account of the differentiated implementation of reform, the uneven development of post-socialist capitalism and changes wrought in the geographies of economic and political control and management. These factors combine to promote the importance of considering the spatiality of transformation processes and to provide the context for looking at the region as a site for change and interaction.

This chapter, therefore, sets the scene for looking at the work of IFIs in Russia, at the regional and federal scales and provides, not only the background, in terms of theoretical thinking, to their policy frameworks and programmes, but also an analysis of impact of the implementation of the four pillars of transition orthodoxy in Russia.

## **Chapter 4**

### **Methodology and information sources**

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#### **Introduction**

This chapter examines the methodological considerations made and the methodologies employed while undertaking the practical research for this thesis. The theoretical and conceptual frameworks, which structure and determine the path of this thesis, have been considered in the previous two chapters, but it is worth mentioning here that because of the fluid nature of processes in the transformation context I assumed a reflexive approach to conducting field research. Assuming reflexive research process allowed me to go beyond seeing the fixity of processes and institutions and to examine dimensions of fluidity and complexity (see Painter and Goodwin, 1995: 351). Whilst there is an attempt to minimise the separation of theory and practice, as each informs the other, it is, however, useful to discuss the more practical side of conducting the research in its own right.

The field work locations of this research included: Leningrad oblast, Sakhalin oblast, St Petersburg, Moscow and Vladivostok (Russian Federation) (see Map 1 showing the field locations in Russia), Washington D.C. (US), and London (UK). The latter two fieldwork locations were chosen because the major IFIs studied in this thesis are headquartered in these cities. The reasons for choosing Sakhalin and Leningrad oblasts were discussed in the introduction to the thesis. Moscow was, of course, also an important fieldwork location because as the capital of the Russian Federation it is the seat of federal government, a locus of power and influence, and the place where IFIs and other donors have established representative offices. The EBRD has opened a representative office in the RFE in Vladivostok. A variety of

activities were undertaken in each location, including interviews and archival research.

In seeking to understand the relationship between International Financial Institutions and transformation processes in Russia the research process was split into two parts: the first involved identifying the policy frameworks that IFIs have constructed and work with; the second, examined the practical application of the policies in two regions, Leningrad and Sakhalin oblasts, as well as analysing dominant local modes of social regulation at sites of regulation and governance.

#### **4.1. Part one: Identifying the policy framework**

In order to contextualise the policies of IFIs, notions of a 'Washington' and 'Post-Washington' consensus were deconstructed. Building from this process of deconstruction, individual IFIs were examined, they included: the IMF, World Bank Group, EBRD and the European Commission's Tacis programme. In addition to examining the construction of policy agendas by external agents I also examined the Russian Government's own main policy goals, which would influence federal government attitudes to IFI involvement in the Russian economy. Figure 4.1. outlines the sources of information used in this process.

When there were gaps in the provision of quantitative data, every attempt was made to patch them with information received directly from representatives of the institutions. In addition to such forms of quantitative data, on line briefings and internally produced studies and reports were also used. Archival research involved using public library collections (e.g. Library of Congress, Washington D.C.),

Institutional collections (e.g. World Bank Library, Washington D.C.) and the world-wide-web.

**Figure 4.1. Sources of information used in identifying the policy framework**

- i. Institutional web sites: on line briefings, updates, lending statistics, strategy documents (e.g. Country Assistance Programme produced by the World Bank and EBRD Transition Report).
- ii. Archival research: briefings produced for and discussed at strategy meetings concerning past success or otherwise of activities; discussions ensuing from these meetings; details of liaison with the government of the Russian Federation.
- iii. Interviews with officials from IFIs that have had a part in creating and managing policy agendas.
- iv. Interviews with Russian civil servants involved at the national level in setting/working with the policy agenda of the Russian Federation towards relations with international agencies offering their services.
- iv. Archival work in Russia from available sources on decisions made by central government e.g. newspapers
- v. Statistics collated and produced by Goskomstat on lending from international agencies and recipients of loans

As is often the case in conducting research related to the activities of institutions much information relevant to the study is offered 'off the record,' both in hard copy form or, verbally. This in itself presents many problems, not least in terms of handling the information in an ethical manner. Whilst this is a problem that must be faced by many researchers, there is little discussion of the issues involved in the literatures concerning research methodologies. It would be naïve, however, to think that having been made party to this 'confidential' information that the acquired knowledge will not at least affect the perceptions of the researcher, which will naturally be filtered into the research.

#### **4.2. Part two: Analysing the application of the policy objectives on the ground in Leningrad and Sakhalin oblasts**

Part two of the research process involved establishing the type and nature of the projects run within the regions, as well as some case studies that were representative of IFI activity at the federal level and examining the impact of IFI activity at key sites of regulation. A list of IFI and donor projects examined can be found in Appendix A.

Accessing such data was not always simple given the confidentiality attached to some projects and the piecemeal datasets available either publicly or from the IFIs. In the future it might be possible to build from this initial research and also to use data currently being collected by the institutions themselves to enter into a more quantitative analysis of the situation. However, as has already been discussed, the decision to use qualitative techniques was made because of the nature of the theoretical and conceptual apparatus that inform this thesis.

Due to the nature of conducting field research within Russia it became clear that it would not be appropriate to conduct other formal qualitative and quantitative techniques, such as surveys or questionnaires. Such techniques seemed inappropriate for two reasons. First, participants were unwilling to be involved in a 'formal' academic study, such as a questionnaire because of the fear of having information used against them by federal authorities. Second, surveys and questionnaires seemed inadequate in terms of trying to access the fluid and complex nature of processes of regulation and governance at a variety of sites of regulation and governance.

Assessing the impact of projects is obviously complicated and something IFIs and donors have problems doing themselves. Most institutions seems to opt for 'ticking' boxes on simple assessment sheets if project objectives were met, but my aim was to go beyond this form of assessment because the objectives might have been inappropriate to begin with. I sought in the first instance to engage with individuals at key sites of regulation and governance. These were locations where I felt that processes of regulation were mediated and transformed. They included, the local business community, local government, the banking and legal sectors. Wherever possible, I established a dialogue with as many people involved in IFI projects as possible at these sites of regulation and governance.

This enabled me to establish, from a wide variety of sources: the overall aims of projects and their expected outcomes, the stories related to the running of the projects, the working relationships between the Russian actors involved in the projects, individual beneficiaries and the IFIs and other donors, to examine commitment to, and 'ownership' of, the projects and finally, to draw some conclusions as to the impact of the projects on the ground and to consider the wider consequences of these findings in terms of the success or failure of the IFIs in terms of meeting their policy objectives. Figure 4.2. outlines the sources of information used in this part of the research.

**Figure 4.2. Sources of information used to analyse the impact of projects**

- i. Information from institutional websites and archives on the number and type of projects in operation in the regions.
- ii. Interviews with representatives working on behalf of the agencies within the regions.
- iii. Interviews with local politicians and businessmen, and other individuals involved in the negotiation, development and implementation of the projects.
- iv. Interviews with other donor organisations operating within the regions e.g. national government development agencies (e.g. USAID, SIDA and DFID).

During the initial stages of fieldwork in the regions I was able to assess the extent of other donor activity besides that of the major IFIs. So, for comparative purposes I examined some of the projects run by the Department for International Development, UK (DFID) and the Swedish Development Agency (SIDA) in Leningrad oblast and projects run by the United States Agency for International Development (USAID) in Sakhalin.

#### **4.3. Problematising the research methods**

In order to meet the aims and objectives of the research a key task was to access 'elite' networks in the regions and in Moscow. The elite networks that I needed to access included local and federal political elites, local business elites, and IFIs and other donor elites. 'Elites' are understood here to be groups of individuals who possess a substantial share of power on the basis of their active control of resources (Hertz and Imber, 1995; McDowell, 1998, Schoenberger, 1991). In addition to these so-called elites I also needed to access local networks of business people or individual beneficiaries from IFI activity.



#### **4.3.1. Interviews**

Interviews with various members of what are commonly termed 'elites' formed the largest proportion of the qualitative methodology. The method of interviewing seemed to be the most appropriate, as interviews offer access to possibly conflicting and shifting strategic logic and historical contingencies that underpin decisions made by institutions or individuals (Schoenberger 1991), which are not revealed through the analysis of statistical data. Furthermore, interviews can provide invaluable insights in to the complex network of internal and external relationships between the agents concerned, which would otherwise be inaccessible. In fact, individual networks can be understood as being part of larger networks and structures (Cormode and Hughes, 1999:299). I would further argue, as Cochrane (1998: 2131) does that:

'the key is not to be found in the elites themselves, but in the broader systems, processes and structures of which they are a part...(.) We are not faced with a choice between analysis in which structural context is emphasized and analysis focussed on local agency, but rather with the need to explore the ways in which each helps constitute the other.'

The interviews were all semi-structured in nature. Interview content varied according to individual, for example, according to their role within an IFI, federal agency, oblast administration department or their position in an enterprise, bank or legal firm. There were, however, common themes that were addressed in each interview, allowing for some comparison between the comments of the interviewees, providing not only the opportunity to build up a picture of the operations of the institutions in Russia but the reactions of various parties to them. Schoenberger's reasoning for using the semi-structured approach seems applicable here:

‘The open ended interview...does afford possibilities for encouraging or forcing the respondent to think things through. If the interview takes the form of an interactive dialogue rather than an undeviating journey through a fixed series of question-response pairs, the intellectual engagement of respondents and hence the accuracy and validity of the responses, are likely to be much greater.’ (Schoenberger, 1991:183).

By employing this method, the range of issues covered in the interview and the depth in which they could be discussed was much greater than would be afforded by using an almost questionnaire-like interview structure.

Of real importance when conducting interviews with elites or others was the desire to assess the ‘embeddedness’ of social relations and practices that the interviewees were a part of. Following the lead of Onias (1999) one way I sought to unravel this was to assess the relation of individual actors to others, which affects their own behaviour and bears consequences on their chosen paths of actions. For example, adopting this strategy meant that throughout the interviews it was important for me to be aware of the potential for interviewees to use silence to convey meaning and for them to use multiple voices. Individuals can of course speak from experiences other than their own, based on what they have been told to say in official response to questions. Furthermore, individuals can adopt the language of others having been exposed to it, though it might not affect deeply on their own social capital<sup>1</sup>.

Another practical problem to face during the interview process was the reluctance of interviewees to go ‘on the record’. In all cases an agreement ensuring confidentiality was made and interviewees have not been quoted directly. This was in fact essential for all federal employees, as a decree was passed at the Federal level requiring all

state employees to report through the appropriate channels all contact with foreign researchers<sup>2</sup>, meaning that unless I gave such assurances I would not have been able to conduct the majority of interviews.

Of course, such issues had real implications for the writing up of the field research. In order to present the research I adopted a system of referencing interviewees in terms of the institution or organisation for which they work and the date on which they were interviewed so that the reader has the opportunity to contextualise the remarks made and see that comments made are not based on supposition or hearsay. A list of all interviewees and dates of the interviews can be found in Appendix B. Having given assurances of strict confidentiality, I deemed it inappropriate to quote individuals, even anonymously, because this would have meant reneging on promises made to a substantial proportion of the interviewees. Therefore, I have sought to weave the results of my interviews into the body of the text though I have in all instances contextualised statements by referencing individuals in the aforementioned manner.

#### ***4.3.2. A two way mirror***

An acknowledgement of the positionality of the researcher is important. It is important to recognise that the researcher's outlook and interpretation of material is formed by the social relations that they are exposed to, both within the academy and between them and the environment within which they live more generally (Cook and Crang 1995). I endeavoured to be reflexive throughout the fieldwork and writing processes. Whilst recognising the positionality of the researcher affects

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<sup>1</sup> For a further discussion of the problem of 'multivoicedness' and exploring embeddedness empirically see Oinas (1999)

research, this does not mean that the research is somehow less valid than if conducted by someone else, for example, in my case a Russian citizen, nor does it seem constructive for this to hinder the researcher in terms of proceeding with the project. As Patai concluded:

‘Ultimately we have to make up our minds whether our research is worth doing or not, and then determine how to go about it in ways that let it best serve our stated goals..(.) But in an unethical world, we cannot do truly ethical research’ (Patai 1991:150).

In the field it became apparent that in order to gain both the confidence of the respective individuals and access to information I needed to adopt different strategies to be accepted. My intention was not to play games in order to gain trust and access. But, it would be misleading to suggest that ‘me’, as the interviewer conducted or responded to the interview process in the same way. For example and in very simple terms, the mode of dress and the language used in interviews was very different when meeting IFIs and local business people. The interviewees’ perceptions of the researcher were crucial in determining the course and nature of the interviews.

Within an interview situation there exists an interesting set of power relations between the researcher and the researched. These of course vary, across time and space and according to the individuals concerned. McDowell (1992) and Schoenberger (1991; 1992) have discussed the power relations often faced in the ‘corporate interview’. I am, as McDowell is (1992), inclined to contest Schoenberger’s assertion that the interviewer should err on the side of caution and not exert too much control in the interview situation. Actual experience would

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<sup>2</sup> This decree was officially passed in May 2001.

suggest that the interviewer is unlikely to be in a position to assume such, control, or power in an interview situation with individuals from elites. As McDowell (1992) found, it is more common to find oneself in the position of being supplicant, asking for time and knowledge. However, strategies can be adopted to combat this to some extent. I offered knowledge in return to the interviewee where appropriate. This did not involve compromising other sources of confidential information.

Gender can become an issue in the interview process. This was certainly the case when conducting interviews with, for example Russian local government officials. Initially it proved to be a barrier to a free flow of information. As McDowell suggests;

‘We should recognise that interviewing is a game in which participants often are playing with a different set of rules. Both the scholar and the respondent construct a particular version of themselves in interviews which is then re-interpreted and re-presented in different ways’  
(1992:214)

In addition to gender, nationality was sometimes a barrier to my research in Russia, but adapting to the ‘language’<sup>3</sup> of the interviewee was the most successful course of action to deal with this. Attention has been paid to this in terms of the impact that this can have on the research process (Sidaway 1992; Madge 1993; Spivak 1993). However, having conducted research in different countries and different types of environment, experience would suggest that there is not one set of power relations that can be attributed to a particular interview situation. Power relations varied, mostly according to the personality of the interviewee and their willingness to

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<sup>3</sup> By ‘language’ I mean, not only languages such as English or Russian but also types of language within language, for example, business language, IFIs and donor language.

interact in the research process and this was not defined in terms of their position in a particular type of elite or because of geographical location.

#### ***4.3.3. A question of trust***

Establishing a relationship of trust from the outset plays a key role in the construction of the image that the interviewee has of the researcher. This ultimately affects the possible depth of discussion reached during the interview process and longer term working relationships. It became a critical issue in the research process, due to the nature of the research and the people being interviewed, e.g. individuals working in the business world, having concerns about their competitors and/or authorities obtaining sensitive information about their activities. Representatives working for IFIs were also anxious about speaking 'out of turn,' with regard to the official line of their organisation. This might of course not necessarily have been in line with their personal opinions. Furthermore, I made sure each interviewee was clear that my intention was not to apportion blame for the problems that both Russian and foreign parties have faced in their endeavours to stimulate the emergence of a democratic and fully functioning market economy, but rather to understand more clearly processes of transformation.

#### ***4.3.4. Problematising Language***

'There is generally an unstated assumption that research is in a language which the researcher or reader of the text assumes that they can understand' (Smith 1996: 162).

It is important to give consideration to issues relating to researching in a foreign language, and what implications this has for the research/writing process. Most

especially when the writing is done in the researchers native language. As Derrida concluded (1991), translation is both essential and yet impossible. We need to translate in order to get close to an understanding, however, in the process of translation, original meaning and/or association is easily lost. Words might be associated with multiple meanings and associations in one cultural/linguistic context, which does not exist in another, whatever attempts are made towards a 'perfect' translation. I paid much attention to the problems translating and representing other peoples' ideas in this thesis. I had to accept that any translation would be reduced and become a somewhat distorted representation of other texts and practices (Smith 1996). The problem is not very different from that encountered by doing research in my 'own' native language. But the task is perhaps more complex, and potentially more dangerous, when working with foreign languages.

During the research process, I became aware of the need to understand nuances of language. Different groups of people understood different things from the use of certain words. For example, language used by economic analysts working for IFIs was specific and loaded in some cases with what seemed to be very different meanings from those that local politicians used and understood. In some circumstances I had to 'translate' terms into something more familiar to the interviewee. For example, when talking about 'social capital' I avoided the use of words relating to money or capital when discussing such issues with local Russian businessmen, but the term was widely used by those working for IFIs.

#### **4.4. Reading between the lines**

In an interview, it is important to be aware of the difference between reality and rhetoric and to be able to do so with confidence involves identifying different sources of information. Interviews with a number of individuals offer one possibility and so do archival materials. But undertaking archival research and in particular by using newspaper sources one must also recognise the need to read between the lines here as well. Reading the newspaper, in itself can be considered a science. It is possible to question the extent to which a truly free press exists in any country despite its laws. In Russia, however, it is a well-known fact that there are strong links between, not only business and editorial interests, but also between editors and federal and regional government influences. This of course influences the way that stories are reported and throughout the Soviet era government control influenced what was recorded then. While this could present problems I would argue, first being aware of the pitfalls, and second, being 'active' in the field is one way to manage the problem.

#### **4.5. Statistical misreporting**

Finding and being able to use, what we might term, reliable statistical information at the regional and national level in Russia can be difficult, as discussed earlier. Goskomstat<sup>4</sup> relies on all federal subjects to supply accurate data to the agency, which in turn it then uses to produce reports and to compile national statistical data. The manner in which statistical data are collected and compiled at the subject/regional level has the potential to vary greatly. Of course, the fact that in the past there were disincentives to provide accurate statistical data still affects the ways

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<sup>4</sup> Goskomstat is the official federal agency responsible for collecting and compiling statistical data concerning all subjects of the Russian Federation.



in which information is gathered today. Wherever possible alternative sources of data<sup>5</sup> were used within the study to allow for the triangulation of statistical data.

#### **4.5. Heraclitus' ever changing river**

One of the main problems associated with this type of social science research is that the object of study is a constantly shifting target. The pace of change in the Former Soviet Union has been unprecedented and the economic, social and political environment remains unpredictable. The election of Vladimir Putin as President, has brought a real sense of stability to the Russian nation, but as a result of the government's determination to push through reforms, the economic and social environments are in a constant state of flux. Furthermore, as the research focuses on the activities of IFIs that are headquartered outside Russia and whose policy decisions are at least in some part determined by their 'ultimate' financiers, national governments and commercial banks, their funding allocations and policy initiatives are subject to change in response to exogenous factors.

I have not limited this analysis to studying IFI activities in a narrow period of time, as processes of change are fluid and complex. I feel that to do so would be to artificially truncate processes. This would not allow the opportunity to examine path dependency and path shaping processes in such detail. This said, the bulk of IFI projects examined in this thesis were conceived in the late 1990s to 2000, following the financial crisis. By the mid 1990s IFI policy frameworks were clearly established and IFI activity in Russia was at a peak but there was increasing discontent with the way IFIs was trying to influence transformation processes in

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<sup>5</sup> Such as data compiled by institutions as the IMF

Russia (see Stiglitz, 1998a; 1999). In the aftermath of the financial crisis, IFIs had the forced opportunity to reassess the scale and nature of their activity in Russia but a key question is how and to what extent they have transformed their efforts in attempting to influence processes of change in Russia since 1998?

#### **4.7. Building research networks**

In conducting field research for this thesis, I relied to a certain extent on the snowballing of contacts to gain access to elites and individuals. Despite my networks developing over time, they were limited in many senses because of the reliance on others, to help in their extension. To counter this I made every attempt to make independent contacts where possible, though this was not always easy, with regard to accessing individuals at certain institutions.

#### **4.8. Conclusions**

Conducting research in a variety of field locations across different continents required me to adapt, as a researcher, to different research environments. But the same methodological concerns were kept in mind, regardless of location. Being consistent in my methodological approach was facilitated by a desire to engage reflexively with the fluid and complex processes interacting at key sites of regulation and governance.

## **Chapter 5**

### **International Financial Institutions and the Russian Federation: the policy frameworks**

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#### **Introduction**

This chapter examines the policy frameworks that have been formed by IFIs active in the Russian Federation. The policy frameworks that have been widely adopted by IFIs involved in trying to mediate transformation processes have been influenced, if not determined by, what is commonly known as the 'Washington Consensus,' and latterly the 'Post-Washington Consensus'. Consideration is given to these policy agendas, the discursive scripting of IFIs and their role in the global economic regulatory framework. A key aim of this chapter is to set the context for examining IFI involvement in Leningrad and Sakhalin oblasts, as well as examining their involvement at the federal level.

The chapter examines in detail policy decisions made since the 1998 financial crisis, in the era of a so-called 'Post Washington Consensus'. However, attention is also paid to the way in which operations have developed since 1991. This provides important insights into how the policy frameworks have evolved to date.

#### **5.1. International Financial Institutions and the International Economy**

The collective term 'International Financial Institutions' (IFIs) is used in preference to other alternatives, including International Lending Agencies (ILAs). The term ILA, implies that institutions are involved 'lending' assistance, financial or technical. This is not the case. In the first instance, technical assistance is given and there is not usually expectation of any form of repayment.

Second, not all IFIs involved within the circuits of financial capital are primarily charged with lending. The IMF, one of the most well known institutions within the global financial system, is concerned first and foremost with the surveillance of foreign exchange activities of countries. Use of the blanket term 'IFIs' gives scope to include development banks and other financial agencies that are run by more than one nation. Only IFIs that carry out operations in Russia are discussed in this chapter. Before looking at the operations of IFIs, their regulatory role in the global economy is discussed.

#### ***5.1.1. The discursive scripting of International Financial Institutions***

Two key institutions were conceived as part of the Bretton Woods agreement in July 1944 by the Western allies: the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD). Their role was to act as intergovernmental agencies, coordinating appropriate surveillance and reconstruction activities in light of the post war international payments crisis. Since their conception these institutions have grown in importance in terms of their role in the regulation of the global economy (Kapstein and Milanovic, 2001; Mikesell, 2000). In holding the largest reserve of assets that can be loaned to countries needing financial assistance, it is clear to see the potential power that these institutions can exercise within the international economy. From the outset these institutions have been imbued with capitalist ideology. This has obviously influenced the way that their respective roles have evolved and the way in which they expect those they assist to adopt their ideologies and regulatory discourses.

As discourses are constituted by sets of rules and practices by which we interpret and give meaning to thoughts and processes, then discourses give the power to script actors and their role in the international community (Foucault, 1992). It is through a dominant western discourse that IFIs have become defined and legitimated (Corbridge, 1992; DuBois 1991; Escobar, 1985; Popke, 1994; Shapiro, 1989). The IMF is commonly characterised as the 'hegemonic grandfather' of the international monetary system and that every nation is bound to its principles by membership. The protests in Seattle and Washington demonstrated the strength of feeling of certain groups against the 'hegemony' of these global institutions.

I do agree that such a historical and social construction is formed out of contextually specific material conditions, which is further legitimised through particular linguistic and discursive structures (see Foucault, 1992 and Popke, 1994) *but* pragmatism should play a part when thinking about the work of IFIs. Pragmatism informs this thesis. Otherwise, there is the danger that everything becomes trapped in a meta-narrative in which there is no room for diversity of action or thinking. Moreover, in promoting the notion of a dominant meta-narrative through which IFIs are perceived as hegemonic entities, there is the danger of setting up a desirable 'worthier' alternative to challenge and/or replace the existing narrative. But constructing such a binary challenge is to ignore the possibility of multiple possibilities, actions and decisions (see Gibson-Graham, 1996).

This is perhaps exactly what the IFIs have themselves been blinkered with respect to 'fashioning' a more homogenous global economy. In seeking to replace 'state socialism' with 'capitalism' they have constructed a binary challenge. In seeking to

uphold the dominant discourses of the global economic regulatory framework those that control the IFIs have tried to preclude the possibility of their being multiple possibilities even multiple modes of regulation. But this thesis demonstrates that though there is a dominant discourse, which informs the regulation of the global economy, there are multiple modes of regulation competing with this dominant structure. Furthermore, these multiple modes, operating at a variety of geographical scales and through time cannot necessarily be categorised as a binary challenge, the modes are more complex and fluid than this.

With these caveats in mind the chapter moves forward to discuss the construction of meta-narratives, which have informed the policy decisions of Washington based IFIs since the 1990s.

## **5.2. The ‘Washington Consensus’**

The term the ‘Washington Consensus’ has echoed around the world since 1990. Williamson (1999) has recently come to challenge the commonly held assumption that Washington based institutions, including the World Bank, have imposed a set of liberalising reforms that countries need to make in order to become liberal market economies trading freely in the global economy. Instead, he suggests that what is known as the set of reforms that constitute the Washington consensus resulted from a general intellectual convergence that he believes underpins them. Whichever viewpoint is taken there is no disputing that the Washington-based IFIs, and to some extent European based IFIs, appear to share the same policy goals.

Williamson might have conjured up the term to mean something different, but the common perception on hearing the term Washington Consensus is one that promotes 'neoliberalism' and 'market fundamentalism' (Soros, 1998:30). It is worth unpacking the above terms in order to understand exactly what IFIs are supposedly advocating.

'Neoliberalism' as a discourse has evolved from Adam Smith's notions of 'liberalism' first described in his treatise the *Wealth of Nations* (Smith, 1838). The liberal argument advocated the abolition of government intervention in economic matters. It was recommended that there were no restrictions on manufacturing, no barriers to commerce, no tariffs; free trade was suggested as the best way for an economy to develop. Such ideas were 'liberal' in the sense of there being no controls. Over time the application of this individualism has encouraged 'free' enterprise and 'free' competition. The new/neo part of 'liberalism' has developed with the perceived intensification of global economic processes over time, especially in the post-war era (Baldwin, 1993; Yeates, 2002). 'Market fundamentalism' is essentially part of the discourse of 'neoliberalism'. 'Market fundamentalism' is the term attributed to the belief that the common interest is best served by individual decision-making processes, and that attempts to maintain the common interest by collective action, distort the market mechanism (see Smith, 1838). In short, to believe in the merits of market fundamentalism is to believe in the merits of economic liberalism (Soros, 1998).

Williamson (1990) proposed that the set of policy reforms that most officials within Washington thought would be appropriate to apply in the Latin American context could be summarised in ten propositions:

- i. Fiscal discipline
- ii. The redirection of public expenditure priorities towards areas with the potential for high returns and improved income distribution e.g. primary health care, primary education, infrastructure.
- iii. Tax reform (lowering marginal rates and broadening the tax base)
- iv. Interest rate liberalisation
- v. Competitive exchange rate
- vi. Trade liberalisation
- vii. Liberalisation of FDI flows
- viii. Privatisation
- ix. Deregulation (removing barriers to entry or exit)
- x. Secure property rights

Krugman (1995) has stated that he sees the Washington Consensus as involving ten points that can be easily summarised in one sentence as, 'The belief that Victorian virtue in economic policy – free markets and sound money is the key to economic development' (Krugman 1995:29).

The Washington Consensus, as outlined above, does involve many reforms that ultimately lead to a reduction in the role of government within reforming countries (Stiglitz, 1994; 1993). Williamson (1996; 1999) has argued that the drive behind this move towards increased liberalisation and reduced level of government was a direct response to the overly statist policies that were seen to be 'hindering' development. Whether correct or not, the move to peddle more reforms that encouraged the development of more liberal markets and a reduced role for government, came to be seen as an ideological position. An ideological position that



IFIs, controlled by powerful trading nations, want and need to push in order to maintain their security and the status quo<sup>1</sup>.

While the original consensus was formed around issues concerning the development problem of Latin American countries in the 1970s and 1980s, the agenda had universal acceptance within the policy-making community and was, at a later juncture, applied to countries facing political and economic reform following the collapse of communism. The logic behind accepting this development strategy can be easily challenged due to the very simple fact that the economic and political systems of the communist/socialist world were inherently different in almost every facet from those Latin American countries.

Furthermore, there have been many criticisms levelled at the original consensus, not least against the perceived advocacy of the dramatic reduction in the size of government as well as the rapid privatisation of the economy. Given the legacy of the communist system, nowhere else would these reform policies be more sharply put to the test in terms of their success in assisting with post-socialist transformation processes. Assistance from IFIs to the Russian Federation began in 1991, before the institutions themselves started to reassess their policy objectives in light of the success or failure of them.

### **5.3. The 'Post Washington' Consensus**

When former Vice President of the World Bank, Joseph Stiglitz (1999) gave the keynote address, '*Whither Reform? Ten Years of the Transition*,' to the World Bank

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<sup>1</sup> For example, see the work of Smith (1984), which discusses debates concerning the development of underdevelopment and the 'see-saw' effect of development between 'developed' and 'less developed' countries (see also Edwards, 1985 and Sen, 1982)

Annual Conference on Development Economics it was seen by commentators to show the first real public display of cracks appearing within the policy framework endorsed by the IFIs based in Washington. In his address, he spoke of the way in which he saw the Washington Consensus as having failed. In particular, he criticised the priority that had been given to rapid privatisation and the comparable lack of attention that had been given to establishing competition or building social and organisational capital that can support such reforms. This was not the first time he has criticised the Washington Consensus. He publicly did so at a conference in Helsinki in 1998.

‘The policies advanced by the Washington Consensus are not complete, and they are sometimes misguided. Making markets work requires more than just low inflation; it requires sound financial regulation, competition policy and policies to facilitate the transfer of technology and to encourage transparency, to cite some fundamental issues neglected by the Washington Consensus’ (Stiglitz 1998a:1).

Stiglitz (1999) has since called for the need to change approach to problems of transition. He begins by stating facts now widely acknowledged, at least by economists. It is recognised that Russia ‘failed’ in terms of making economic transition and China has ‘succeeded’. This is probably an unfair comparison in the first place. The tacitly admitted second fact is that the Russian programme was endorsed by Senior Western Economists while the Chinese approach was not perceived by these Senior Western Economists to meet the standards of the Washington Consensus. Stiglitz then sets out to offer an explanation of the claims he is making. He clearly blames neo-classical orthodoxy for keeping the institution of private property and contrasts it with the Chinese adaptation of local property arrangements to the market. He goes further and rejects the claim that the Russian transition was in fact harder to ‘manage’ than the Chinese. China, he states, needed

both to restructure and to solve the development conundrum simultaneously, though whether it has fully 'reformed' state owned enterprises is debatable (see Lui and Garino, 2001). The conclusion that he comes to is that the apparent failure of Western economic theory to guide the transition process successfully prompts a search for a new paradigm. This has been termed the 'Post Washington Consensus'.

In very simple terms, it seems that Stiglitz seeks to make two critical points. The first is to state the problem of corporate governance explicitly in macroeconomic advice. Any suggestion regarding macroeconomic policy rests on the assumption that firms, for example, are guided by the profit motive. Stiglitz suggests incentives that might be used to make the system function more effectively, other than purely shareholder's profit and goes on to advocate the construction of a 'stakeholder' environment but of course this option requires the cooperation of existing shareholders and a legal framework to support it. In other words, the mode of regulation therefore needs to evolve to support these prescribed social practices and new institutions.

He does identify the significance of social norms and practices during a process of transition and points out that to its detriment neoclassical economics largely ignores these institutions and social practices as irrelevant to production and exchange. He does not, however, perhaps go far enough in making the link between the existing 'protestant work ethic' that prevails within the system of western market capitalism and its cultural embeddedness and the absence of this in the Russian economic system and therefore the futility of trying to make neo-liberal prescriptions. He sees government, for one, as playing a critically important role in the transition process

and goes on to make it abundantly clear that he sees both big business and government as having more than just the potential to act in a non-socially optimal manner. Of course, the big question is how to manage this. This issue remains unresolved in his paper.

As with any other 'post' something scenario, there is the issue of the extent to which the previous 'era' is left behind. There is of course the legacy of this previous state. However, in the context of considering a 'Post' Washington Consensus, it is necessary to question the merit in Stiglitz advocating the shift towards something that still has its roots in a policy agenda that he deems fundamentally flawed. This 'development' and 'transition/transformation' issue remains thorny for all those involved in making policy decisions. There is some confusion as to whether working within the framework of a Post-Washington Consensus implies a belief, that while insufficient, the reforms that are included within the Washington Consensus are necessary to promote development/ transformation. A key issue is therefore does the post consensus add a new and critical dimension to the process and policy direction?

Institutions such as the IMF, World Bank, EBRD and EU do seem to have created/adopted this 'new' consensus amongst themselves, as is evident from Country Reports and strategy documents, for example, published since 1998. What does seem to be clear is that the adoption of a Post Washington Consensus involves working towards sustainable, egalitarian and democratic development (Stiglitz, 1999). It is not just concerned with increasing, for example, per capita GNP. Discussions continue within the institutions as to the future direction of policy

making but there does seem to be agreement that the institutional dimension of the transformation process has been neglected and the balance needs to be redressed (World Bank, 2000c: 2). It is now being argued that, making the markets work within transforming economies requires good financial regulation, competition and the promotion of technology transfer and improved transparency (Stiglitz, 1998; EBRD, 2000b; EU, 2001; Hellman et al. 2000a; Broadman and Recantini, 2001).<sup>2</sup> This shift in thinking is further underpinned by the recognition that the attitude of the Russian Government toward IFIs is an important factor to consider (General Accounting Office, 2001). The Russian government, for example, now seems to be reluctant to encourage any increase in the scale of operations of institutions<sup>3</sup>. The IFIs and other development agencies are responding to this and limiting their liabilities, investment portfolios and scale of operations in Russia.<sup>4</sup>

Furthermore, the issue of 'good governance' has risen to the forefront of policy debates in this era of the 'Post-Washington Consensus' (see Chapter 8 for a discussion of the problems of 'poor' corporate governance in Russia). The logic behind this suggests that in order to encourage the liberalisation of markets, government needs to be effective and complementary when working with business and markets. It has been shown that an 'effective' state is vital for development (World Bank, 1997). What exactly might constitute an 'effective' state is highly debateable. It is, however, clear to see that since the Post-Soviet collapse there has been a marked decline in the effectiveness of the state, especially in Russia (Gustafson, 1999; see also discussions in Chapter 3).

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<sup>2</sup> See also, for example, World Bank 'Governance and Anti-Corruption web pages at <http://www.worldbank.org/wbi/governance/>

<sup>3</sup> Personal communications from officials working in the Moscow offices of IFIs, including the World Bank, Tacis, DFID and USAID.

<sup>4</sup> The EBRD seems to be the only IFI which has not scaled down its activities in the past few years.

The 1997 World Development Report (World Bank, 1997) maintained that a weak institutional environment allows for greater arbitrariness on the part of agencies and public officials. So, a priority for countries with weak institutional networks becomes instituting rules and norms that provide incentives for individuals to act within the collective interest while at the same time curbing arbitrary action and containing corruption (Braguinsky and Yavlinsky, 2000). Alongside this should be moves to build administrative capacity. Separating powers and introducing a system of checks and balances should strengthen the institutional framework (see Broadman, 2002; Broadman and Recantini, 2001). But, as the previous chapters have demonstrated the evolution of social practices and institutions varies through space and time and is contingent on many competing factors at a variety of scales.

Throughout the transformation process, Washington Consensus time, or Post-Washington Consensus time, it is important to recognise that whilst there is much controversy following policy decisions made at particular times, these decisions were frequently made in direct response to the perceived needs of the time and the prevailing convictions of the time. Analysing the situation with the benefit of hindsight always allows for the potential to be naturally critical. So, while it is popular to cast IFIs as 'ruthless' capitalist driven institutions who act unswervingly in their quest to promote free market economics and who act furthermore, as conspirators to the process of globalisation, it would be naïve to forget that in any development or transformation process that there are at least two sets of actors involved; the institutions and the country that is seeking/receiving assistance.

Policy decisions are not necessarily made blind to the realities of being able to operate within a recipient state. In the case of Russia, the situation has always been complicated due to the history between the donors and recipient. The legacy of the cold war could not be, and to some extent still cannot be, simply swept away. Different priorities and different ways of thinking and going about the reform process have undoubtedly had a huge impact on the construction of policy agendas, or at least they should have done (GAO, 2000). An issue to consider, however, is just how realistic the institutions have been in forming their agendas with respect to being able to operationalise their policies within Russia and to what extent they have taken account of Russia's complicated federal system. A related question that will also be tackled in this work is, how institutions measure 'success'. Is it in terms of money spent or results obtained? First, the institutions themselves need to be examined more carefully, both in terms of their remit and their policy towards working in Russia.

#### **5.4. The International Financial Institutions: first the IMF**

The following section provides important background information concerning the remits and the nature of activities that the IFIs examined undertake. This helps to contextualise their activities in Russia, as well as demonstrating the extent to which the IFIs modus operandi have been informed by the Washington and latterly post-Washington consensus.

The International Monetary Fund (IMF) was founded on December 27, 1945. Headquartered in Washington D.C., the Fund acts as a cooperative intergovernmental monetary and financial institution. All the Fund's policies and

activities are guided by its charter, the Articles of Agreement and are conducted under a decision making structure that is constantly being modified. The Fund was explicitly created to:

‘... promote international monetary cooperation; to facilitate the expansion and balanced growth of international trade; to promote exchange stability; to assist in the establishment of a multilateral system of payments; to make its general resources temporarily available to its members experiencing balance of payments difficulties under adequate safeguards; and to shorten the duration and lessen the degree of disequilibrium in the international balance of payments of its members’ (IMF, 2000:2).

There are now 183 member countries in the Fund.

The IMF is a powerful political institution, but statements on the official website refute claims that its mission is to enforce fiscal rectitude among its members (IMF, 2001). It is true that the IMF is not a development bank, nor a world central bank. But, by maintaining tight surveillance on the foreign exchange activities of its members, as well as controlling its purse strings carefully, one might seek to question the premise that it is not ‘an agency that can or wishes to coerce its members to do very much of anything’ (IMF, 2001).

It is important, however, to recognise that the Fund alone cannot, and does not, make decisions about the policies that it calls its members to pursue. It is, in fact, the membership itself, which dictates to the IMF the policies it will follow. There is a clear chain of command running from the governments of the member countries to the IMF. A key question is then, which governments wield greatest power within the Fund and can therefore be seen to be influential in directing its policy



framework? By understanding the quota system it is possible to come to some conclusions.

#### ***5.4.1. Quotas and Voting Rights***

Each member country deposits a sum of money with the Fund, called a quota subscription. The quota serves several purposes. First, it forms a fund that the IMF can draw from in order to help member countries in a time of difficulty. Second, the quota is used as a basis for determining the amount the member can borrow from the IMF or receives from the IMF in periodic allocations of special assets, SDRs<sup>5</sup>. Third, the size of a country's quota determines the voting power of a member. The IMF, via an analysis of each members GDP and economic performance sets the size of the quotas.

It is clear to see that the United States with its quota of 37 149.3 SDRs buys itself the largest percentage of the votes within the organisation. Japan, Germany, France and the United Kingdom are the next biggest 'shareholders' within the Fund and therefore have substantial voting powers<sup>6</sup>. The rest of the votes are divided amongst regional groupings of countries. The group with the largest number of votes includes 10 countries within Eastern and Central Europe. With 111 696 votes in total it is clear to see that after having been divided up between these countries voting power seriously diminishes after the top five have used their votes. The EU member states hold 29.88 per cent of total Fund votes. Adding their votes with those

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<sup>5</sup> Special Drawing rights (SDRs): a quasi-international currency. The SDR is a weighted average of several currencies. The weights reflect the importance of each country in world trade and are revised periodically. The position has been for some time: US dollars (39%), German deutschmarks (21%), Japanese yen (18%), French francs (11%) and UK sterling (11%). As of January 2, 2002, SDR 1 equalled US\$1.30901

<sup>6</sup> This information was accessed from the official website: <http://www.imf.org>

of the US one can see that these countries hold 47.04 per cent of the total votes. Alongside Saudi Arabia and China, the Russian Federation is the only country to have its own allocation of votes, the rest of the members, excluding of course the five largest shareholders, are split into voting groups. This division of the voting rights according to stakeholderhood of course has implications for policy making.

#### ***5.4.2. Conditions of Membership***

With membership to the Fund comes the expectation that countries will pursue policies that will increase in an 'orderly' and 'constructive' way its own national wealth and that of the whole membership as well as being obliged to refrain from restricting the exchange of its money for foreign money (IMF, 2000), this is what could be termed a 'neoliberal' policy (King, 1991).

The IMF has no legal remit to act as enforcer to these codes of conduct, but it can exert 'moral' pressure as well as having leverage over the policies of members that borrow from it. The assumption within the clauses of membership is that any lapse in fulfilling the self-imposed obligations must be the result of factors beyond the member's immediate control. If the member is a persistent offender, however, then they might become ineligible to borrow money, have tranches of loans promised, held until further notice and as a last resort be ejected from the Fund. Conditionality is attached to lending.

### ***5.4.3. Surveillance and Lending***

During the 1990s the IMF lent billions of dollars to countries at the centre of the Asian crisis and to Russia. Russia alone received \$20.4 billion to support its economic programme for 1998 (IMF, 1998). Due to the way in which these loans were made, many observers have misunderstood the role of the Fund and perceive it to be primarily a lending institution. The IMF, however, clearly states that the principal function of the Fund is to act as a supervisory institution for coordinating efforts to achieve greater cooperation in the formulation of economic policies, in brackets a 'neoliberal' agenda<sup>7</sup>.

The IMF provides financing to member countries for them to make a range of international payments. The Fund does not, however, loan money for specific projects as development banks do. The assets that are purchased from the IMF are deposited with the member country's fiscal agent, usually the central bank. Once in the hands of the member country the IMF claims that it is difficult to monitor what exactly the assets are being used for.

Most IMF assistance is provided through a Stand By Arrangement (SBA). The SBA is designed to deal with short-term balance of payments difficulties of a temporary nature. The SBA should be repaid within 3 to 5 years. The Extended Fund Facility (EFF) is used for countries facing longer-term balance of payment problems resulting from more structural problems. A time period of 4-10 years is allowed for the repayment of these loans to give enough time for the member to implement reforms and stabilise their position.

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<sup>7</sup> See again the official website.

In addition to financial assistance, the IMF provides technical assistance to member countries. The Fund frequently advises on: the design and implementation of fiscal and monetary policy; institution building; the handling and accounting of transactions with the IMF; the collection and handling of statistical data; and training officials at the IMF institute with the help of other international financial institutions (IMF, 2001).

#### ***5.4.4. Collaboration between the IMF and World Bank***

Officially the IMF maintains close contact with its sister Bretton Woods organisation the International Bank for Reconstruction and Development (part of the World Bank group). The relationship between the organisations is mostly non-financial, except for the Bank being a prescribed holder of SDRs. It is important to remember that each institution has its own separate functions and operations, as well as different mechanisms to finance its activities.

Yet, membership to the World Bank is restricted to countries that are already members of the IMF under the World Bank's Articles of Agreement. It was thought that by making this a stipulation of membership that members would be able to repay the Bank's loans by for example accepting and following the regulatory jurisdiction of the IMF, concerning, for example, control of exchange rates and exchange restrictions. It is clear to see from an examination of their spheres of operation that the institutions are designed to be able to set the perimeters within which their members function economically.

Following the recently published guidelines for a working partnership between the organisations, the IMF is to provide temporary balance of payments assistance and to focus on the macroeconomic aspects of members' economies. The World Bank's remit is to deal with long-term project and economic development finance. Despite these differing remits the sister organisations are committed to working out complementary policy frameworks. The admission that it is vital for advice provided by the Fund and Bank to be consistent and mutually reinforcing, highlights the tight regulatory framework that recipient countries have to be willing to work within if they are to receive assistance from these institutions.

Indeed in 'response to new developments related to the globalisation of the world economy, the IMF and the Bank have further strengthened their collaboration' (IMF,2000:2).

The institutions have tried to achieve this in four areas of their work: by working to reduce the debt-service burden of heavily indebted poor countries (HIPC Initiative); by identifying financial sector weaknesses and in attempting to promote sound financial systems; and by banking supervision. The issue of 'good governance has been attached to these areas of work in Russia. Achieving 'good governance' has been has gradually been moving up the policy agenda in terms of its perceived importance in aiding the transformation from a planned to a market economy. Even before the 1998 financial crisis there has been an increasing range of literature, including working papers, produced by both organisations on anticorruption and institutional failings (see Pannier, 1996; Schliefer, 1996; Stiglitz, 1998), but the crisis still happened and it revealed fundamental weaknesses in the emergent financial systems, especially in terms of an enforceable and appropriate regulatory framework (see Illarionov, 1998; and Chapter 3).

### **5.5. The World Bank Group**

The World Bank group includes the International Bank for Reconstruction and Development (IBRD), the International Development Association (IDA), the International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency. The IBRD, the central organisation within the World Bank Group, was established like the IMF, in July 1944. The remit of the Bank is to encourage capital investment for the reconstruction and development of its member countries, as its name suggests. The Bank facilitates investment by either channelling private funds or by making loans from its own resources. Members must pay a subscription to the Bank. The Bank sets the size of a member's subscription, according to the member's share of world trade and this in turn determines the voting rights for members. The voting rights for members of the World Bank are not surprisingly, unlike those that exist for the IMF. It is therefore clear to see that countries such as the United States are in a position to exercise a great deal of power within these Bretton Woods institutions.

An important arm of the World Bank Group is the IFC, which is active in Russia. The IFC's role is to help fund private initiatives, for example, the launching of new capital projects. The IFC operates along similar lines to the EBRD, in that it can invest directly and give loans to private investors. The IFC can borrow capital from the IBRD to re-lend to private investors whom do not have guarantees from their governments.

### ***5.5.1. Structural Adjustment Loans***

Structural Adjustment Loans (SALs) are the most commonly used instrument by the World Bank to give assistance to a member country. As the term implies, the loans are made to assist in the reform of sectors of the economy. For example, a loan might be given to help with the reform of the energy sector within the economy. In theory the reforms should encourage the move long term economic growth based on free market principles for the sector, or to alleviate the social and environmental costs of the reform process.

### ***5.5.2. Country Assistance Strategy***

In addition to the SAL programmes, a committee involving both employees of the Bank and officials from the member country concerned puts together a document known as the Country Assistance Strategy (CAS). This document sets out the basis for Bank operations within the member country concerned. The CAS is based upon the Bank's own assessment of the member's priorities, past portfolio performance and creditworthiness. The document ultimately sets out the level and composition of financial and technical assistance that the Bank seeks to give a member country.

While the country has to share this vision that they are expected to comply and work with, the Bank clearly states that the vision is compatible with the wishes of its shareholders. The CAS usually takes a three-year focus on the activities of the Bank within the member country. Reports on, for example, infrastructure, macro-economic policy, agriculture and health are put together for the final document. The construction of the final document involves many iterations. In the case of the Russian Federation during the last CAS there was an increasing level of

participation from the government of the Russian Federation (World Bank, 2001). The member country is entitled to comment on drafts of the document, the process being called a participatory CAS but this section has demonstrated that the member country is always subject to the terms and conditions of the World Bank Group and these conditions are geared towards standardisation of a member country's dominant mode of regulation with that of a 'global neoliberal' economic regulatory framework.

### **5.6. European Bank for Reconstruction and Development (EBRD)**

The European Bank for Reconstruction and Development (EBRD) was founded in 1991 in direct response to the political and economic changes that were occurring in Eastern Europe and the Former Soviet Union. The sixty members of the bank (58 countries, the European Community and the European Investment Bank) are committed to support the transition from planned to market economies following the collapse of communist regimes, in their 26 countries of operation (EBRD, 2000a). In theory, the success of the EBRD in fulfilling its remit will be proved when it no longer needs to exist.

The EBRD operates independently of other the Washington based institutions, but the indicators that it uses to rank a country's progress<sup>8</sup> along the transformation path more than suggest an adherence to the priorities for reform that the Washington institutions have advocated. The obvious difference between the IBRD and the EBRD is that the IBRD primarily lends to central government whereas the EBRD has much more involvement within the private sector.

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<sup>8</sup> See Bradshaw (2001) and Lavigne (1996)



The EBRD finances projects in both the private and public sectors. It provides funding for financial institutions, infrastructure, industry, commerce and technical assistance. Loans, equity investments and guarantees constitute the main forms of EBRD assistance. The credit risk of loans made can be taken on solely by the EBRD, or they can be partly syndicated to the market. The EBRD also offers guarantees in order to help borrowers attract investors. The bank also tries to help the development of micro, small and medium sized enterprises (EBRD, 2000a). In order to achieve this goal the EBRD has made financing available to enterprises that qualify for assistance via intermediaries, these include: banks in which the EBRD has an equity stake or with which it has signed a loan (for example, see Chapter 7 and the EBRD's involvement in the Far Eastern Bank); and investment or venture capital funds in which the Bank has made an equity investment.

#### ***5.6.1. The EBRD and private sector involvement***

It is the extent to which the EBRD operates within the private sector that sets it apart from other institutions involved in assisting in the transformation process. By the end of 2000, private sector activities represented over 70 per cent of the total number of Bank operations. The EBRD's commitment to operations within the private sector is underpinned by the belief that privatisation is the key to promoting the transformation from a planned to market economy (EBRD, 2000a).

The main way that the EBRD tries to influence this process is to strengthen the financial sector, by investing directly in financial institutions and then by using local intermediaries to channel funds to the enterprise sector, especially small medium sized enterprises (SMEs). Where the EBRD is a shareholder it has appointed

members to the supervisory council of the bank in order to promote the practices of 'good' corporate governance, management accountability, sound banking principles and proper environmental practices.

'Building a sound financial system is fundamental to the transition to a market economy. The creation of new banks and the privatisation of existing state owned banks play a key role in this process. Recent experience has demonstrated that such banks are more profitable than their state owned counterparts, and that they lead to increased lending to the real sector of the economy such as SMEs' (EBRD 2000a:4).

Private equity funds are the most significant source of financing for SMEs from the EBRD. By the end of FY 1999 the EBRD had committed US \$948 million to 73 equity funds, making it the single largest investor amongst its countries of operation (EBRD, 2000a).

### **5.7. The European Union (EU)**

The European Union, in comparison with the other IFIs studied in this thesis, is a more overtly politically driven institution. The Union comprising fifteen member states is primarily concerned with issues pertaining to within its borders, and the possible extension of those borders. But, of course, issues relating to trade, energy and security, which will impact on its member states naturally attracts the attention of the Commission. Therefore, the EU has made formal attempts since 1991 to work in some form of partnership with Russia. The EU attaches political, strategic and economic significance to Russia, which is set to border the eastern most extent of the EU in the future. The EU could be Russia's most important trading partner (see OECD trade statistics, 2002<sup>9</sup>)

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<sup>9</sup> These statistics can be accessed via the OECD website: <http://www.oecd.org> or from the report 'Development Dimensions of Trade' (OECD, 2001)

It is the Partnership and Cooperation Agreement (PCA) signed in 1994 that forms the basis of the partnership between the EU and Russia. The Agreement came into effect in December 1997 but the EU and Russia have worked together for many years prior to this. The document details all the areas of interest that the EU has with Russia, for example, the importance of the 'Northern Dimension' and the parameters within which Russia and the EU will operate on trade terms (EU, 1997).

#### ***5.7.1 Technical Assistance to the CIS (Tacis)***

In July 1991, the EU adopted a regulation establishing the legal authority for the European Commission to implement a technical assistance programme, later named the Technical Assistance for the Commonwealth of Independent States (Tacis). Since this time the Commission has been responsible for implementing the programmes. The EU has re-authorised Tacis three times since its creation via regulations issued by the Council of the EU in 1993, 1996 and 1999. Both the regulations and periodic policy resolutions both issued by the Council provide the Commission with overall political guidance for the running of the programme. Representatives of the fifteen members of the EU oversee implementation decisions and the development of programme objectives. There is input at all stages from the Russian government (EU, 2000).

Implicit in the Tacis programme design is the assumption that technical assistance is a relatively inexpensive and cost efficient way to promote reform (EU, 2000). In focussing on the transference of 'know how' about market systems to Russia it was hoped that this would have a real impact on the economic reform process. These basic reforms would then help in attracting foreign investment, which it was felt

Russia needed in order to fund the high cost of modernizing and restructuring the Russian economy. No large sums of money were given to help enterprises restructure or to finance the social safety net while reforms were being implemented.

### ***5.7.2. The Northern Dimension***

The Northern Dimension in the external and cross border policies of the European Union covers the Baltic Sea region, Arctic Sea region and North West Russia. The aim of the programme is to address the challenges of the above regions and further aims to increase cooperation between EU member states, the EU applicant countries and Russia. As such, the Northern Dimension is implemented within the framework of the Europe Agreements with the Baltic States, the Partnership and Cooperation Agreement with Russia and the European Economic Area regulations (Ojanen, 2001). The areas for cooperation, include: environment, nuclear safety, energy cooperation, Kaliningrad, infrastructure development, business cooperation, Justice and Home Affairs, social development. The Northern Dimension is operationalised via the EU's financial instruments for the region, Phare, Tacis and Interreg. Tacis is the financial instrument used in relation to Russia.

### ***5.7.3. Bistro and Tempus***

Bistro and Tempus are the names of two types of technical assistance programmes, which form a part of the Tacis programme. The Tacis Bistro facility is specifically designed to respond rapidly to requests for support to small-scale projects. The projects should in all circumstances be completed within the six-month limit, which

is set. The budget for each project, and therefore maximum amount of assistance received from the EU is 100 000 Euros.

As the Bistro facility is effectively subsumed within the wider Tacis programme the areas of cooperation and priorities are the same as those clearly stated within documents such as the Tacis Indicative Programme (EU, 2000). The areas on which the Bistro projects focus include, enterprise support and financial services, human resources (education and training, public administration), social protection, agriculture, energy, transport, telecommunications and the environment.

The type of activities to be funded can either be in the form of training, or written expertise, or indeed a combination of the two. A clear aim of the Bistro facility is that the projects should have a systemic impact with results that can benefit a number of actors in the sector either directly or via a full dissemination of project findings. Project proposals are compiled and submitted jointly by the EU and Russian partners. As with most Tacis projects the Russian partner is the official applicant for the funding. It has become increasingly apparent over the past few years that Tacis is leaning more heavily towards devoting more funds to these smaller scale and short term projects (EU, 2000).<sup>10</sup>

### **5.8. Collaboration between International Financial Institutions**

There is, collaboration between Washington and European based IFIs, though some relationships are stronger than others. The IMF has concentrated its efforts for collaboration, although not solely, with the World Trade Organisation (WTO). An

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<sup>10</sup> Further evidence gathered from personal communications with representative working at Tacis offices in the North West region and Moscow (2001).

agreement was signed in 1995, which builds upon the relationship that has existed with the contracting parties to the General Agreement on Tariffs and Trade (GATT). The evolution of this relationship, while logical, given the operations of each organisation, has fuelled the emotive perception of the 'three horsemen of globalisation' riding roughshod over the international economy with nations such as the US in the saddle. Russia as yet is not a member of the WTO, though Putin has made it clear that gaining membership is a priority (Putin, 2002). But gaining entry to the WTO requires Russia to push ahead with key reforms that the IMF and World Bank have also sought to push forward over the past decade, the Russian President is aware of Russia's exclusion from the formulation of these 'membership' rules and the dominance of a neoliberal regulatory discourses (see Chapter 8).

While the IMF and WTO enjoy a fruitful working relationship, working with other organisations seems to be limited, as seems to be the case for the World Bank Group. The IMF states that it 'cooperates' with regional development banks, which obviously includes the EBRD (IMF, 2000). The extent to which they cooperate is unclear. Officially areas on which they have worked together include, coordination to resolve balance of payments crises, early clearance of arrears, normalisation of creditor relations and technical assistance programmes for member countries (IMF, 2000). The IMF appears to have less contact with the European Commission concerning matters of technical assistance. With limited contact between organisations outside of Washington it seems that an understanding of other institutions policies comes from operatives working within member countries. There is a limited amount of cooperation between the institutions even within Russia,

though many of their representative offices are located within close proximity of each other in Moscow.

## **5.9. International Financial Institutions and their operations within the Russian Federation**

### ***5.9.1. The Russian Federation and the IMF***

The relationship between the Russian Federation and the IMF has certainly not always been easy. In fact, following the financial crisis of 1998 and the controversy surrounding the use of IMF loans within the Federation, there was much questioning of the rationale behind the continued lending to Russia. Lending to the Russian Federation began in 1992, following the collapse of the Soviet Union. Members of the G7<sup>11</sup>, anxious about the security and economic implications of the domestic crisis that faced the Russian Federation, used the IMF to initiate their involvement in the transformation process. Table 5.1. overleaf provides an overview of the IMF strategy for Russia to date.

The following table (Table 5.2.) details the loans that have been made to the Russian Federation to date. The size of the loans has increased since 1995. This was in direct response to the uplift in confidence regarding the progress of transformation processes within the Federation. The policy community within Washington D.C. generally felt that the Russian government had committed themselves to reform, despite the increasingly difficult economic circumstances that they faced (IMF, 1995). The loans were conditional on key reforms being made, these included: stabilisation of the ruble, liberalisation of prices and trade, and privatisation. These were clearly representative of three of the four pillars of

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<sup>11</sup> The G7 has become the G8 following Russia's admission to the Group

**Table 5.1. Overview of IMF strategy for Russia, 1991-present**

<b>Time period</b>	<b>Key points of the strategy</b>
1991	<ul style="list-style-type: none"> <li>• October moratorium on Russia debt payments, call for IMF assistance</li> <li>• IMF provides technical but not financial assistance to Soviet Union, relationship continues with Russia when Soviet Union is disbanded</li> </ul>
1992-1995 Controlling inflation	<ul style="list-style-type: none"> <li>• Russia becomes a member of the IMF (June 1992)</li> <li>• US \$1 billion disbursed under first agreement (June 1992), there are macroeconomic conditions attached</li> <li>• US \$1.5 billion disbursed under new transition economies facility (June 1993)</li> <li>• Programme went off track (September 1993) a new programme is agreed despite concerns over weak Russian performance (March 1994); US \$1.5 billion disbursed; programme failed to meet objectives</li> <li>• Russia signs agreement for US \$6.8 billion under first standard IMF programme (April 1995); monthly monitoring is instituted</li> <li>• IMF concurs with Russia's move to a managed exchange rate system as a part of the monetary programme; inflation is brought under control for the first time</li> <li>• Russia seems to meet programme requirements; later shown it missed two targets</li> </ul>
Mid 1996-1998 Increased attention on Structural reforms	<ul style="list-style-type: none"> <li>• IMF and Russia agree to 3 year arrangement that involves more structural reform requirements (march 1996)</li> <li>• Russia is poor at meeting requirements; tax requirements are continually not met</li> <li>• Government budget deficits are financed with securities issuance and IMF/World Bank money</li> <li>• IMF continues to make disbursements making allowances for the instability associated with upcoming Presidential elections</li> <li>• Increased growth (beginning 1997); Asian financial crisis affects investor confidence by the end of the year</li> <li>• Agreement for the 1998 programme requirements are not reached until June</li> </ul>
July-September 1998 Financial crisis	<ul style="list-style-type: none"> <li>• Worsening financial crisis leads to the introduction of an interim IMF package of US \$11.2 billion (July); an initial disbursement of US \$4.8 billion</li> <li>• Given the nature of the crisis no further disbursements are made under this programme</li> </ul>
1999-present Post crisis	<ul style="list-style-type: none"> <li>• Agreement over new US \$4.5 billion package (July 1999), one disbursement of US \$640 million made</li> <li>• Failure to meet requirements (1999); no further disbursements made; IMF continues giving technical assistance</li> </ul>

**Source: Analysis of IMF documents and interviews with IMF officials; GAO analysis (2000)**



transition orthodoxy. In 1998, however, the IMF had to reassess its position with regard to Russia following the financial crisis and the apparent misuse of IMF funds (See later). As a direct result of this lending to Russia ground to a halt, though one further disbursement was made in 1999

**Table 5.2. Summary of Disbursements and Repayments to the Russian Federation in SDRs, from January 1, 1991 to June 30, 2002**

Year	<i>General Resources Account (GRA)</i>	
	Disbursements	Repurchases
1992	719 000 000	
1993	1 078 275 000	
1994	1 078 275 000	
1995	3 594 250 000	
1996	2 587 861 200	359 500 000
1997	1 467 252 800	359 500 000
1998	4 600 000 000	673 921 875
1999	471 429 000	3 101 138 750
2000	0	2 189 497 343
2001	0	2 997 937 522
2002	0	457 734 503

Source: Treasurer's Department, Accounts and Financial Reports Division, IMF (2002)

In 1998 a financial crisis struck the Russian economy. The aftershocks of the Asian crisis reverberated throughout the international economy, initiating the crisis in Russia. One of the well-publicised causes of tension between the IMF and the Federation during the crisis was the allegation that money lent by the IMF and deposited in the Central Bank of Russia (CBR) had disappeared abroad and could not be sufficiently accounted for. Until PricewaterhouseCoopers concluded their report into the situation on behalf of the IMF it remained unclear as to whether capital flight was being financed with IMF funds or that the money was being diverted in to the wrong hands, or even stolen. The evidence suggests that loans from the IMF did provide relief to the Federation, easing the problems with their

external financial position. But the total amounts involved were small in comparison with the sums involved in capital flight and to Russia's other sources of foreign exchange, notably export earnings. The Fund has concluded that the extensive capital flight was not caused by the loans but rather by the failure to establish a positive domestic environment for investment (IMF, 1999).

PricewaterhouseCoopers did, however, unearth evidence to suggest that domestic transactions between the CBR, the Financial Management Company (FIMACO) and other commercial banks had not been adequately reported. By hiding the existence of the transactions, the true state of reserves within the economy, were underestimated. If properly reported it is doubtful that the IMF would have disbursed the funds that they did in 1996. This breach of trust between the financial institutions has left a bad taste within the policy-making community. While the Director of the IMF's European II Department claimed in 1999 that Russia's policies following the crisis of 1998 were deserving of IMF support it is important to question the extent to which this 'incident' has been forgotten (IMF, 1999).

All disbursements released since July 28, 1999 under the 17 month US \$4.5 billion lending programme have been held in an account at the IMF. Such a move by the Fund suggests that while the institution and its voting members recognise the need to continue assistance strategies within the Federation they remain uncertain as to the reliability of Federal institutions within Russia.

'Russia's transition to an open market-orientated system is proving to be more difficult and slower than anticipated. But both Russia and the international community will be better served if the IMF remains engaged and provides assistance under strict conditions' (IMF 1999:2).

The conditions imposed upon Russia are indeed strict, the CBR is not allowed to handle the disbursements that are released by the Fund directly. Furthermore, the criteria that have been agreed between the Fund and the Russian government requires the latter to make aggressive moves within the realm of reform with particular focus on fiscal issues as well as those of domestic institutional responsibility. Table 5.3. below shows Russia's position in the Fund to date.

**Table 5.3. Russian Federation: Position in the Fund, as of June 30, 2002**

<b><u>General Resources Account:</u></b>	<b><u>SDR Million</u></b>	<b><u>% Quota</u></b>			
Quota	5 945.40	100.0			
Fund holdings of currency	11 401.43	191.7			
Reserve tranche position	1.14	0.02			
<b><u>SDR Department:</u></b>	<b><u>SDR Million</u></b>	<b><u>% Allocation</u></b>			
Holdings	6.29	N/A			
<b><u>Outstanding Purchases and Loans:</u></b>	<b><u>SDR Million</u></b>	<b><u>% Quota</u></b>			
Stand by arrangements	471.43	7.9			
Extended arrangements	4 356.69	73.28			
Systemic Transformation	628.99	10.58			
<b><u>Latest Financial Arrangements:</u></b>					
<b><u>Type</u></b>	<b><u>Approval Date</u></b>	<b><u>Expiration Date</u></b>	<b><u>Amount Approved SDR Million</u></b>	<b><u>Amount Drawn SDR Million</u></b>	
Stand-by	28. 7. 1999	27. 12. 2000	3 300.00	471.43	
EFF	26. 3. 1996	26. 3. 1999	10 893.47	5 779.71	
<b><u>Projected Obligations to Fund*:</u></b>					
		<b><u>SDR Million</u></b>			
	<b><u>2001</u></b>	<b><u>2002</u></b>	<b><u>2003</u></b>	<b><u>2004</u></b>	<b><u>2005</u></b>
Principal	58.4	600.00	1 445.9	1 117.4	850.8
Charges/Interest	160.3	82.80	133.20	92.00	61.70
Total	58.4	682.8	1 579.10	1 202.8	908.1
The estimates of charges and their due dates are estimates and subject to change (* Based on the existing use of resources and present holdings of SDRs)					

Source: Treasurer's Department Accounts and Financial Division, IMF (2002)

### ***5.9.2 The Russian Federation and the World Bank***

The Russian Federation joined the World Bank in 1992. Since 1992 the Bank has approved over US \$11 billion in loans for 45 operations. To date, 33 operations are underway. Some have been cancelled and therefore total commitments from the

Bank now stand at US \$10.4 billion. Cumulative disbursements to Russia stood at US \$2.5 billion for investment loans and US \$4.7 billion for adjustment loans (World Bank, 2000). From the outset of the transformation process the Bank stated that Russia, '...has initiated an unprecedentedly broad, complex and difficult process of economic reform' (World Bank 1992: xv.)

Assistance from the Bank in the first years of Russia's transition from a planned to market economy focused on the importance of stimulating the emergence of a private sector as well as maintaining financial stability during the transition. World Bank policy was clearly driven by previous experiences of economies experiencing the process of transformation. The mechanisms and policy tool, perhaps best generalised as predominantly those of the Washington Consensus were to be applied to the transforming economy (see Table 5.4. for a summary of the World Bank's strategy for Russia).

There has been a discernible shift in policy since 1998. The operational objectives remain the same; development of a market economy based on private sector initiative, institutional development and protection of the most vulnerable during the period of transformation. But the Bank has recognised over the past few years that the process of institutional development has not been given enough attention although the Bank initiated technical assistance and training programmes in order to stimulate institutional development.

**Table 5.4. Overview of the World Bank's Assistance Strategy for Russia, 1991 – 2002**

<b>Time period</b>	<b>Key points of the strategy</b>
1991-1992 Forming the Russia programme	<ul style="list-style-type: none"> <li>• US \$30 million 'trust' fund established for the former Soviet republics (August 1991)</li> <li>• Resident mission is set up (Autumn 1991)</li> <li>• Russia becomes a member of the World Bank Group (June 1992)</li> <li>• First US \$600 million rehabilitation loan approved (August 1992)</li> </ul>
1993-1994 Rapid construction of a portfolio of projects	<ul style="list-style-type: none"> <li>• Pressure from G7 to develop and start projects quickly</li> <li>• Early debates on adjustment vs. investment lending</li> <li>• Approx. US \$2.3 billion for 9 investment loans in multiple sectors approved</li> <li>• Significant start up delays in project implementation resulted in slow disbursements</li> </ul>
1995-1996 Evaluating effectiveness and charting a new strategy	<ul style="list-style-type: none"> <li>• Project implementation proves more complicated and only US \$278.4 million of US \$3.4 billion approved investment lending has been disbursed (as of December 1995)</li> <li>• President of World Bank visits Moscow and makes project 'effectiveness' a priority (1995)</li> <li>• High level review of projects to identify and address implementation problems (1996)</li> <li>• Post election period designated as a period for comprehensive structural reforms and moves towards adjustment lending (1996-)</li> </ul>
1997-1998 Shifting the focus to Federal structural reform	<ul style="list-style-type: none"> <li>• Country director named and authority decentralised to Moscow office (1997)</li> <li>• World Bank/Federal government dialogue heightens</li> <li>• Focus shifts from regional/local level projects to the Federal adjustment lending</li> <li>• Financial crisis has deleterious impact of portfolio of projects</li> </ul>
1999-2000 Focusing on long term efforts	<ul style="list-style-type: none"> <li>• Russia is the weakest member of the World Bank but intensive efforts improve project performance</li> <li>• Focus shifts to addressing systemic weaknesses that the financial crisis highlighted</li> <li>• More modest funding levels</li> </ul>
2001-present Focus on long term technical assistance projects	<ul style="list-style-type: none"> <li>• Continued focus on systemic issues and on offering technical assistance to Federal organs</li> <li>• World Bank continues to seek limiting its portfolio and financial exposure</li> </ul>

**Source: Analysis of World Bank documents and interviews with World Bank officials; GAO Analysis (2000)**

Following the July 1996 elections, the Bank believed that conditions for transformation were as favourable as could be expected and therefore stepped up involvement with Russia. While conditions for a concerted reform effort were not assured, at the policy level commitment to reforms was perceived to be strong. The World Bank's fiscal strategy through to 1999 took this so-called window of opportunity into consideration and supported the comprehensive and accelerated programme of structural reform.

When the crisis of 1998 occurred the Bank had three ongoing structural adjustment operations: a Social Protection Adjustment Loan, a second Coal Sector Adjustment loan, and US \$1.5 billion SAL3 (the Bank's largest loan to Russia which was originally part of a US\$22.6 billion package from the IMF, World Bank and the Japanese government). During 1999 operations were restructured, but they are still being implemented. In 1999, the World Bank's board of executive directors approved a new CAS for the Russian Federation (Figure 5.1.).

**Figure 5.1. Summary of the CAS for the Russia (1999-2001)**

<b>World Bank Country Assistance Strategy (CAS) for the Russian Federation</b>	
Five key features of the CAS:	
i.	Reaffirming that the Bank group must position itself for a long term relationship with Russia;
ii.	Sharpening strategic focus on poverty reduction by helping to re-establish the foundations for the growth and strengthening of targeted social safety nets;
iii.	Enhancing the focus on the institutional barriers to growth, including governance issues;
iv.	Intensifying portfolio management to improve impact; and selectivity in the lending program to preserve financial headroom;
v.	Investing in the Bank Group's knowledge base to deepen understanding of the Russian economy and provide the best possible policy advice and financial support in the years ahead.
Source: World Bank (1999)	

The CAS heralded a further shift in emphasis to deepen the process of structural reform. This involved a concentration on the reform of systemic policies and institutions intended to improve the performance of the public sector. This was deemed vital for the smooth and effective functioning of a public administration, for efficient private sector development, and for the development of an attractive investment environment for foreigners and domestic investors alike (World Bank, 1999).

The CAS also outlined a shift in responsibility from the IBRD to the IFC for operations in which funds are lent on to commercial enterprises and other forms of commercial lending. There was also a gradual shift in IBRD lending emphasis away from regional investment projects and project lending in infrastructure and energy in favour of increased emphasis on systemic aspects of institutional development (World Bank, 1999). In the social area, it gave the highest priority to strengthening the targeting of social protection, as well as addressing the TB/AIDS health crisis, and improving the efficiency of service delivery in health and education. It could be argued that these latter aims were addressing the failings of the Russian state rather than systemic reform.

After the financial crisis in August 1998, only three projects were added to the Bank's portfolio of operations up until 2001, mainly because of the uncertainty surrounding the stability of the domestic economy and the commitment of the Russian government to further reforms. The projects were: the Regional Fiscal Technical Assistance Project (US \$30 million), the State Statistical project (US \$30 million), the Sustainable Forestry Pilot Project (US \$60 million).

The 1998 crisis had a deleterious impact upon the Bank's investment loan portfolio. The decline in the performance of the lending portfolio has been attributed to; the difficult macro economic conditions, the decreasing creditworthiness of the regions and other project beneficiaries, continuous changes in government, disrupted project implementation and delayed decision-making on key issues. World Bank statistics reveal the decline in the number of projects rated as satisfactory from 74 per cent in June 1998 to 33 per cent by July 1999. Some projects could obviously not cope with the effects of devaluation and others were simply not reform orientated enough to be sustainable given the framework within in which they were set up. Since 1998 there has been a noticeable decrease in the pace of project implementation. In financial year (FY) 1999 US \$359 million was disbursed for the investment portfolio in comparison with the US \$722 million that had been released in FY1998.

In July 1999, it was agreed that the Bank and the Government would set targets for each problem project so that they could be seen to be making adequate implementation progress, in some cases this process of appraisal involved a restructuring of the projects. This more aggressive stance taken by the Bank and the government in monitoring the progress of the projects achieved significant improvements in the quality of the loan portfolio in terms of the targets that had been set by the IBRD. The results of the Country Portfolio Performance Review (CPRP) held in February 2000 showed that the performance of the portfolio was much improved with 60 per cent of projects being rated as satisfactory, as opposed to only 33 per cent the previous year. By the end of the year 2000, the percentage had been raised again to 76 per cent. Despite such improvements in performance,



the Bank, in agreement with the government, have agreed to maintain the vigorous monitoring of the portfolio to ensure that it is sustainable (World Bank 2001).

Following the significant progress made in the World Bank's portfolio of projects the following major projects have been launched since 2000: treasury modernisation project, fiscal federalism and fiscal reform project, Northern restructuring project, education reform project, Kharbarovsk habitat conservation project, municipal heating project, Moscow urban transport project and the municipal water and wastewater project. It is clear to see from this list of current projects that the World Bank has shifted the focus of its operations and engaged more heavily in areas concerned with social and environmental protection<sup>12</sup>.

### ***5.9.3. The EBRD and the Russian Federation***

It is clearly stated within the founding Agreement of the EBRD that assistance will only be given to countries committed to the principles of multi-party democracy, pluralism and market economies (EBRD, 2000a). However, membership to the EBRD was granted to the fifteen newly independent states that emerged from the break up of the Soviet Union, by 1992, one year after the collapse of the communist regime. At this time there was not necessarily a commitment within the Russian Federation to a full transformation of the political and economic environment. See Table 5. 5. for an overview of the EBRD strategy for Russia since 1991.

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<sup>12</sup> For more information about the projects see <http://worldbank.org/projects/results/>

**Table 5.5. Overview of the EBRD strategy for Russia, 1991-present**

<b>Time period</b>	<b>Key points of the strategy</b>
1991-1993 First EBRD efforts focussed on technical assistance	<ul style="list-style-type: none"> <li>• Technical assistance targeted for privatisation, training and advice on reform legislation</li> <li>• Initial plans for financing projects lacked focus, spread over 11 sectors</li> <li>• Weak business climate in Russia and limited number of sound financing opportunities</li> </ul>
1993-1998 Programme development and growth	<ul style="list-style-type: none"> <li>• Rapid growth of programmes, approx US \$ 1 billion in new projects in 1996 alone</li> <li>• Shifted emphasis away from technical assistance, focussed on fewer sectors and developed new goals</li> <li>• Focus shifts to the financial sector (to help promote development of SMEs) and the energy sector</li> <li>• Conscious effort to cluster projects in reform minded regions</li> <li>• Increasing reliance on financial intermediaries for project implementation to encourage institution building</li> </ul>
Mid 1998-2000 Financial collapse and recovery	<ul style="list-style-type: none"> <li>• As a result of the financial crisis the EBRD suffered heavy losses, mainly in the banking sector</li> <li>• Very limited number of projects approved in the aftermath, entire country portfolio examined</li> <li>• Cautious re-engagement with Russia by mid 1999, mid 2000 ready for possible major re-engagement</li> <li>• Focus of operations remains SME development, financial sector development, infrastructure development with a few priority regions and specific targeted support for some large enterprises</li> <li>• Promotion of lender and shareholder rights, business standards</li> </ul>
2001-present Strengthening of portfolio	<ul style="list-style-type: none"> <li>• Increased engagement in setting codes of conduct for business</li> <li>• Increased involvement in specific large enterprises</li> </ul>

**Source: Analysis of EBRD documents and interviews with EBRD officials; GAO analysis (2000)**

In spite of this lack of clear political direction, in 1993, the EBRD launched the Russia Small Business Fund (RSBF), aimed at supporting small and medium sized enterprises (EBRD, 2000). By 1994 the Board of Governors had approved a medium term strategy for operations within the Russian Federation. The focus of the strategy for operations in the mid to late 1990s focussed banking reform as well as supporting the growth of the SME sector, these designated priority areas have remained at the core of EBRD activities to date. The issue of good corporate governance, though always of concern to the EBRD in terms of loans made to SMEs and the banking sector, has risen to the forefront of the policy agenda since 2000. The EBRD is playing a key role in the writing of a new corporate governance code for Russia (see Chapter 8).

The EBRD has stated that their main strategic goal over the past few years has been to: 'Support through our projects and policy dialogue the confidence building process at the microeconomic level' (EBRD, 2000) following in particular their initial work in the sector of banking reform, which was seen as a prerequisite to further SME development. Over the past couple of years the EBRD has re-examined their policies towards the corporate and financial sectors, the small and medium size enterprises (SMEs), the infrastructure and environment and in particular their regional approach (EBRD, 2001a).

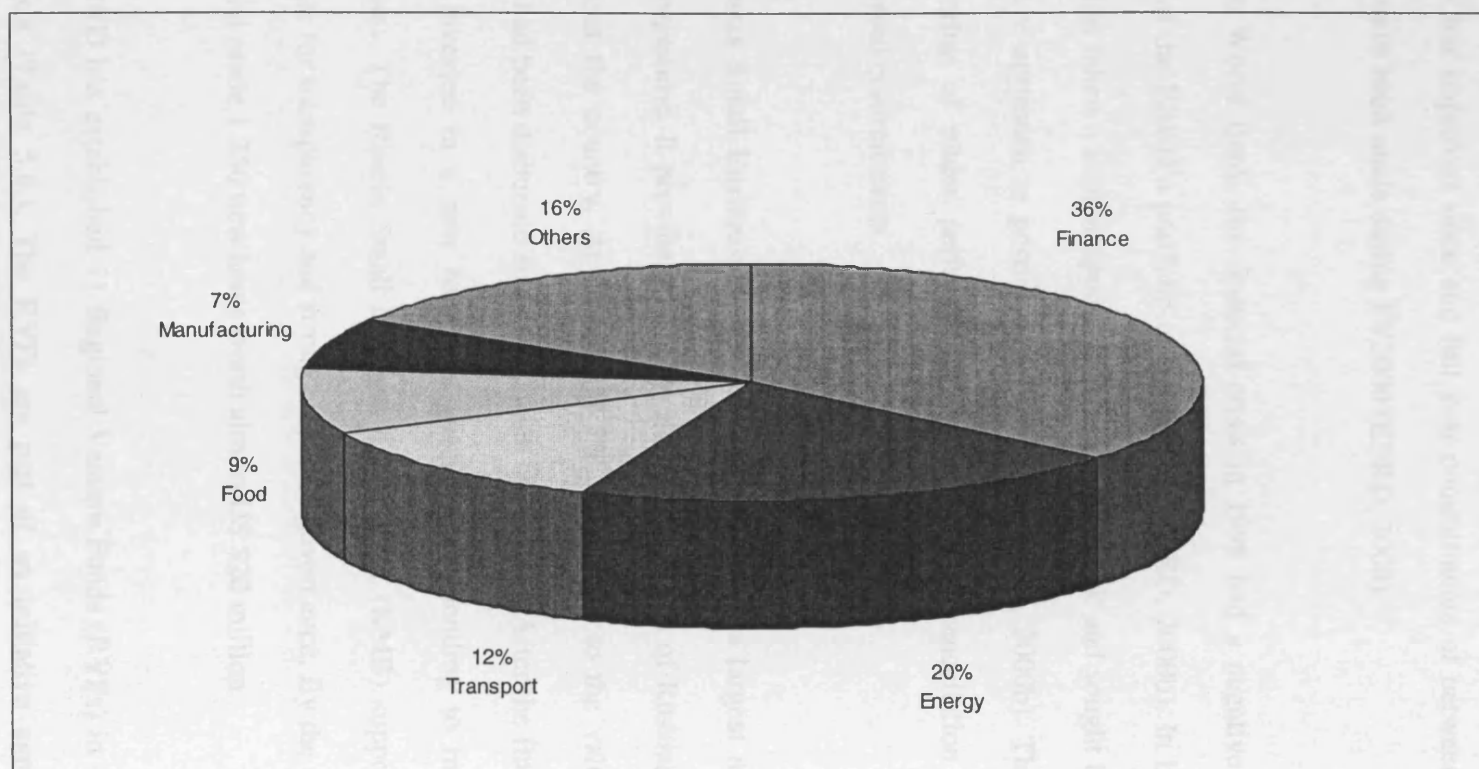
In the corporate sector the EBRD continues to push for the rapid expansion of investment. Through its active involvement in this sector the EBRD is looking to establish and show high standards of business conduct. In supporting companies who are taking a longer term perspective of business development the EBRD has

been attempting to raise investor confidence amongst foreign strategic investors. The Russian companies looking for support from the EBRD have to undergo a tighter process of selection and have to commit themselves to following EBRD guidelines for transparency and good practice.

The emphasis of the work that the EBRD is undertaking within the financial sector is not that of rapid expansion but rather systemic reform. The goals of the EBRD are to promote competition, stimulate more effective corporate governance and to reduce the degree of politicisation of the financial sector (EBRD, 2001a). The EBRD is also trying to accelerate the process of reform within the banking sector, supporting the process of privatisation of state owned banks and the gradual depoliticisation of the financial sector all together.

In the period from 1991, when EBRD operations began in Russia, until September 2000, the Board of Directors had approved financing of US \$3.44 billion for 110 projects, and a total project value of US \$10.9 billion (see Figure 5.2. for details of EBRD funding for Russia by sector; and Map 5 for the regional distribution of funds). This represents nearly 20 per cent of total Board approvals during this period (EBRD, 2000). By June 2000 the EBRD had managed 441 technical cooperation (TC) projects with a total funding of US \$190.5 million sourced from bilateral and multilateral donors. The EBRD argues that the TCs have, and continue to play, an important role in the conception, implementation and monitoring of infrastructure related projects. The TCs specifically involve working with Russian companies in need of restructuring and in projects that benefit small businesses.

Figure 5.2. EBRD Funding for Russia by sector, 1991-2000



Source: EBRD (2001)

The start of new EBRD activities in the Federation declined in number following the financial crisis of 1998. In 1999 investment only reached US \$191.4 million. Activity has improved since and full year commitments of between US \$573-661 million have been made during FY2000 (EBRD, 2000).

Like the World Bank, the financial crisis in 1998 had a negative impact on the quality of the EBRD's portfolio of investment (EBRD, 2000b). In light of this, the EBRD has taken a similar approach to the World Bank and sought to adopt a more aggressive approach to portfolio management (EBRD, 2000b). This involves the restructuring of under performing projects and the cancellation of signed but undisbursed commitments.

The Russia Small Business Fund (RSBF) is the EBRD's largest micro and small loan programme. It provides financing through branches of Russian banks located throughout the country. At the end of FY 1999 loans to the value of US \$380 million had been disbursed since the launch of the fund. After the financial crisis the EBRD invested in a new bank that specialises in lending to micro and small enterprises. The Russia Small Business Credit Bank (KMB) supposedly acts as a showcase for transparency and strong corporate governance. By the end of FY 1999 KMB had made 1 250 new loans worth almost US \$20 million.

The EBRD has established 11 Regional Venture Funds (RVFs) in selected regions of Russia (Table 5.6.). The RVFs are part of an initiative agreed by the G7 governments and the European Union in 1993 at the Tokyo Summit. The aim of the

programme is to support the 15 000 newly privatised enterprises within the Russian Federation<sup>13</sup>.

**Table 5.6. EBRD Regional Venture Funds (RVFs)**

<b>Name</b>	<b>Oblasts/Territories</b>	<b>Donor Government</b>
Black Earth	Belgorod, Kursk, Lipetsk, Tambov, Voronezh	European Union
Central Russia	Ivanovo, Nizhny Novgorod, South West Kostroma, Yaroslavl, Vladimir	Germany
Far East and Eastern Siberia Fund	Irkutsk and regions to the East including Primorsky Krai and Khabarovsk Krai	Japan
Lower Volga	Samara, Saratov, Volgograd	United States
North West and West Russia	St Petersburg and Leningrad oblasts, Arkhangelsk, Karelia, Murmansk, Novgorod, Pskov, Tver, Vologda	Finland, Norway and Sweden
St Petersburg	City of St Petersburg	Germany
Smolensk	Smolensk	European Union
Southern	Krasnodar, Rostov, Stavropol	France
Urals	Chelyabinsk, Perm, Sverdlovsk	European Union
West Siberia	Atlay, Novosibirsk, Kemerovo	European Union

Source: EBRD (2001)

The enterprises are to be given assistance in restructuring and adapting to function within a market economy. Each RVF has been given us \$30 million to invest as new equity in SMEs and other private enterprises to finance projects that are predicted to earn a commercial return<sup>14</sup>. The EBRD is not the only partner to finance an RVF. EBRD capital is supplemented by US \$20 million from a donor government<sup>15</sup>. The added finance is used to cover the operating costs of the RVF, as well as consulting support to the enterprises in which the RVF is investing. The involvement of the donor governments allows the RVFs to invest in companies that might not seem

<sup>13</sup> These enterprises were privatised under the Russian Government's Mass Privatisation programme which started in 1992. See Chapter 3 for a discussion of the privatisation process.

<sup>14</sup> Smolensk RVF has been awarded US \$12 million and the North West and West Russia RVF has received US \$60 million.

<sup>15</sup> Smolensk RVF received US \$8 million and the North West and West Russia RVF received US \$40 million.

immediately attractive to investors. In addition to this, their involvement also provides assistance and expertise in improving financial management and in developing and marketing and distribution capabilities (EBRD, 2001c).

The EBRD's current strategy document for the Russian Federation, in addition to detailing its current activities within the Federation, details some changes that it is seeking to make to its policy. One issue is of particular relevance to this study, the regional focus of the EBRD's operations in Russia. The aim of the EBRD is to increase its impact: '...through a pro-active more comprehensive approach in working with selected priority regions' (EBRD, 2002<sup>16</sup>).

The following regions have been short-listed, based on their track record on reform and financial strength: Perm, Samara, Vologda, St Petersburg and Novgorod. The EBRD claims that this fresh regional focus will complement World Bank efforts that are specifically aimed at improving federal-local financial management. Such schemes involve initiating a close reform dialogue with the regional authorities, the clustering of SME projects and more concerted efforts to find and assist private sector investments.

#### ***5.9.4. The EU and the Russian Federation: Tacis***

In December 1990 the European Council first made the decision to offer technical assistance to the then Soviet Union. The assistance was intended to help with the progress of reforms and to help in the establishment and functioning of a market based economy and democratic society. The main reasons lying behind this decision

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<sup>16</sup> A statement made on the EBRD's official website. See <http://www.ebrd.com>



are fairly self evident, but worth stating briefly. The European Union (EU) was anxious that the increasing political and economic instability in the Soviet Union could affect its member states. Furthermore, there was a strongly held belief that in aiding transition, potentially large flows of refugees could be limited, as internal crises, of all forms, social, political, and economic, were predicted to occur within the Soviet Union. Intervention at some level was also deemed important in promoting the safe management of nuclear facilities and products. Maintaining good trade relations was also of concern. In the most recent Indicative Programme it is clearly stated that today the European Union:

‘...attaches a very high importance to its long-term partnership with Russia, reflecting not only increasing geographical closeness, especially with the planned EU enlargement, but also the awareness that stability and prosperity in Russia are essential to the well being of the entire European continent’ (EU, 2000:3).

It is now the Partnership and Cooperation Agreement (PCA) that forms the basis of the continued deepening relationship between Russia and the EU. Signed in 1997 the agreement establishes the legal and institutional framework for a working partnership between Russia and the EU. The PCA contains commitments for both sides and a number of priorities and specific targets have been selected in the PCA Joint Work Programme, which currently includes nineteen areas of co-operation.

From the outset the EU chose to offer technical forms of assistance. The price tag for offering more direct forms of investment in infrastructure development was a deterrent to this alternative path being chosen. The choice to opt for technical assistance fitted in with the popular assumption that Russia, although ‘mis-developed’ under the communist system also enjoyed the benefits of a large

industrial base, an educated population and an abundant supply of natural resources. It was therefore agreed within the EU that a large programme of several hundred targeted short term projects would help to assist Russians to revitalise their ailing economy, further to integrate Russia in to the global economy and to help in stabilising the political situation in the country (EU, 1995).

The key objective of the Tacis programme, from its inception, has been to assist and accelerate market economic reforms and democratic reform in Russia (see Table 5.7.). Additional objectives pertaining to the establishment of a democratic society and legal reform were added in 1993 and 1999. The EU recognised from the outset that its potential to influence change in Russia was limited. It is stated in the European Council resolution<sup>17</sup> that created Tacis in 1991 that the resources made available to Tacis were very small relative to the size of Russia and the huge problems that it was likely to face through a transition period. Recognising then, that successful individual projects could have limited impact in such a large country, Tacis was to concentrate its efforts in only a few key sectors. Furthermore, it was seen as beneficial to cluster projects in reform minded localities and regions to help, in theory, to have the greatest possible impact (EU, 2000c). It was, however, acknowledged within the EU, that in addition to facing the challenges of the constantly changing political situation and the size of the task at hand that it was also constrained internally, especially in terms of the size of its staff available to work on the programme.

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<sup>17</sup> European Council Resolution made in 1994

**Table 5. 7. Overview of TACIS strategy for Russia, 1991-present**

<b>Time period</b>	<b>Key points of the strategy</b>
1991-1994 Focus on making a quick impact	<ul style="list-style-type: none"> <li>• Main focus of projects is on democratic reform, limited attention is paid to giving democratic assistance</li> <li>• Projects were generally smaller scale and focussed on making a rapid impact</li> <li>• Special attention was paid to training Russians in theories of market economics</li> <li>• Many projects were aimed at giving local level support and training</li> </ul>
1995-1998 Focus on forcing systemic change	<ul style="list-style-type: none"> <li>• The challenge of the reform process proved greater than anticipated</li> <li>• Attention is shifted towards larger scale projects and towards working at the federal level</li> <li>• Target sectors remain the same and assisting in promoting economic reform also stays a priority</li> <li>• TACIS objectives become increasingly aligned with broader EU political goals in Russia</li> </ul>
1998-present Post financial crisis rethinking leads to modified approach	<ul style="list-style-type: none"> <li>• The crisis reinforces the assumption that transition would be a decade long process</li> <li>• Greater emphasis is placed on supporting the development of: market institutions, rule of law, and civil society</li> <li>• More attention is given to supporting change at the grass roots level</li> <li>• Project selection reflects greater emphasis on mutual benefits for EU and Russia</li> </ul>

**Source: Analysis of TACIS/EU documents and interviews with TACIS/EU officials; GAO analysis (2000)**

Throughout policy documents it is clear that the Tacis programme puts great stock in the importance of close cooperation with Russian partners in strategic planning, and project design and evaluation. In trying to work closely with Russian partners the EU's aim was to tie Tacis projects to Russian priorities, which in turn would reflect the realities on the ground in Russia. Those involved in the Tacis programme noted that the support of Russian government officials at the Federal and Regional levels was also essential if the projects were to be a success. In sum, there needed to be a positive environment for the projects to be operationalised within.

#### ***5.9.5. Tacis Policy Instruments***

The Tacis programme has used almost exclusively five different forms of technical assistance throughout its project life within Russia. It has offered:

1. ***Policy advisors to government agencies***: this has been used as the primary instrument for Tacis. European policy advisors work closely with their Russian counterparts and assist in the execution of the reform agenda. For example, advisors have been used in the drafting and implementation of new tax laws.
2. ***Training and advice to the private sector***: the number of such projects has dwindled over the past five years but many of the early projects involved training people in the workings of the market economy. As more Russians understand about the functioning of the economy this instrument becomes less effective and there are also issues concerning the effectiveness of mass teaching programmes, which can not be supported outside the class room in a practical nature.

3. ***Internships***: the programme has financed internships allowing Russians to work at European firms for periods of 2-3 months. Russians have been given the opportunity to work at all levels within European companies but the focus has been on management.
4. ***Funding studies, including pre-investment plans, market research and feasibility studies***: the rationale behind the use of this instrument is that Russians might not have the access that they need to data, in order to make informed business or reform decisions. In this situation, money is given for this data to be collected and analysed. Within the past few years, for example, Tacis conducted a study of the feasibility of a gas distribution network extension for the Ministry of Finance. The work was used afterwards as a basis to support a World Bank loan.
5. ***Developing and reforming legal and regulatory frameworks, institutions and organisations***: one of the designated roles of the Tacis programme has been to help the Russians establish key institutions and processes essential to the functioning of a market economy. This is quite some challenge, therefore, Tacis programmes have been closely aligned with other IFIs activities in this area in order to maximise potential impact.

#### ***5.9.6. Structure and Amount of Tacis Assistance to Russia***

The European Union has been giving aid to Russia since 1991. Of the US\$2 011 million that has been given to Russia in the period 1991-2000, US\$1 226 million has been allocated within the framework of the Tacis Russian Federations Action Programmes (EU, 2001). For most of this period, commitments have ranged from

US\$243 to US\$292 million annually although commitments for 1999 and 2000 fell considerably<sup>18</sup>.

Tacis assistance has been allocated across seven major sectors of economic activity. From the table (Table. 5.8.) below it is possible to see that programmes dedicated to helping with institutional, legal and administrative reform and policy advice and small project programmes have received the most support. While in the initial years of the Tacis programme private sector support and economic development was certainly a priority area.

**Table 5.8. Russian Federation Action Programmes (in million US\$<sup>19</sup>)**

	1997	1998	1999	2000
Institutional, legal and administrative reform	14	26.5	13.2	24.7
Private sector support and economic development	25.6	28.2	15.9	12.4
Alleviation of social consequences of transition	9.7	2.6	4.4	5.3
Development of infrastructure networks	21.2	17.6	9.7	0
Environmental protection, natural resource management	4.4	8.8	7.1	3.5
Rural economic development	11.5	7.9	4.4	0
Policy advice; small project programmes	27.3	24.7	20.3	34.4
Others	3.5	8.8	7.1	6.2
<b>Total</b>	<b>117.2</b>	<b>125.1</b>	<b>82.1</b>	<b>86.5</b>

Source: EU (2001<sup>20</sup>)

### **5.9.7. Tacis Strategy since 1991**

While Tacis strategy for Russia has evolved over time, some central tenets remain. Technical assistance is the main focus of operations. In the early years from 1991 projects were small scale and of short duration, emphasizing the presumed need for speed in terms of stimulating aiding in the pace of change to Russia's economic system. Working predominantly at the regional level, projects often involved organising conferences, training programmes, study tours and writing reports. The

<sup>18</sup>One factor, which might account at least in part for this drop in commitments, is the introduction of an incentive scheme within the programme. Approximately 10% of total programme funding for 2000 has been removed from country budgets and set aside to finance the best project proposals from all TACIS countries.

<sup>19</sup> Converted for ease of comparison from € at exchange rate of €1 to US\$0.88, January 15, 2002)

<sup>20</sup> This data was obtained from the official EU website, External Relations Department see: [http://europa.eu.int/comm/external\\_relations/ceeca/tacis](http://europa.eu.int/comm/external_relations/ceeca/tacis)

projects developed throughout the mid 1990s, as the drive to economic reform and the institution of democracy were the stated goals of the Tacis programme. Despite these dual policy goals economic reform remained the priority and in order to try to have more of an impact on the systemic reform process Tacis projects switched their focus away from the regional to the federal level.

The crisis in 1998 caused the Commission, like other institutions, to reassess their commitments and activities within Russia. Officials generally seem to have concluded that transition had not proceeded, as it should, because the institutional underpinnings for the market economy and the democratic society were lacking (EU, 1995: 4). As a direct response then to the crisis, project selection began to include more grass roots efforts related to the development of a civil society that would support both democratic and economic reforms. Developing the small and medium size enterprise sector became a priority (EU, 1999: 5).

Just as other IFIs altered the focus of their policy objectives post-1998, institution building has risen high, if not to the top, of the agenda. Working with increased intensity at the grass roots level more emphasis has also been placed on 'twinning' between Russian and EU institutions. It has also been possible to see Tacis projects being linked more closely with the broader issue of Russia's integration within Europe. For example, this has meant the growth in the number of projects aimed at improving transport links, upgrading border crossing points and customs procedures and addressing environmental concerns in the North West of Russia. Such projects play a key role in the development of the Northern Dimension project aimed at improving integration in the Baltic region. For example, Leningrad oblast, by virtue

of its geographical position has benefited from projects aimed at improving the transport infrastructure within the region. However, as yet the projects in the North West of Russia have not focussed on institution building as such, but rather on environmental projects and infrastructure development.

### **5.10. Conclusions**

The IFIs who have worked in Russia over the past decade, have faced a highly volatile working environment. In light of the financial crisis, and in some instances prior to this, IFIs have publicly recognised that legal and institutional development is essential to the overall transformation of the Russian economy. One could argue that successful project implementation has in the past been undermined by the lack of an appropriate legal and institutional base. In other words, the dominant mode(s) of social regulation in Russia have not evolved sufficiently to support the implementation of projects. The IFIs have had to recognise this. Furthermore, IFIs have been forced to acknowledge the close link between the macro economy, regulatory weaknesses and systemic risks within the financial sector (Stiglitz, 1998a; 1999).

In this era of a 'Post-Washington consensus' it is clear to see that all the institutions are moving towards a broader based approach to reform, one that is concerned with institutional development. While seemingly ideologically united, actual collaboration and cooperation between the institutions is limited. To what extent this is detrimental to the effective implementation of policy reform remains to be seen. I would argue that the application of 'transition orthodoxy' is more to blame



because by applying its premises in a rigid manner IFIs were unable to take due account of the complexities of the Russian system.

The endorsement of ‘the other’ way of regulating the economy, rather than ‘another’ way fuels perceptions inside and outside Russia that the IFIs only work to reinforce the discourse of neoliberalism and market fundamentalism. Moreover, IFIs, mainly Washington based IFIs, face greater difficulties in successfully implementing projects because the dominant ideology that informs them prevents them from adopting a more fluid and flexible approach to transformation processes.

The IFIs have had to work in the context of shifting scales of authority and with the recent adoption of the Gref<sup>21</sup> programme for economic development and reform, IFIs have again been forced to rethink the way in which they give assistance to Russia. This programme is, for example, part of Putin’s larger strategy to regain control of the regions. One thing is clear, however, save the EBRD, the major IFIs working in Russia have not adopted a regional approach to their assistance and have paid little attention to the uneven development of Russia’s regions. While IFIs are active at the regional level, their efforts are piecemeal and often result in duplication. Explanations for this lie in the belief that systemic reforms can only be successfully conducted at the federal level. But, I would counter this argument by saying that without due appreciation of the social practices and institutions that underpin the current system the work of IFIs will continue to face real problems. These processes are dominant and locally institutionalised at the regional level.

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<sup>21</sup> See Chapter 8 for discussion of the Gref Programme introduced in June 2000. For further information see <http://www.economy.gov.ru/>

Therefore the following case study chapters focus on IFI impact at the regional level and examine local modes of regulation.

## Chapter 6

### Identifying oblast responses to donor activity in Leningrad oblast

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#### Introduction

Examining aspects of past and present donor activity via case studies is important when trying to understand how policy frameworks are translated into practice. Furthermore, it is vital to gauge the reactions provoked within the regions in response to donor activity. More broadly speaking, this gives key insights into what kind of impact/effect projects have within Russia, especially on institutions and social practices, in both Leningrad and Sakhalin oblasts. Examining donor projects provides opportunities to access processes of local regulation and governance.

In turn, this analysis of key responses/processes identified within the oblasts, through the examination of donor projects, adds weight to the argument that IFIs are frequently, though not always, misguided in the planning and execution of their projects in that due appreciation is not given of the *reality* of social practices and institutions and the critical role that they play in the transformation process. It has been explained (see Chapter 5) that many projects are, at least in theory, targeted at changing social practices and institutions to fit with a 'desired' model for promoting the solidification of a mode of social regulation, which in turn will support the blueprint of a capitalist model of the regime of accumulation. But the Russian economy, as has been demonstrated, is one predicated upon hybridism and embeddedness (Carlsson et al. 2001; Gaddy and Ickes, 1998a; 1998b; Gustafson, 1999; Hanson, 1997b; see Chapter 3) and attempting to force changes through such projects is at best optimistic.

Promoting inward investment within the oblasts seems to be a priority for IFIs and other bilateral donors due to its supposed positive impact on the solidification of an 'appropriate' regime of accumulation, and of course many activities of bi-lateral donors are associated in some circumstances with the work of trade councils representing particular countries. Therefore, in the following chapters, attention is paid to the way in which this process is 'managed' within the oblast economies, both with and without the aid of donors. This involves looking at the interaction of all agents concerned. These processes, among others, highlight the ways in which the mode of regulation has evolved in Leningrad oblast since 1991 and provide an insight into the ways in which IFIs have impacted upon particular facets of governance and regulation.

As the extent and nature of projects that IFIs are undertaking within regions is changing, generally diminishing, there is however, increased activity at the national level (World Bank, 2001b: 4), which parallels moves towards the re-centralisation of the Russian state. These case studies should be considered against the backdrop of work occurring at the federal level (see Chapters 5 and 8). For the purposes of discussion and analysis, the following two case study chapters are structured thematically and focus on previously identified sites of regulation and governance (see Chapters 3 and 4) where processes interact and generate multiple responses to managing transformation<sup>1</sup>. It is first, however, necessary to contextualise the transformation processes occurring within the oblast by sketching, the path of the economic development and the salient politics of the oblast.

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<sup>1</sup> A list of the donor projects examined in this research can be found in Appendix A.

### **6.1. An economic geography of Leningrad oblast**

Leningrad oblast has a population of 1.68 million people (approximately 1.14 per cent of the Russian total) and is the 28<sup>th</sup> largest oblast in Russia covering 83 908 square kilometres. Leningrad oblast is situated in the Northwest of Russia, lying on the Gulf of Finland, an inlet of the Baltic Sea (see Map 2). The oblast shares international borders with Estonia and Finland, as well as administrative borders with five other subjects of the Russian Federation: the Novgorod, Pskov and Vologda oblasts, the Republic of Karelia and the City of St Petersburg. The oblast's main city is St Petersburg, though the city is defined as a separate subject of the Russian Federation. There are eight other cities within the oblast. The oblast itself is composed of 29 municipal regions, which are in turn subdivided into districts.

The development of St Petersburg as a capital, trading port and naval base and its subsequent transformation into one of the most important industrial, political and cultural centres in the eighteenth and nineteenth centuries, helps to explain the thriving economic position of the Northwest area of Russia at this time. In this period, Leningrad oblast became a locus for industrial development and particularly naval construction as the oblast housed the majority of enterprises connected to the construction of the Baltic Fleet and arms. The industrial and strategic importance of the Northwest region, both to Russia and her neighbours, has continued through to the present day. For example, several Scandinavian and Baltic countries continue to hold strong economic ties with the oblast (Oldberg and Hedenskog, 2000: 62).

St Petersburg, later Petrograd, and Leningrad, was the starting place of the October revolution in 1917. Following the revolution and the civil war that preceded it the

geopolitical significance of the Northwest region changed as the capital moved southeast to Moscow. The province surrounding, and including at that time St Petersburg, was renamed Leningrad in 1924 and in 1927, according to new administrative divisions, it was named Leningrad oblast.

In order to service the industries of Leningrad city (now St Petersburg) in the Soviet period, a vital and powerful fuel and energy base was constructed within the oblast. Some notable enterprises in the oblast include, for example, the Volkhov and Nizhne Svirskaya hydroelectric power stations, the Volkhov aluminium factory (the first in the USSR), as well as major paper mills, whose production accounted for approximately 23 per cent of the paper produced in the USSR until 1985 (Leningrad 2001b). Collectivisation in the agricultural sector resulted in the expansion of, for example, potato production. However, agricultural production in terms of livestock husbandry and grain manufacture did not increase as much as anticipated by Soviet planners (Leningrad, 2001b). At the present time, it is possible to see an enduring focus on, among other areas of production activity, timber and pulp manufacturing, as entrepreneurs continue to exploit the oblast's most plentiful natural resources.

#### ***6.1.1. A brief overview of the oblast's economy***

The oblast is highly urbanised with an estimated two thirds of the population living in what have been delimited as urban areas. Per capita gross regional product for FY2000 was approximately 18 per cent below the national average, but is continuing to climb steadily (Goskomstat, 2001b). This upturn can be largely attributed to increased production in the industrial sector with local production reaching over 39.2 billion rubles in 2000, up 25.6 per cent on figures for 1999

(*Russia Journal*, 05.06.2000). During the first half of 2002 growth of local production was 36.6 per cent compared with 3 per cent for the country as a whole (*Argumenti I Fakti*, No. 32, August 2002) Statistics show that the heaviest concentration of income generated in the oblast is in the industries related to energy production and raw materials processing.

In 1998, for example, the oblast together with the city of St Petersburg sold 65 thousand tonnes of gasoline (3.3 per cent of the total of the Russian Federation) and sold over 74 thousand tonnes of diesel fuel (3.8 per cent of the total sold in Russia). Recent figures suggest that the large oil refinery at Kirishi supplies 49 per cent of the oblast wholesale market for petroleum products (*Delovy Peterburg*, July 22, 2001). Prior to the recent surge of FDI in the region, revenues generated in Kirishi accounted for more than half of the region's tax revenue. In addition to the oil refinery, there are over 300 basic industrial enterprises, most of which are corporations, operating in the oblast<sup>2</sup>.

Since the collapse of state control, most of the existing enterprises that have evolved from former Soviet enterprises have faced the full weight of the challenges of restructuring. But key industries within the oblast have benefited from soft budget constraints afforded by the oblast government in the past (Interview, Oblast Administration, 20.04.2001)<sup>3</sup>.

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<sup>2</sup> The number of industrial enterprises was calculated from Leningrad region business register, available on request from the Committee of Economy and Investments of the Government of the Leningrad Region

<sup>3</sup> For a more detailed discussion of the regional restructuring of large scale enterprises see section 6.3.5.

The Oblast Administration has suggested, however, that one of the major problems for the oblast in the economic sphere is the lack of skilled workers, engineers and technicians (Interview, Oblast Administration, 03.05.2001<sup>4</sup>). If this is the case then this heralds a change from the past when the technically acclaimed universities and institutes of St Petersburg, in particular, contributed significantly to the provision of a highly skilled workforce in Leningrad oblast. In fact, many foreign investors have cited the availability of good labour supplies to be a reason for choosing to locate operations in the oblast (Orttung, *RRR*, August 12, 2002). The regional administration's concern is therefore likely to be related to attracting even more investors than they have already and being able to satisfy that labour demand.

While there is theoretically a lack of skilled labour in the oblast, employment growth in the regional economy has not kept pace with that in the Russian economy more generally (Goskomstat, 2001b). This can perhaps be explained by the fact that industrial production mix in the oblast is concentrated in more slowly growing/rapidly declining sectors (Goskomstat, 2001b). Projecting such a trend into the future suggests that oblast generated revenues are likely to grow more slowly than in other oblasts within Russia. However, such projections do not necessarily allow for dramatic, or even relatively small, increases in levels of foreign direct investment and enterprise establishment, which can affect on gross regional product and revenues.

Naturally, the changing fortunes of the regional economy are closely linked with the politics of the oblast. It has been demonstrated that political actors and networks

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<sup>4</sup> See also the official website of Leningrad oblast: <http://www.lenobl.ru/economy>, last accessed 01.07.2002



have played a pivotal role in the way that the transformation process has evolved in Russia (Bradshaw and Hanson, 2000; Broadman, 2002; Hanson, 1994; Solnick, 1996; Stoner Weiss, 1997). It is therefore useful for the purposes of discussion and analysis to give an overview of the politics of Leningrad oblast since 1991, but particularly focussing on the key transitional years from the mid 1990s to the present day.

### ***6.1.2. An insight into the politics of the oblast***

The politics of Leningrad oblast have not attracted an overwhelming amount of attention in the Russian or international press since 1991<sup>5</sup>, mainly because the political climate has been dominated by two seemingly 'stable' Governors. While as individuals they are colourful in many ways, in comparison with their peers elsewhere in Russia, they have not stood out as overtly radical political leaders (Carnegie, 1999: 635). Of course, there have been many political actors within the oblast, however, given the constitutional power and influence associated with the position of Governor it is clear to see how Governors themselves play a key role in shaping the politics of a oblast.

The first Governor of the oblast, appointed by Yeltsin, was Aleksandr Belyakov but in the first gubernatorial election held in Russia he lost out to the Communist backed candidate Vadim Gustov (OMRI Daily Digest, 30.09.1996). Vadim Gustov had previously headed the Leningrad oblast Soviet until the administrative unit was dissolved in 1993. Since the collapse of the Soviet state in 1991, and even prior to

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<sup>5</sup> This statement is made of the basis on extensive archival searches through Pravda (one of the biggest national newspapers in Russia), The Moscow Times and OMRI Reports 1992-2001

that within the Party network, Gustov was an influential player (OMRI Daily Digest, 30.09.1996; Interviews: Oblast Administration, 20.04.2001; Local Academic, 26.04.2001; Oblast Administration, 03.05.2001).

In his campaign for the gubernatorial elections in 1996, though backed by the Communists, he went on the record as being an independent favouring the free market (St Petersburg Times, 24.08.1996). He distanced himself from the national patriots and promoted the image of himself as a professional executive with pragmatic<sup>6</sup> policies. Individuals in the business and diplomatic communities<sup>7</sup> have noted that Gustov's reform mindedness was a key variable in the oblast making progress in terms of economic development<sup>8</sup>.

The governor rode high on the fact that the regional economy took an upturn in 1997, very shortly after his election: GDP grew and reached a positive growth figure of 1 per cent (Goskomstat, 1998). That year, there was also a 0.4 per cent decrease in the rate of unemployment, down to 5.6 per cent and the amount of taxes collected in the first three quarters grew 19 per cent (Goskomstat, 1998). Gustov is commonly associated with the recovery of the regional economy from its deep transitional recession, as well as establishing policies designed to attract investment in the region.

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<sup>6</sup> The 'pragmatic' policies involved staking a stance of pro-reform mindedness over the longer term rather than pushing through packages of reforms very quickly. For example, one explicit aim was to promote longer-term sustainable growth through attracting both long-term foreign and domestic investment as well as the regeneration of the key industries within the region.

<sup>7</sup> Evidence gathered through interviews April- July, 2001, St Petersburg and Leningrad region

<sup>8</sup> Though readily problematised, 'economic development', it seemed was understood by the majority of the businessmen interviewed to involve the region's increased exposure in the international arena, increases in per capita FDI and general production statistics as well as the development of associated institutions.

While he and the administration played a role in this, it would be naïve to think that there were no other factors involved in the start of the process of economic recovery. But of course, the administration's policies positively encouraged growth, if not just in part, because of the confidence that was inspired among foreign and domestic investors. For example, preferential tax laws (see Table 6.1.) and other such schemes were introduced under his administration and certainly accounted for the marked interest from international firms in choosing to locate operations in the region.

The Governor and his team have been characterised in the press and diplomatic communities as astute economic actors who fully recognised the natural economic advantages of the region that they could promote successfully and acted accordingly (Carnegie, 1999). The regional administration has become well known for offering tax privileges to compliant investors in the oblast<sup>9</sup>. Yet, while making such financial concessions, they have also tried to ensure that the oblast itself is benefiting in as many ways as possible from increased investment activity; for example, in infrastructure development or increased tax revenues given the wider tax base (*Delovoy Peterburg Kommersant*, 06.06.2001). Gustov played a key role in trying to attract new investment in to the oblast but also paid great attention to existing enterprise directors and managers. In fact, in the 1996 regional legislature the regional industrial enterprise directors were heavily represented with 26 deputies and out of the 18 that stood for re-election in the following year over half held their seats and continued to do so until 2000 (RRR, 18.12.1997).

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<sup>9</sup> Federal law changed in 2001 preventing regional governments from offering discretionary tax privileges as national standard rates of tax were introduced in the new tax code.

Table 6.1. Summary of system of privileged taxation in force in the Leningrad region, 1994-2001

Type of tax	Tax rate set at the federal level (% rate)	Tax rates of Leningrad oblast (% rate)	Summary of tax privileges for investors in the Leningrad region <sup>1</sup>
Enterprise and organisation profit tax	22	18	During the first three years of an enterprise's development (that is working in the 'productive' sphere) within the Leningrad region, which is either domestically financed or partially financed by foreign investment, this enterprise is not liable to pay the full rate of (federally set) profit tax if a prior agreement has been made with the regional administration; any taxable profit will be reduced when real costs are subtracted from this preliminary figure (by not more than 50 per cent), all tax revenues from this tax source will be directed towards subsidising public services and the agricultural sector
Profit tax on intermediary activity	30	18	Reduced regional rate available following negotiations with regional government
Profit tax in the banking sector	30	18	Financial companies (e.g. banks and investment funds) are not liable to pay the full rate of (federally set) profit tax if they provide privileged loans (at a lower rate than that offered by the Central Bank of Russia). The tax rate will be reduced by not more than 50 per cent but only if lending programmes are directed towards the development and creation of enterprises, which are approved by the Government of the region
Profit tax in the insurance sector	30	18	Reduced regional rate available following negotiations with regional government
Real estate tax for enterprises	2	2	Those enterprises eligible for a reduction in enterprise and organisation profit tax listed above are also eligible for up to a 50 per cent reduction in real estate tax; river ports situated within the region are not liable to pay the full rate of real estate tax
Land tax	na	na	Enterprises eligible for the above reduction are also eligible for up to a 50 per cent reduction in the rate of land tax <sup>2</sup>

<sup>1</sup> Source The law of the Leningrad Region "On privileged taxation of enterprises and organisations situated on the territory of the Leningrad Region" N2-03, passed 15.06.1994

<sup>2</sup> Source: The law of the Leningrad Region "On payment for land utilisation" N4-03, passed 27.07.1994

Perhaps displays of shrewdness played a part in Primakov appointing Gustov as First Deputy Prime minister in 1998 with responsibility for regional issues, CIS and youth issues. However, Gustov's time in this office was short-lived as he was dismissed in April 1999. Gustov unsuccessfully challenged the temporary replacement incumbent to the gubernatorial chair in 1999. Valeriy Serdyukov<sup>10</sup> was appointed acting Governor of the oblast when Gustov was appointed to the Primakov cabinet in September 1998 and was elected to the position in 1999. He remains in office to date and has the potential to stay in office for another term as constitutional law has been changed to allow for this<sup>11</sup>. This is because importance has been attached to maintaining investor confidence in the oblast. Representatives of blue chip companies operating in the oblast suggested that ensuring political stability in the oblast was essential to maintaining investor confidence (Interviews: Foreign Investor, 08.05.2001; Foreign Investor, 10.05.2001, Oblast Administration, 03.05.2001).

Serdyukov is generally perceived to be a less colourful character than Gustov, and perhaps less 'easy going' in terms of dealing with IFIs, bi-lateral donors and other foreign actors. Nevertheless, representatives of the aforementioned parties confirmed that Serdyukov and his team were still easy to work with in comparison with other oblast governments, in their personal experience (Interviews: Oblast Administration, 03.05.2001; Foreign Investor, 08.05.2001; Bi-lateral donor, 16.05.2001). Informants suggested that the administration was indeed justified in

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<sup>10</sup> Serdyukov is a member of Putin's Unity party (RRR, 23.09.1999)

<sup>11</sup> An amendment to the gubernatorial election law was passed by the State Duma in the second and third readings, which allows for just a few governors to run for their third and fourth terms in office. Among the Northwest regional leaders Prusak (Novgorod region) qualifies for the fourth term and Serdyukov (Leningrad region) for the third term. Both are widely recognised as reform minded governors who work in cooperation with Federal government.

being a little more cautious with regard to, for example, large-scale exposure to foreign investors, in terms of the negative impacts that such activity can and has had within the oblast.

The two governors who have had greatest impact in terms of shaping the oblast's economy have differed in terms of leadership style and perhaps slightly on policy, but these general reform programmes did not differ significantly (Oldberg and Hedenskog, 2000). Furthermore, the neighbouring St Petersburg city administration has faced frequent criticism for widespread corruption within its structure, while the government of Leningrad oblast has been judged to countenance less corruption than most. This reputation has earned it greater respect and trust in many circles, especially from the various trade councils that operate within the Northwest region of Russia (Interviews: Bi-lateral donor, 16.05.2001; Bi-lateral donor, 28.05.2001; Bi-lateral donor, 31.07.2001, Diplomatic Community, 31.07.2001).

Since 2000, the Presidential representative for the Northwest region of Russia, Victor Cherkosov, also plays a role in defining the politics of the oblast and in some instances mediating relationships between the federal subjects under his supervision with federal government. Opinions remain somewhat divided as to the real impact that the appointment of the Presidential representatives have had within Russian politics and what their real role is (Orttung, *RRR*, 11.05.2001). Along with managing political issues on behalf of the federal government, the President has entrusted the representatives with maintaining control over spending of finances from the federal budget, for realising federal programmes and the use of federal property.

So, in general the representative appears to have the role of trying to standardise practices and processes in the federal subjects according to relevant federal laws. As the introduction of a new level of federal power was introduced two years ago, both the representatives and federal subjects have found themselves on a steep learning curve when negotiating their relationships with each other. The standardisation of oblast with federal laws has meant that many oblasts have had to adjust laws that they had previously passed. The presidential representative, for one, is responsible for monitoring this situation. This would suggest that there is the potential for tension and friction between the representative and the Oblast Administration given the latter's prior 'freedom'.

Representatives of the Leningrad Duma, who were interviewed, concurred in suggesting that the presidential representative for the Northwest region, Victor Cherkesov, had been working hard since his appointment to ensure standardisation and compliance to federal laws in the Northwest region (Interviews: Oblast Duma, 06.06.2001; Oblast Duma, 30.07.2001; Rutland, 2001). However, they did not suggest that the introduction of this new level of federal power had overly infringed on their activities, mainly because they felt that in comparison with other oblasts in the Northwest, Leningrad Duma had not made substantive moves away from federal policy, or that they were in a position of not being able to find a way to 'work within' the bounds of federal policy.

It appears that Leningrad oblast enjoys a professional and respectful relationship with federal government (Ekspert, 18.10.1999). Over the past years there have been very few incidents or debates in which the oblast has been in vocal disagreement

with the federal government and has 'officially'<sup>12</sup> complied with federal laws and accordingly adjusted their own legislation.

This political and economic background provides the context for IFI and other donor activity in the oblast as well as flagging important concerns and processes occurring within the sphere of local governance and regulation. It further suggests, more importantly, that the Oblast Administration is actively pushing for changes to the mode of social regulation and governance practices, though within certain bounds. Therefore begging the question as to what the IFIs and other donors hope to achieve in the oblast. There are of course many different sectors of life that IFIs and other donors engage in that might not be priority areas, at least yet, for the Oblast Administration. However, it does appear that a disproportionate amount of donor support in the oblast is targeted towards helping improving the business environment. It is indeed difficult to gauge the causal effect of IFI and other donor projects on the evolution of social practices and institutions when Russian actors are themselves pushing for reform and changes. This is an important issue that needs to be discussed further particularly because IFIs tend to favour working in pro-reform regions.

## **6.2. The nature and extent of donor assistance in Leningrad oblast**

The involvement of foreign actors in shaping the transformation of Russia is widely regarded with 'suspicion' by many Russians actors in both the public and private sectors (Interviews: Local academic, 26.04.2001; Oblast Duma, 06.06.2001;

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<sup>12</sup> Leningrad region has, for example, reformed its preferential tax laws (see Table 6.1.) to comply with Federal tax laws. However, the regional administration still offers tax incentives and privileges to enterprises operating within the region. They take advantage of loopholes in other legislation to be able to do this.



FIAS/IFC, 2001). Extensive field research in the Leningrad oblast revealed that different groups of economic agents in the oblast held different opinions as to the worth of IFIs and other donors working in the oblast. Opinions varied according to the perceived benefits that they as individuals received and the levels of 'interference' that they felt they had to endure.

Historically, the oblast has not attracted as much specifically targeted assistance or attention from the major Washington-based IFIs, compare with its neighbours, St Petersburg and Novgorod. This is not atypical for the majority of oblasts in Russia, given the focus of assistance within a handful of 'selected' oblasts<sup>13</sup>. The uneven distribution of donor assistance is an important issue, and the subject of further analysis in the thesis. Leningrad oblast has, received proportionally most direct attention/assistance from bi-lateral donors, such as Sweden, Finland and the UK, as well as Tacis funds from the European Union. This is not surprising given the oblast's geographical location and therefore strategic economic, political and environmental importance to European countries. That said, the oblast has also been exposed to a higher proportion of technical assistance projects as opposed to structural adjustment programmes<sup>14</sup>. Again, this has implications in terms of the 'real' potential impact that projects might have in the oblast. For example, 'conditionalities', as discussed in Chapter 5, can rarely be attached in the same manner to technical forms of assistance.

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<sup>13</sup> For a detailed discussion of this a priori unofficial federal 'selection' see Chapter 8

<sup>14</sup> The region is exposed to Structural Adjustment programmes conducted at the Federal level as, for example, new legislation filters through. For a discussion of programmes conducted at the Federal level by IFIs see Chapter 8.

Regional enterprises, in many cases with the assistance of the oblast government, have taken advantage of several financial schemes to aid them in forcing the restructuring process. These include, for example, credit lines from the World Bank. The total amount available in the line is US \$85 million (World Bank, 2001). Through this scheme enterprises have the opportunity, having passed stringent selection criteria, to be given good credit terms, as they set about restructuring, and increasing attractiveness to potential investors, with the help of foreign and Russian consultants. Unfortunately, figures for the total amount of monies disbursed through this credit line within Leningrad oblast were not available, nor were the numbers of companies that had taken up this credit line.

One of the more significant moves that the World Bank has made within the oblast is to open a \$100 million credit line to Ford Vsevolozhsk, a subsidiary of the Ford Motor Company. The money is to be used to complete the construction of the Ford plant in Vsevolozhsk to assemble Ford Focus automobiles (Ekspert, 25.06.2001). The announcement of this particular deal signalled to the oblast and its neighbours the World Bank's new policy of actively supporting foreign investment projects in the oblasts, while focussing on providing technical assistance now at the Federal level. The oblast has, however, recently taken part in a World Bank/IFC study of administrative barriers to investment that is examined later in this chapter.

There are Tacis and the EBRD offices in the city of St Petersburg that are dedicated to managing projects in the Northwest region of Russia. The EBRD office, to date, has not had much involvement in the oblast's economy due to a lack of suitable projects (Interview: IFI, 27.04.2001). There is indirect EBRD involvement in the

oblast via their support of the development of the service industry in St Petersburg, which acts as the service centre for Leningrad oblast. Enterprises operating in Leningrad oblast for the most part use, for example, the banking facilities and other financial and legal services of the city of St Petersburg (Interviews: Foreign Investor, 08.05.2001; Foreign Investor, 10.05.2001; Russian SME, 05.06.2001a; Russian SME, 05.06.2001b; Commercial Bank, 14.05.2001; Commercial Bank, 18.05.2001). Therefore, EBRD activities in the oblast are discussed in this chapter through analysis at these sites of regulation and governance.

Since its creation in the early 1990s, the Tacis office has been very active. It is estimated from available data that over thirty-five projects have been run in Leningrad oblast (Tacis, 2002; Interview: IFI, 04.05.2001a). They range in scope and scale, but all fall within the policy frameworks as discussed earlier (see Chapter 5). The majority have been Bistro projects, which is representative of Tacis operations as a whole in Russia (Tacis, 2002: 4). Tacis projects that are discussed in this chapter in detail include: the 'Synergy Project' (aimed at enhancing Synergy between Leningrad oblast and St Petersburg) and an SME-focussed regeneration programme. Other significant projects that have been either totally or partially Tacis funded in the oblast include: the Baltic Port development programme (Primorsk port), and the food-processing programme (dairy industry). These projects are fairly representative of the other work that Tacis has been engaged in. There were, for example, a large number of investment conferences held in the oblast since 1997. Tacis funded a conference (November 11-12, 1999) with the Northwest Association, devoted to showing plans for several investment projects. These projects had been selected and prepared for presentation to potential investors by

Tacis experts. Tacis has recognised that one of its programmes key strengths lies in its ability to fund such activities which are perceived positively by many economic actors in the oblast, from Russian quarters (Tacis, 2001b: 3; Interviews, Russian SME, 01.06.2001; Oblast Administration, 03.05.2001) as well as foreign investors and trade councils (Interviews: Trade Council, 11.05.2001; Bi-lateral donor, 28.05.2001; Diplomatic Community, 31.07.2001). However, most informants also suggested that while worthwhile in terms of providing an opportunity to network there were other such opportunities without Tacis projects. Just as World Bank projects conducted in the oblast should be viewed against the backdrop of projects conducted at the federal level, so should Tacis programmes, and for that matter EBRD projects.

Several bi-lateral donors have shown a keen interest in working in the oblast. In particular there is a strong and enduring relationship between the Swedish, Finnish and British development agencies and Leningrad oblast. For example, DFID (UK) recently held a competition among the eight oblasts that it has previously selected to work in<sup>15</sup>. The Leningrad oblast was one of two successful oblasts to win the competition and maintain a close working relationship with DFID (Interviews: Bi-lateral donor, 16.05.2001; Bi-lateral Donor, 11.06.2001; Diplomatic Community, 31.07.2001<sup>16</sup>). Interviews throughout the oblast revealed distinctly different attitudes towards working with bi-lateral donors in comparison with larger IFIs. Potential reasons for this are discussed later in this chapter.

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<sup>15</sup> This 'competition' was held as DFID has shifted its operations, as other international donors have, to focus at the federal level with some regionally based support.

<sup>16</sup> See also information about DFID working in Leningrad oblast at: <http://www.britain.spb.ru/khf/>, last accessed 01.07.2002

One thing is clear, the more investor friendly the oblast has become and the more it has become exposed in the international arena, the more interest has been shown in the oblast. Suggesting that once on the upward curve the easier it is to benefit from alternative sources of finance/assistance. This suggests that processes of uneven development within Russia are becoming more entrenched and marked as donors increasingly focus their efforts in certain oblasts.

### **6.3. Responses to donor activity at key sites of regulation and governance**

One way of measuring the real impact that IFIs and other donors have had within the oblast in terms of influencing social practices and institutions is to look at the ways in which various Russian actors at specific sites of regulation and governance have reacted to these projects. But, to be able to look at the impact projects have had the details cannot be divorced from the reality of what agendas and practices Russian actors are engaged in on a daily basis. After all, such daily activities and policies exemplify the nature of social practices and institutions within the oblast. Therefore, general attitudes to facets of regulation and governance are analysed alongside the projects that IFIs and donors have run in Leningrad oblast.

#### ***6.3.1. The Oblast Administration: its policies***

The Oblast Administration, and more specifically the economic departments of the administration, are an obvious and regular point of contact with IFIs and other donors. So, given their importance as sites of regulation and governance, they merit detailed consideration with regard, for example, to the institutions and social practices that they propound and embody in the oblast. Concerns about the economic development and regeneration of the oblast are of great importance to the

Oblast Administration, this involves not only the restructuring and regeneration of existing industries but also the need to attract inward investment in to the oblast, particularly from foreign sources (Sergei Naryshkin, Chair of the Committee for International Relations and External Relations, St Petersburg Times, 22.05.2001).

There are other areas of concern for the Oblast Administration, not just in the realm of economics. However, this is the focus of this particular analysis due to the importance attached to the economy by IFIs and oblast governments as the *catalyst* to change in other spheres, because reform potentially provides the finances to facilitate further reform initiatives. Furthermore, a functioning capitalist economy is understood to provide the basis for societal development away from the socialist blueprint. In response to the question: what is the priority of the Leningrad government's economic policy, the official answer was:

'In the first place, [our aim is] to create the conditions to attract investors and to maintain a favourable investment climate in the oblast. Our policy is directed at a number of different objectives: the development of regional investment legislation and a legal basis in the sphere of business support, open access to information in the oblast and the creation of a specialised market infrastructure. Investors are confident in our reliability and have so far had no cause for regret' (Leningrad, 2001<sup>17</sup>).

It is not explicitly stated anywhere in his comments that a priority for the oblast is to stimulate the emergence of a fully functioning market economy, rather the emphasis is on creating a manageable and workable business environment given the realities of local and national institutions and social practices. These it seems only need to change in part.

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<sup>17</sup> Information accessed from the official website of the regional administration: <http://www.lenobl.ru>, last accessed 01.07.2001

With the exception of the EBRD, the local government has worked in partnership with the IFIs previously mentioned in this thesis, as well as other bi-lateral donors. The Oblast Administration of Leningrad oblast, most notably under the leadership of Gustov, set about trying to make the oblast 'investor friendly'. It has been claimed that such a policy, was stimulated by the reform programmes introduced in neighbouring Novgorod oblast (Interviews: Oblast Duma, 06.06.2001; Foreign Investor, 10.05.2001; Commercial Bank, 18.05.2001; Oblast Duma, 30.07.2001).

It has been noted by members of the local diplomatic community that Leningrad's more 'tortoise' like approach to economic development has benefited the oblast's economy in the long run, particularly in comparison with surrounding and competing federal subjects (for example, Novgorod), including the city of St Petersburg who have acted in a more 'hare' like fashion, desperate to attract all manner of investors whatever the opportunity and social costs (Interviews: Trade Council, 09.05.2001; Trade Council, 11.05.2001). The way, it appears, that they have measured Leningrad's 'success', and therefore reached this conclusion, is that the oblast is now one of the ones regularly attracting big blue chip foreign companies, indicating that, at least relative to their neighbouring competitors, the *perceived* barriers to investment in the oblast are lower than elsewhere. The local government has achieved this through long term and sustained reform initiatives in the oblast (FIAS/IFC, 2001). In comparison, other oblasts have sought to attract investors from the early 1990s without necessarily having their own oblast's priorities established and somehow translated practically into legislation (FIAS/IFC, 2001). Such legislation offers the chance to reinforce those objectives and offer 'protection' to the oblast economy from, for example, 'exploitation' and a direct

outpouring of financial resources and profits that could be plugged back in to infrastructure development.

This, they suggest, indicates just how far the oblast economy has been transformed into a business environment more akin to those of advanced capitalist countries. I would argue that while the business environment is rapidly changing, personal experiences and evidence gathered from interviews with foreign companies and a World Bank Report<sup>18</sup> reinforce the widely held perception that the Russian economy, and therefore the business environment, remains a highly complex and unpredictable place in which to engage in business activities. Personal ties and networks still dominate and the legal system is not adequately developed to fully protect investor's rights (Braguinsky and Yavlinksy, 2000; Rose, 1998). A key question remains: will/can the Oblast Administration transform the economy and business environment further, so that it moves closer to the idealistic blueprint, and is this something that is desirable in their eyes?

### ***6.3.2. Investment Policy in the oblast***

Leningrad oblast has been touted as one of the oblasts to 'watch' in terms of its attractiveness to foreign and domestic investors. Interestingly, throughout the majority of interviews (Interviews: Leningrad oblast, St Petersburg and Moscow, April- July 2001), both within the business community in the oblast itself and in Moscow, there was a real consensus as to why this was the case. Leningrad oblast is now among the top ten oblasts in terms of volume of foreign investment per capita.

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<sup>18</sup> FIAS/IFC Report (2001) 'Study of Administrative Barriers to Investment within the subjects of the Russian Federation', mimeo



FDI had accumulated to a total of US \$110 million in 1997, US \$180 million in 1998, US \$340 million in 1999 and \$400 million in 2000 (Goskomstat, 2001b). Explanations lie in the oblasts favourable investment and stable political climates as well as its proximity to European borders and key arterial trading routes to Moscow.

Over US \$400 million was invested in the oblast in FY2000. Philip Morris, for one, is active in the oblast. The cigarette factory is now able to produce 90 per cent of Philip Morris brands sold in Russia. Kraft Foods has recently completed a new coffee packaging plant with the ability to package 20 per cent of all the demand in Russia and plans are in the pipeline to launch a new production line in the city of Gorelovo, Leningrad oblast. Caterpillar has built a road construction material plant and the International Paper Company has expanded its operations in the oblast through its subsidiary, JSC Svetogorsk. Swedwood International has begun work on building a timber processing plant. Potential investors in the oblast include, Electrolux (Swedish) and Valio (Finnish), IKEA (Swedish), Volkswagon (German), John Deere (US). To date the most active countries in the oblast in terms of private investment are the US, Sweden and Germany (Leningrad, 2001c). American investment constitutes approximately 80 per cent of all foreign investment in the oblast (Internet Conference on Investments, RIA Oreanda, Economic News, 02.03.2001). The oblast is obviously enjoying great success in attracting investment due to its policies.

Research shows that the main aspects of Leningrad oblast's investment policy are to:

- Establish oblast investment legislation and build a solid base for business support,

- Increase oblast exposure in federal and international arenas, and to provide easy access to essential information,
- Establish critical market infrastructure to facilitate the investment process,
- Restructure existing enterprises to enhance their investment potential.

Suggested sectors in the oblast for investment include: the fuel and energy sector and the development of energy resources, deep wood processing (investors are invited to lease timber plots from the oblast's administration), transportation and telecommunication projects<sup>19</sup>, tourism and tourist infrastructure development (in association with St Petersburg), and establishing a research and design complex.

The local government economic departments have a good reputation for 'holding the hands' of potential foreign investors and helping them through the complex processes of registration and obtaining all the correct permits (Interviews: Foreign Investor, 08.05.2001; Trade Council, 09.05.2001; Trade Council, 11.05.2001; Commercial Bank, 18.05.2001). It is unclear whether the same treatment is offered to Russian investors.

It is clear to see that the government of the oblast is actively trying to build lines of communication with potential foreign investors. For example, in conjunction with the US Consulate General, the local government has hosted internet conferences (e.g. March 2001) regarding existing and potential US investment in the oblast. The oblast government has also taken seriously the development of its own website<sup>20</sup> and is keen to embrace all Information Communication Technologies (ICTs) that

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<sup>19</sup> According to the 'Transit programme', which was developed in compliance with the Presidential decree July 6, 1997, the cargo transit route through the Northwest region to Europe via Leningrad region and the city of St Petersburg, is to increase by at least 100 million tonnes per annum. Such a dramatic increase in transit tonnage suggests that rapid port expansion and associated logistical complexes is essential in the Leningrad region.

<sup>20</sup> See <http://www.lenobl.ru>

will enhance its image in the international arena as well as attract valuable attention (Interviews: Oblast Administration, 20.04.2001; Oblast Administration, 03.05.2001; Bi-lateral Donor, 16.05.2001; Bi-lateral Donor, 28.05.2001).

The regional government has obviously established good working relationships with advantageous partners of its own volition. Leningrad government officials and representatives from local businesses took part in establishing constructive dialogues with American business people. Such a move has been further enhanced with the deepening business and socio-cultural relationship established initially through the twinning of the State of Maryland with Leningrad oblast.<sup>21</sup> In May 2001 Serdyukov and a team of aides and representatives of the business community visited Maryland to talk to other potential green field investors:

‘For the first three or four years during which we were trying to attract investment, we proposed a number of potential projects to investors. But then we realised that we could be much more effective by creating better conditions for business providing information about these conditions to our prospective foreign partners, and by simply promoting the oblast itself. We think that that conditions are good enough here that they should attract investment on their own’ (Sergei Naryshkin, Chair of the Committee for International Relations and External Relations, St Petersburg Times, 22.05.2001).

The Oblast Administration, in particular the committee for Economy and Investments has been keen to expose itself internationally, to work at attracting capital in to the oblast but also to work on creating the optimal investment climate.

Sergei Naryshkin might think that the conditions are good enough in the oblast to attract investment on their own, and they are in some ways. The proof being that

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<sup>21</sup> For more details of this twinning scheme see section 6.6.

many international investors have opted to locate their production facilities in the oblast but there is still a lot of room for 'improvement' and clarification and standardisation of procedures, if this is possible. Investors constantly reiterate the point that conducting business in Russia atypical of any other country (Troika, 2001)<sup>22</sup>. Such strength of feeling and realisation of the situation has prompted many of the IFIs, especially the World Bank to look at how this situation can be improved. This was the motivation behind the following project that the Leningrad oblast participated in.

### ***6.3.3. World Bank project: studying administrative barriers to investment***

The central hypothesis that the mission was researching was: administrative barriers to investment constitute some critical impediments to investment in Russia. The focus on the oblast level was partly practical, as it would be difficult to study administrative barriers throughout Russia. Furthermore, it was considered to be an acknowledgement that there are powerful *de facto* and *de jure* oblast influences in the investment environment in Russia, despite the fact that the federal legal framework is supposed to provide the basis for it. Of course, administrative barriers only represent one set of impediments to investment activity. Others, often related include the influence of the mafia, shortcomings in the financial sector, corporate governance, and infrastructure underdevelopment (see for example, Bradshaw, 2002; Brock, 1998; Hellman, 2000b; Johnson, La Porta et al. 2000; McCauley, 2001).

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<sup>22</sup> It is, however, important to remember that the overall level of FDI in Russia is still very low therefore Leningrad oblast is seeking to gain a reasonable slice of a small pie (Oldberg and Hedenskog, 2000).

The project reiterated the point that the only foreign investors coming to Russia were those that *had* to be there. Their proof was found in the FDI statistics from Goskomstat<sup>23</sup>. Notably absent are export-orientated manufacturers and those involved in a more 'globalised' production system, which exist in other transition economies, including East Central Europe, the Baltics and China (FIAS/IFC, 2001:2; see UNCTAD, 1999). I would argue, that the study did not uncover any startling revelations. In fact, this type of study, though useful in terms of clarifying some issues or backing up statements with proof, only serves to identify yet again the same issues, but is not particularly instrumental in doing anything about them.

The mission identified three major themes that span a set of problems that are difficult to find solutions to, mainly because they are dealing with Russia and practices and institutions are highly embedded. First, most government agencies that investors have to deal with are under some form of dual supervision. This means that they must formally report to a federal level parent ministry or agency while simultaneously receiving substantial resources and instructions (either formally or informally) from oblast level authorities. This naturally creates divided loyalties, *unclear mandates* and most importantly a *critical lack of accountability*. While this is intrinsically a civil service reform problem and part of the fiscal federalism issue too, there have been few or no moves to face this problem by the Oblast Administration (FIAS/IFC, 2001:6). This is not uncommon throughout Russia as local government finds itself unable to influence civil service reform issues. Feelings of negative acquiescence are prevalent within the oblast based civil service

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<sup>23</sup> See Goskomstat annual investment statistics by region, 1991-2001

functions (Putin, 2002). This is apparent on a daily basis when one interacts at any level with civil service functions in Russia.

Second, many government agencies, lacking adequate resources to execute their remits and functions properly, try every possible means to raise money. One frequently used method is to offer 'desirable' or supposedly 'necessary' consultancy-type services to businesses. This can involve, for example, the Committee of Land Resources and Land Organisation offering consultancy services to the same enterprises that need to apply to them for land rights and permits and submit to their inspection demands (FIAS/IFC, 2001:5; Interviews: Russian SME, 01.06.2001; Russian SME, 05.06.2001). This creates conflicts of interest. The bottom line is that such practices will not disappear over night, and one step to changing the situation is for civil service functions to be adequately resourced. But other steps would also be required, namely first and foremost, a change in attitudes and socially 'accepted' norms and practices of civil service behaviour.

The third conclusion is closely linked to the second. There persists in Russia, especially in the public sector but also in the private, a complex of attitudes including deep ambivalence about the merits of competition; a related and lingering fondness for personal relationships as a solution to managing the extensive and pervasive bureaucratic red tape; and a quasi sense of 'pride' in cheating the system. The message from the project is clear. Both federal and oblast leaders need to take decisive action to facilitate meaningful competition via extensive deregulation, and regulation of procedures, otherwise there is the danger of facing further economic

stagnation (FIAS/IFC, 2001:6). But there are few suggestions as to how to achieve this.

The final 'products' from the project included reports on the identified barriers to investment in the oblasts studied. The reports included recommendations designed to help remove unnecessary bureaucratic procedures, improve efficiency, consistency of treatment and a more business friendly approach to procedures and regulations that must remain. But the biggest problem that the project team faced was disseminating project information between the 'clients'. The clients included the Oblast Administrations studied, and at the federal level the Ministry of Anti-Monopoly Policy and Entrepreneurship.

The clients obviously have different interests. This is a frequently recurring problem for many IFIs and other donors, they have to operate within a highly complex political environment and in many instances this can prevent them from pursuing and achieving certain objectives. They must be sensitive to the political environment within which they work and, at the same time, be realistic as to what impact they can have. The Leningrad Oblast Administration although involved in the project, were unable to elaborate on how they might proceed with the findings of the project and more importantly how they could 'fit the findings in' without causing too much disruption to the current status quo (FIAS/IFC, 2001; Interviews: Oblast Administration, 20.04.2001; Oblast Duma, 06.06.2001; Russian Partner to IFI, 21.06.2001)<sup>24</sup>. It was also evident that there were local feelings of unease with regard to the way in which the federal authorities would react to the findings of the

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<sup>24</sup> DFID has since offered small scale funding to the local government, which would allow them to arrange for more technical assistance, helping them to respond to the findings of the FIAS/IFC report. It is not known whether the local government has pursued this possible source of funding.

research and therefore what kind of measures they would adopt. These feelings reflect the less than harmonious relationships that exist between federal and local authorities when each other's autonomy is challenged.

One of the core problems that they faced was that certain departments or committees operated independently of official policy, and according to the precedents they have established for themselves and the likelihood of changing this was slim in the short to medium term. After all, the work needs to be done, and given that there are inadequate resources to do so, this problem will remain. It seems therefore, that though there is a desire to instigate change to *embedded* practices, no one closely involved is inclined to do so because the *incentives are not great enough*.

The Oblast Administration sees that one of the biggest contributions that IFIs and other donors can make is in helping them to fulfil their investment objectives. This was the motivation behind their involvement in the World Bank/IFC study. However, the local government has not of course restricted its involvement with IFIs and donors to enhancing economic development through increased investment activity. For example, other projects they have been partners in include: improving heating and electricity supplies for the City of Gatchina, municipal water supply and sewerage management in selected towns in the oblast, and the development of an alternative system of environmental permits<sup>25</sup>, as well as the compilation of a comprehensive cadastral register.

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<sup>25</sup> These projects were in part or totally funded by the Swedish International Development Agency (SIDA) between 1997-2001). DFID was involved in co-funding the cadastral register projects. Tacis has also shown an interest in these projects.



However, interviews with various stakeholders in the process revealed clearly that economic development was seen as the priority, because this in turn would help the oblast to be able to afford and promote real transformation in other areas, such as municipal housing, education and health facilities. So, in addition to trying to attract investment into the oblast the economic departments of the Oblast Administration have focussed on the need to restructure enterprises and to encourage the growth of the SME sector.

#### ***6.3.4. Leningrad oblast: economic development policies and IFIs***

The Leningrad oblast government's economic development plan for 1997-8 focussed on the development of less favoured areas of the oblast<sup>26</sup>, especially those that they deemed had suffered most during the transition process.

The consensus of opinion within the economic departments of the Oblast Administration was that Podporozhye district, 300 kilometres from the city, possessed all the characteristics of an economy in the pit of recession. The logic driving the implementation of the Bistro programme, and their backing of it, was that there were industries in the district, which with adequate targeted support and minimum investment could grow rapidly and that there were considerable market opportunities in the oblast as well as wider market for the usual range of new businesses.

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<sup>26</sup> Information accessed from Leningrad oblast website: <http://www.leobl.ru/economy>, last accessed 01/07/2002

Drawing on previous SME-driven economic regeneration programmes carried out by the project leaders in supposedly comparable parts of the UK (Consett, Bilston and Sheffield/Barnsley) and in Poland and Slovakia the plan was to develop a strategic plan for the local economy that focussed on building partnerships between oblast/district government, large industries and SMEs in growth areas (EU, 1998). Just how comparable these oblasts could be in the first instance is debatable given among other things the legacy of Soviet economic development processes and the prevailing legal and financial conditions (e.g. lack of access to credit lines) for the SME sector in Russia. This said, the Bistro project, 'SME focussed economic regeneration programme for Podporozhye district, Leningrad oblast', was implemented between January 1998 and September 1998, in accordance with Bistro project guidelines (see Chapter 5).

The Department of Small Business Development in the Leningrad government played a pivotal role in the project, liaising with the foreign project coordinators and local businesses, although the project was initiated and proposed by the British based consultancy firm (Interview: Project Officer for IFI, 20.06.2001). As such, whilst there was a broad base of support for the project from the Oblast Administration interviews revealed that perhaps different parties involved in the project held different conceptions as to how the project was to unfold and as well as the nature of the outcome of the project and the benefits that such a scheme would bring to individuals and to the district, and oblast (Interviews: Oblast Administration, 03.05.2001; Project Officer for IFI, 20.06.2001).

This seems to be an issue that is pertinent to many projects that are carried out, with the aid of IFIs and other donors, in both Leningrad oblast and within Russia more generally. Of course, this is not to say that there is necessarily always some kind of obstructive divergence between the expectations of interested parties. However, certainly in the case of this project, the project title itself suggests that headway was to be made in encouraging SME induced economic regeneration of one district in Leningrad oblast. In reality, however, the mere fact that the total project duration was nine months, as is standard for Bistro programmes, suggests that the Oblast Administration's general expectation of seeing real results were at best optimistic given the scope and time frame for this project.

Expectations diverged both in terms of the Russian partners anticipating more than was attainable (Interviews: Russian SME, 01.06.2001; Russian SME, 05.06.2001a; Project Officer for IFI, 20.06.2001), as well as the other way round, in terms of the Western consultants expecting more commitment and cooperation from their Russian partners and other concerned parties than actually materialised (Interview: IFI, 04.05.2001; Bi-lateral Donor, 16.05.2001; Project officer for IFI, 20.06.2001). Whilst enthusiastic at the outset of the project, evidence gathered from interviews suggested that interest waned slightly as soon as the project details were discussed and agreed by the parties. In fact two officials, who for reasons of confidentiality cannot be quoted directly, suggested that the main lure of being involved in the project was the opportunity to participate in a study trip to the UK for six days.

The aim here is not to characterise the project as a white elephant from the outset but rather to introduce some oft repeated themes that arise from studying such

interactions and projects managed between western European and Russian partners and in this case partners from local government<sup>27</sup>.

An analysis of the projects specific objectives and comments made about them and their implementation reveal more clearly the way in which both the local government in particular worked with the project designers and the local business community suggesting that while the project brought some potentially positive benefits the struggling business community of Podporozhye, the project was never going to make a 'deep' impact either.

The following five programme objectives each targeted at being able to achieve the ultimate objective of developing and then implementing a strategic development plan for the district.

- To support the Leningrad oblast in implementing practical measures to promote the economic regeneration of the Podporozhye district;
- To identify growth areas for reconstructed, slimmed down companies in existing sectors in the district economy;
- To support the growth of SMEs in new sectors serving the local economy, the oblast and further afield;
- To ensure maximum take up by the district of national and international development resources (financial and technical);
- To bring together information and activities from all the above in order to develop a SME focused Strategic Development Plan for the district together with a clearly targeted and timetabled Action Plan, based on public/private sector partnerships to stimulate and lead business growth.

The activities undertaken in order to facilitate the meeting of the above objectives included: a survey of the district and its economy, discussions with oblast and district and administrations and a 6 day study tour to the UK for 2-3 selected officials, visits to key locations in Podporozhye district, and to draft a joint strategic

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<sup>27</sup> See section 6.3.2. For a discussion of the reaction of the business community to working with IFIs

plan for the district. The final tangible product was a detailed Strategic plan/Methodology for SME development in the district.

Some of the local businessmen involved in the project indicated that the study brought to the fore some important issues, but mainly organisational and administrative issues that they were already aware of (Interviews: Russian SME, 01.06.2001; Russian SME, 05.06.2001a; Russian SME, 05.06.2001b). The project in their eyes was therefore worthwhile and instructive, mainly because it taught them some new things but reinforced some of their own personal beliefs and objectives. Positive, new things that came out of the study included learning about the possible sources of finance and technical support available to them from national and international sources. But the issue that appeared to be most important was the way in which the appropriate Committees within the local government structure acted upon the development strategy. The objectives, though well intentioned, had not necessarily been achieved in their eyes because the local government had failed to translate them in to making a real impact. Whether or not the local government were ever in a position to be able to force the regeneration of a depressed economic district is debateable in the first place.

I would argue that the project held much potential in *theory*, but given the reality of its scale and scope and the reliance on local government it was unlikely, in the first place, to make any real impact in the Podporozhye district. The local government appear to have been expecting definitive answers to dealing with the issue but were not committed to following through on the recommendations made by the project team. Project officials seem equally aware of this problem but reiterated the point

that such projects needed to be funded and run because it was better to try and make some impact, however small, than none at all (Interviews: IFI, 20.04.2001; Project Officer for IFI, 20.04.2001).

Moreover, it is commonly felt amongst the donor community that the real impacts of such projects are likely to be seen in the longer term. The theory being that the Russian partners new learning can readily be translated in to practice as social and political institutions and practices evolve. But as projects are, after all, aimed at stimulating such changes in the first place, there is a chicken and egg conundrum that needs to be faced.

#### ***6.3.5. Restructuring local industrial enterprises***

As discussed in the previous section, the Oblast Administration, at least on paper, has attached a high level of importance to the restructuring of industrial enterprises:

‘The reason for a restructuring programme for enterprises is that whereas the oblast’s economy has become financially stable and highly liberal, [at least in comparison with the situation prior to 1990,] the slow process of reforms at the level of certain enterprises has stayed one of the main obstacles to its economic growth’ (Leningrad, 2001<sup>28</sup>).

The statement goes on to claim that the Oblast Administration has further targeted some priority areas within this restructuring programme, for example: liquidating the supposedly unprofitable enterprises, updating the product assortment produced within the oblast, developing anti-crisis programmes for certain enterprises, optimising cash flows for enterprises (Leningrad, 2001). The last two ‘priority’ areas do not stand out as being policies that encourage ‘efficiency’ or full-blown

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<sup>28</sup> Information accessed from <http://www.leobl.ru/economy>, last accessed 01.07.2002

enterprise restructuring as would be understood within the context of a market economy, but are seen as important to maintaining the integrity of the oblast's economy.

Soft budget constraints have and might still continue to exist for certain enterprises within this 'pro market reform' oblast<sup>29</sup> (Interviews: Oblast Administration, 20.04.2001; International Accountancy Firm, 19.04.2001; Trade Council, 09.05.2001; Commercial Bank, 14.05.2001). This remains a sensitive and contentious issue. It would be wrong to suggest that all actors within the economic functions of the oblast's government concur on the merits or otherwise of propping up key industries. Vested interests play a big part. However, interviews do not allow for undiluted access to the reality of the situation despite their being 'off the record'. Officially speaking soft budget constraints are not condoned but large-scale 'Russian' run and owned enterprises are undoubtedly viewed as critical to the oblast's economy and as such might continue to receive 'special' treatment. Representatives of the SME community suggest that at times they suffer as a result of such strategic moves, as they are crowded out of potential markets that they seek to capture some market share in. As is common globally, there is a palpable tension between big and smaller scale businesses.

#### **6.4. Business Associations and the SME sector**

Western analysts have commonly characterised large-scale enterprises and big businesses within Russia as monolithic and inefficient and smaller and medium scale enterprises as flexible, responsive and dynamic (for example, see: Braguinsky

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<sup>29</sup> Soft budget constraints currently exist for the national economy while energy prices remain subsidised (see Hanson, 2000).

and Yavlinksy, 2000; Brezinski and Fritsch, 1997; Broadman, 2002; Grabher and Stark, 1996; Kontorovich, 1999). With such powerful differences between the two it seems self evident that there exist different sets of needs, demands and influences within the oblast economy. There is real potential for conflict.

As has been previously discussed, larger scale enterprises fairly dominated Soviet localities and continue to wield a not insignificant level of residual personal and structural power within the oblasts. In clear contrast, SMEs, despite growing significantly in numbers since 1991, especially within the mid 1990s, continue to face problems in less than clear legislative environments, while at the same time they are held to be the vanguard of change, widening consumer choice, providing employment and tax incomes. In fact SMEs have been exemplified by IFIs (EBRD, 2000c; TACIS 2000b), among others, as the strongest proponents of free market behaviour and activity but they have obviously faced grave difficulties in Leningrad oblast as numbers have in fact fallen from 1999 by nearly 30 per cent to a total of 9 377 thousand in 2001 (Goskomstat, 2001b).

Representatives of the SME community interviewed in the oblast spoke of their feelings of *exclusion* from powerful circles of influence and authority on the one hand, and yet on the other their commitment to trying to avoid wherever possible politically charged struggles and disputes, which have dogged large-scale enterprises. Moreover, the FIAS/IFC study of Administrative Barriers to Investment in Northwest Russia revealed that many representatives of the SME community in the oblast complained of a 'controlling' attitude within the administration. The report also details how some SMEs have allegedly been pressurised by the



administration to offer a 'stake' in the business. In basic terms this can be interpreted as a form of corruption or coercion though more subtle than the round of cash transactions that can be expected when doing business in St Petersburg (FIAS/IFC, 2001). Such practices and embedded institutions have naturally chased away some Russian businesses, especially those seeking to attract foreign investment or assistance, either private or public capital as the conditions certainly from the latter are stringent in terms of the necessity of avoiding corrupt relationships (see also Chapter 5).

Certainly within Leningrad oblast representatives of the SME community maintained that since the mid 1990s legislation passed by the oblast Duma and the Federal legislature has generally encouraged the development to some extent of this sector of the economy. Interestingly despite the EBRD's commitment to SME development as an integral part of their strategy in Russia throughout the 1990s and continuing to date, they have not sponsored any projects or firms in Leningrad oblast. Representatives working on behalf of the EBRD in the Northwest of Russia suggested that this was certainly a hole in their portfolio of investments and one, which they wished to plug in the coming years, as and when suitable projects for investment arose from reliable firms. It is difficult to tell whether or not firms have applied for EBRD funding in the past, and in fact whether the SME community as a whole is either aware or interested in applying for such support funds from the EBRD, given the stringent conditions that they apply to applicants. However, it is clear that the SME community has taken advantage of the programmes of other IFIs and bi-lateral donors seeking to promote the growth and development of this sector

of the economy (Interviews: Bi-lateral Donor, 16.05.2001; Russian SME, 01.06.2001; Bi-lateral Donor, 31.07.2001).

The SME sector has benefited from bi-lateral assistance from among others DFID (UK) and SIDA (Sweden)<sup>30</sup>. For example, DFID has been involved on a project basis in helping new Business Associations find their feet and establish themselves as active members of the oblast's economy. The impetus for the inception of business associations in the north of the oblast emerged from the SME sector. With projects in mind the individuals concerned sought assistance from bi-lateral donors with a specific interest in helping to fund such a scheme. Project funding from DFID lasted for approximately one year. The main thrust of the project was for DFID to provide appropriate technical assistance, through workshops and meetings and project documents. The business association, in this example, remains fully functional and continues to gain members on a regular basis (there are approximately 15 permanent members to date). Their agenda revolves around lobbying for an easier operating environment within the oblast. In particular, they have raised concerns about the discretionary policies of the tax police and other local government departments that they deal with, as well as the importance of the details of the land code (Interviews: Russian SME, 01.06.2001; Russian SME, 05.06.2001a; Russian SME, 05.06.2001b; Russian SME, 23.07.2001).

The Oblast Administration, however, seems somewhat suspicious and wary of the development of the business associations and has sought to challenge their existence

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<sup>30</sup> SIDA has funded Women's resource centres in Leningrad region. The aim is to expand business opportunities in the private sector in Leningrad region in order to initiate and increase cooperation with the SME community in Södermanland, Sweden. The project focuses on strengthening the local resource base in both regions especially through training female entrepreneurs.

(Interviews: Oblast Administration, 03.05.2001; Bi-lateral Donor, 16.05.2001; Russian SME, 01.06.2001; Russian SME, 23.07.2001). Therefore, indicating that the oblast government seeks to maintain control over the SME sector and is anxious about the emergence of new groups that can lobby local government. It is difficult to understand exactly why the local government views business associations in this way. Perhaps it is because political and economic actors involved in local government seek to protect the interests of larger enterprises? It might also be that the lack of experience of business associations and their activities merely instigates feelings of unease? Whatever the motivation behind this active discouragement of the establishment of independent business associations, some departments of the Oblast Administration seek to exert control on the emergence and growth of these business associations in order to hold on to some sort of overall control of the nature of the economic development of the oblast's economy.

There are many hurdles for SMEs in Leningrad oblast, not just in terms of surviving the economic climate and making the business work, but also in actually getting the company started. As has been demonstrated, SME development is being held up by both federal government and IFIs and think tanks as one way to ensure Russia's full economic transformation to being a market economy. Casting the rhetoric aside the actual business of starting and registering a business remains one of the biggest barriers to SME sector growth (EBRD, 2001; FIAS/IFC, 2001). The FIAS/IFC project confirmed that although the investment procedures in Leningrad oblast were well established (see Figure 6.1) they are lengthy and cumbersome and frequently discretionary. Naryshkin, who is a key member of the Oblast Administration, has reiterated this point of view:

‘We still have a very involved system of developing, agreeing upon and approving projects and all of the necessary documents – the process takes too much time. I think that this system should be simplified. In some ways this is within the competence of the Leningrad Oblast Administration, but this is not entirely the case because much of the system depends heavily on the actions and regulations of federal level departments’ (Sergei Naryshkin, Chair of the Committee for International Relations and External Relations, St Petersburg Times, 22.05.2001).

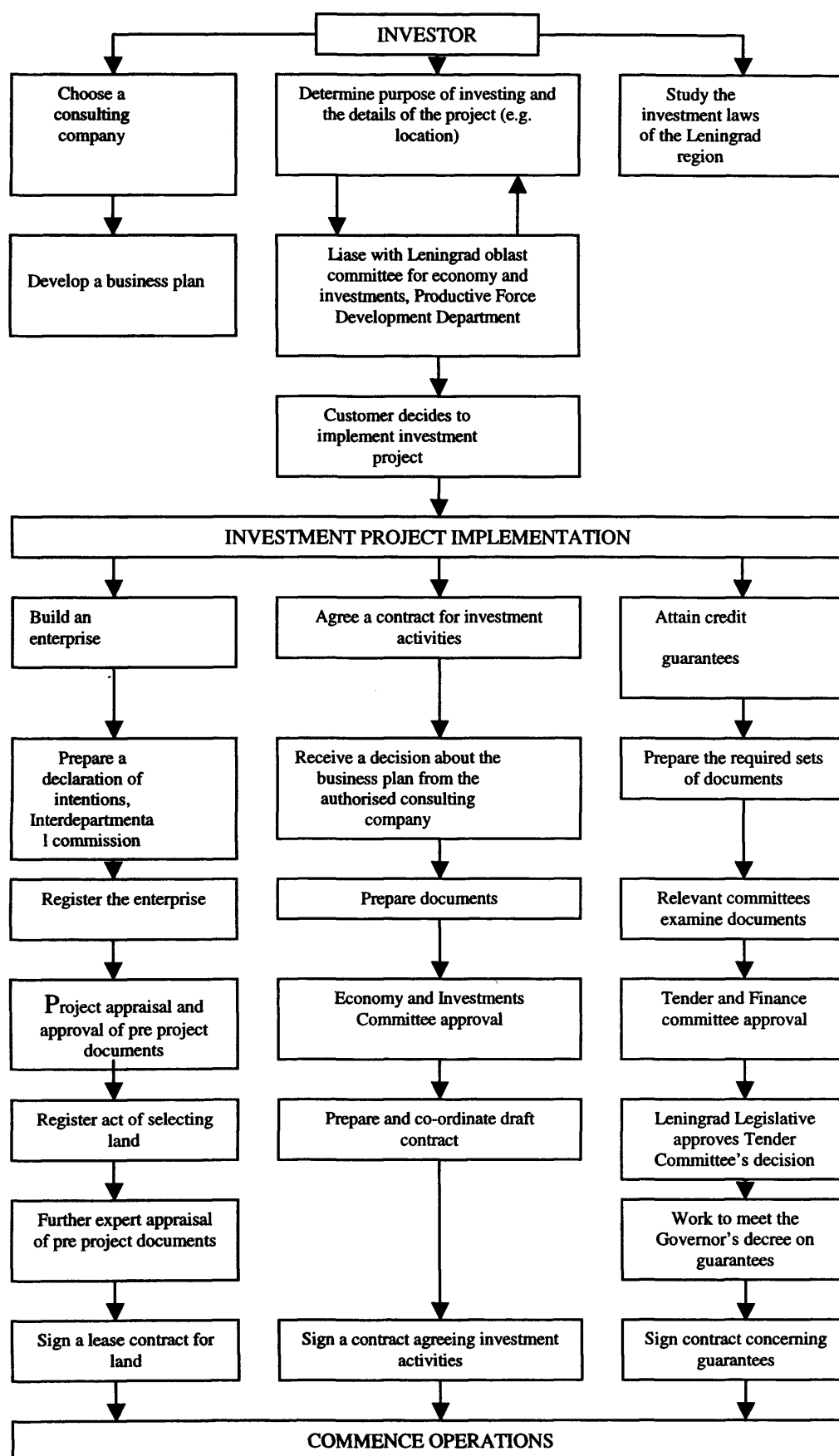
It is possible to argue that the mere existence of such guides and attention to detail, which did not exist at the beginning of the 1990s, indicates that the Oblast Administration has taken reform seriously and has also set about clarifying legal issues, particularly in investment laws. However, most oblast governments have made some attempts to do so and though procedures and laws look good on paper it does not necessarily mean that they are readily transferred when applied practically.

Clearly, the oblast government determines to a great extent the potential development trajectory of the oblast, but it has to do this a wider appreciation of the larger regional context. In this case, thinking about the Northwest of Russia as a whole, but in particular, mediating the oblast’s crucial symbiotic relationship with the City of St Petersburg.

### **6.5 ‘Enhancing synergy’ between the Leningrad oblast and St Petersburg**

The actual and potential linkages between Leningrad oblast and St Petersburg are naturally strong, simply by virtue of their close geographical relationship. The city of St Petersburg lies within the Leningrad oblast. Since 1992 there have been extensive discussions about how to ‘enhance’ the relationship between the two federal subjects. There has even been talk of taking a more radical step and merging the two federal subjects into one. Such plans have, however, never come to fruition

**Figure 6.1. Investment process, as suggested by Leningrad oblast government**  
(Source: Committee for Economy and Investments, Leningrad region, 2001)



and in fact have never passed the discussion stage (RRR, 11.02.1999). This is not surprising given the long standing political tensions that exist between the two administrations and the fact that one or the other would lose out considerably if such plans were actually executed.

Increased integration in strategic planning in the main policy areas (economic policy, spatial planning, transport, housing, and tourism) has been identified by interested parties as being important to the overall socio-economic development of the two federal subjects. To this end, Tacis has funded a project in which the city and oblast would supposedly learn and agree to work more closely with each other. The project was entitled: 'Enhancing Synergy: Integration of Strategic policies of the City of St Petersburg and the Leningrad oblast in the context of the Northwest Region'. The main outputs of the project were a strategic plan for regional cooperation and a joint organisation for future regional strategic planning and the implementation of cooperation projects. In other words, one could say that the project constitutes 'planning a market economy' in some way.

The project started in March 1998 and ran for two and a half years. The partner organisations are the administrations of St Petersburg and Leningrad and the Northwest Association (NWA). The Netherlands Economic Institute (NEI) is the main contractor of the project. Its Russian partner is the Leontief Centre, based in St Petersburg<sup>31</sup>. The underlying premise of the project is that cooperation would lead to better conditions for the private sector (Leontief, 2001:2). Therefore, actively supporting private enterprise development, which is seen as critical to the

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<sup>31</sup> The Leontief centre, is an independent research centre that acts as a Russian partner for IFIs, including Tacis and the World Bank.

continuing transformation of the Russian state. Cooperation in these terms involves, for example: harmonising taxation and licensing practices, joint lobbying with federal government, combined efforts to attract foreign investors and the coordination of financing and crediting policies (Leontief, 2001:4). It was further hoped that the project would enhance the physical environment: improving infrastructure, better distribution of economic and social functions and more attention to issues of sustainability (Interview: Project Officer for IFI, 22.06.2001).

Some form of cooperation between the two federal subjects had been discussed in the past but it transpires that the general reaction to the announcement of the project within the donor and local government communities was neither enthusiastic nor positive (Interviews: International Accountancy Firm, 19.04.2001; Bi-Lateral Donor, 16.05.2001; Bi-lateral Donor, 28.05.2001). At the inception of the project, the government of Leningrad oblast, stressed that a project aiming at cooperation between two administrative entities could only succeed if both would be partners were on an equal footing within the project. Further tension emerged when the NWA claimed full partnership on the basis of the coordination task for the whole of the Northwest region of Russia. As a consequence of this they also wanted the project to involve additional Russian experts who were aware of the situation in the Leningrad oblast, the Northwest region, not just with the city. It was clear that the project would fail from the outset if these appeals were not respected (Leontief, 2001: 8). Changes were made and the project proceeded. This marred the project from the outset but the fairly predictable tensions that emerged between the various structures of power and federal subjects were something that the Tacis project aimed at lessening in the future. The tensions are, however, enduring and result

from feelings of 'territoriality' and very different styles of leadership and attitudes to governance.

I would argue that the specificity of attitudes to governance and mediating change is an issue that IFIs do not take due account of, perhaps because the federal government is the official body ultimately responsible for ensuring coherency and standardisation of practices. Furthermore, for obvious reasons, it is difficult for IFIs and other donors to be explicitly involved in trying to force political change. This is problematic because the persistence of tensions between Russian partners and federal subjects is representative of the real differences that exist in attitudes towards mediating transformation processes which ultimately affects the overall effectiveness of IFIs and donors working in the country. In other words, they cannot ignore the political realities in Russia and hope that their policies will just work.

To complicate issues for Tacis, among the donor community (Interview: Bi-lateral Donor, 16.05.2001) and with local governments (Interviews: Oblast Administration, 20.04.2001; Oblast Administration, 03.05.2001; Project Officer for IFI, 22.06.2001) the organisation has attracted a rather negative press in the oblast. This is due to experiences of poor management and poor execution of projects, most of which are put down to there not being an adequate representative office in the oblast that manages the projects. Historically projects have been 'managed' from Brussels. This situation is set to change with the announcement that the Tacis representative office in Moscow is to expand dramatically, as is the office in St Petersburg, and the majority of projects are now to be run from within Russia (Tacis, Press Release 11.02.2002). This might help to promote better dialogue within the donor



community in the future so that projects, or parts of projects are not replicated. This is something that Tacis has been criticised for doing in the Northwest region of Russia (Interviews: IFI, 27.10.2001b; Bi-lateral Donor, 16.05.2001; Bi-lateral donor, 28.05.2001). For example, Tacis sponsored international consultants to work on a development plan for the port of Primorsk. However, other IFIs and bi-lateral donors had already sponsored such work. The development project was thus replicated as the Tacis monies had been approved and therefore had to be spent on this project (Interviews, 16.05.2001; 28.05.2001; 09.05.2001). Such a state of affairs does little to enhance the reputation of the work of IFIs within the oblast.

As part of the Synergy project over one hundred officials, experts, and representatives of the business community and NGOs took part in the discussion of the 'agenda for cooperation'. Project documents show that the agenda for cooperation consists of fifty-five projects, ranked by priority, seven of the fifty-five have received further Tacis funding. The projects include:

1. A joint strategy for a sustainable improvement of the attractiveness of the oblast for investors
2. A joint programme for the development of organisational and technological conditions for the transit of goods through St Petersburg and the Leningrad oblast
3. Joint marketing of regional tourism
4. Transformation of dacha areas into well equipped areas for recreation and summer residences.
5. Identification of areas of mutual territorial interests of St Petersburg and Leningrad oblast
6. A common waste treatment policy in St Petersburg and Leningrad oblast
7. Creation of an organisational structure for regional planning and cooperation

The above projects have now, for the most part, been completed. It is difficult to discern what the tangible results of these projects actually are. Project documents do exist that detail findings of each individual project and what the recommendations

for future action are. The first project, overlaps considerably with the project run by the World Bank on the study of administrative barriers to investment though the focus on cooperation is different but makes very similar observations, though more diluted. Such a project seems far removed from a post-Washington consensus and ultimately I would argue that in many ways it is. The project does, however, seek to tackle the underlying social practices and institutions that guide the local economies of St Petersburg and Leningrad oblast. An aim is clearly to improve the dialogue between the two parties in order to facilitate widespread changes to the local business environments for one. But the project appears vague and to be a token effort in many ways.

In essence, interviews revealed that cooperation between the two federal subjects was desirable, but not at any cost (Interviews: Oblast Administration, 20.04.2001; Project Officer for IFI, 20.06.2001; Russian Partner to IFI, 21.06.2001; Oblast Duma, 30.07.2001). It seems that the Tacis project had stimulated increased dialogue between the two administrations and this was seen as positive. However, the overall expectations of the project were perhaps unrealistic. The resounding message was that the governments accepted that they needed to work more closely with each other over time to take full advantage of their combined resources, but this was something that the governments would prefer to pursue in their own time at their own bidding. It is therefore difficult to work out exactly what kind of impact the Tacis project will have within the context of the transformation process. This situation is not in any way atypical and one has to question at what point Tacis should have realised this and decided that the project could be a waste of money.

The previous discussions of projects run in the oblast have highlighted the fact that in trying to assist with the transformation of the oblast's economy real barriers to doing so are embedded social practices and institutions. The likelihood of changing these over the long term is dependent on ameliorating, among other things, the legal environment, which will support new practices and institutions.

### **6.6. Banking sector and legal sectors**

It has been demonstrated throughout this case study chapter, and previous chapters, that the transformation of the banking and legal sectors is crucial in providing a stable platform for further transformation within the oblast and federal economy. The legal framework, for example, can offer newly delimited bounds within which economic agents can and should legally act. Codifying new social practices through legal channels reinforces their application and adoption in daily life. This is of course providing that the law is adequately enforced and that there are not socially accepted ways and means of subverting the system. This latter issue remains pertinent within Russia and the Leningrad oblast (Interviews: International Law Firm, 04.05.2001b; Commercial Bank, 14.05.2001; Commercial Bank, 18.05.2001; 14.06.2001; see also: Hellman 2000a; 2000b; Johnson and Kaufmann et al. 2000; Lankes and Venables, 1997; Ledeneva, 2001).

Increasingly, IFIs and other donors have recognised the importance of working in this area. Their engagement is focussed more at the federal than oblast level (see chapter 8). This is because federal legislation needs to be created/reformed. Logic suggests that this will, in turn, have an impact in the oblasts as oblasts are forced to comply with federal legislation. Usually IFIs work directly with federal ministries

either through their own project teams or in conjunction with major legal/financial consultants, for example, PricewaterhouseCoopers. International firms such as PricewaterhouseCoopers have been active in the Russian market since the early 1990s and have strong footholds in Moscow and St Petersburg. In this respect such firms offer invaluable insights into the regulatory frameworks that define oblast activity.

St Petersburg, as a major financial centre that services the Northwest region of Russia, including Leningrad oblast, has attracted attention from IFIs. For example, the EBRD has been heavily involved in the development of the private banking sector, as well as the service industry more generally in the city, through ten long-term projects. Additional projects that have had impacts on this sector have been conducted at the federal level by the World Bank and Tacis (see Chapter 8). It is clear, however, by taking even a cursory look at a local business directory that international firms have moved in to dominate the legal and accountancy markets, bringing with them their own experience. There is therefore not much demand for technical assistance in these private sectors. The oblast government has worked with international firms as it has sought to create appropriate legislation for business activities. What is apparent is the need for Russian businesses to abide by this new legislation.

#### ***6.6.1. The legal sector***

Tax reform is an important issue in the legal sector. The oblast government needs to ensure that it collects the maximum possible revenues from businesses and individuals in order to fulfil federal budget obligations. This means that they have to

minimise the potential and incentives for businesses or individuals to evade paying their tax. This is a national problem (Russia Journal, 20.07.2001). Russian citizens and corporations are not in the habit of paying taxes because they were not required to in the past. This is, therefore, a fairly new concept for many, though with nearly ten years exposure to a fiscal system it should be becoming a habit now. But again the social accepted norm of taking 'pride' in subverting the system is potent.

Calculating the appropriate amount of corporation tax is a complicated affair in Russia, mainly because the legislation has been full of loopholes and there has been much room for personal interpretation, both by corporations and the official tax collectors, known as the tax police. The latter's sometimes arbitrary decisions as to the amount companies are expected to pay despite fully completed tax returns is legendary (Putin, 2002; St Petersburg Times, 29.06.2001; Interviews: International Law Firm, 04.05.2001b; Diplomatic Community, 31.07.2001).

Leningrad government has in the past offered tax incentives as a way of attracting investors and has therefore seized on this fiscal tool as a way of securing the economic development of the oblast. They have also recognised the importance of being consistent, to the best of their ability, in their legislation. Interviews with representatives of the legal community based in St Petersburg but serving the Leningrad oblast made the following comments:

'Our work experience with the government of the Leningrad Oblast has shown that in this oblast, investors receive understanding and assistance from the oblast authorities when solving the problems that involve the application of oblast investment legislation. In addition, our recent experience of developing and promoting amendments to the law on investment in the Leningrad oblast has shown that the government has a constructive approach to initiatives with regard to changing the oblast

investment legislation. This improves the investment climate in the oblast (Olga Litinova, Deputy Head of the Tax and Laws Department and Andrei Sergeev, Expert ZAO Arthur Andersen, 2001).

'In July 1997, the Leningrad oblast passed a law on investment activities, which granted substantial tax privileges to investors. Our experience with many customers such as Philip Morris Izhora, Caterpillar Tosno, Ford Vsevolozhsk and Assi Doman, working on investment projects in the Leningrad oblast, has shown that for many investors, this law has become one of the key factors in making the decision to open new production lines in the oblast. An analysis of the law on investment activities has shown that this law is one of the most progressive legal acts in Russia from the viewpoint of the amount and period of investment privileges that investors are granted. The practical implementation of the law has shown that the economic advantage for both the investors and the oblast is evident and that this regime helps the development of investment activities in the oblast' (Linda Seagle, Vyacheslav, Natalia Shcherbakova, Managers, PricewaterhouseCoopers, Tax Department, 2001).

It is clear that the oblast government has been proactive in fiscal matters wherever possible, at least very much in regard to dealing with important foreign partners. Representatives of the SME sector suggested that the oblast's administration failed to pay enough attention to the growth of the SME sector when making its laws, particularly fiscal laws (Interviews: Russian SME, 05.06.2001a; Russian SME, 05.06.2001b). The oblast government is of course constrained now to some extent by federal laws.

Fiscal issues are not the only legal issues that are important. Land reform has also been problematic nationwide. Up until 2001 legislation remained unclear as to landowners rights and actually how to define property rights<sup>32</sup>. DFID and SIDA have been active in Leningrad oblast in terms of trying to help set up a definitive cadastral register, which is essential to the issue of defining property rights. This is

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<sup>32</sup> See Chapter 8 for a discussion of this.

widely heralded as a valuable project, which needs external sources of funding in order to be completed (Interview: International Law Firm, 14.06.2001).

In addition to IFI and bi-lateral sources of assistance and aid the rule of law programme has been run in Leningrad oblast with funding from the State of Maryland. The project was run during Gustov's time as governor of the oblast, after he and his administration sought to strengthen ties with the State of Maryland. The Rule of Law project was a non-business exchange that aimed at improving the climate for international business. The exchange programme emerged from the twinning of the State of Maryland and Leningrad oblast. The programme had many parts including: jury trial seminars, commercial law programmes and an antimonopoly and tax enforcement programme. Representatives of the Maryland legal system ran the programmes, which involved study trips for Russians to the US, seminars, discussion groups and practical sessions.

The programme, which is for the most part inactive now, offered technical assistance representatives of the legal system. But because of the desire on the part of Russian partners to establish close links with a US state the response to this form of technical assistance was overwhelmingly positive (Interview, 11.05.2001). Of course the project brought benefits to individuals involved, not least in the form of study trips abroad which might go some way to explaining the positive feedback. However, this project is representative of many run on a country-to-country, or oblast-to-oblast basis. Perhaps this is because it is possible to initiate direct engagement by all parties in the process, rather than via seemingly disengaged

offices (Interviews: Bi-lateral Donor, 16.05.2001; Bi-lateral Donor, 28.05.2001; Project Officer for IFI, 20.06.2001).

### **6.6.2. *The banking sector***

The dominance of Moscow run banks in St Petersburg is representative of the situation in Russia (Oldberg and Hedenskog, 2000; Interviews: International Accountancy Firm, 19.04.2001; IFI, 27.04.2001; Commercial Bank, 14.05.2001; Commercial Bank, 18.05.2001). Representatives of two commercial banks stated that the EBRD had been involved in the running of the bank and development of banking procedures through their banking sector initiative since 1995<sup>33</sup>. While most work has occurred in Moscow in terms of defining company policy and procedures, these have been readily translated to branches in St Petersburg. Representatives of the commercial banks stressed their willingness to work with the EBRD while at the same time maintaining that the Banks were now in a position to run themselves (Interviews: Commercial Bank, 14.05.2001; Commercial Bank, 18.05.2001). A prime concern is to attract customers and increase market share. Holding a private bank account, for example, was not common throughout the Soviet period and though there was a relative boom in this new service industry in the mid 1990s the financial crisis of 1998 undermined consumer confidence.

The growth of the banking sector is proof of the evolution of the regulatory and governance environments as companies, for example, become more confident in using service industries and in some respects making their operations more

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<sup>33</sup> For a detailed discussion of EBRD involvement in the banking sector see Chapter 5 for an outline of the programmes and Chapter 7 for an in depth discussion of an EBRD programme run with the Bank of the Russian Far East.



transparent. There is, however, no direct link between having a bank account and being less corrupt (see Hellman et al. 2000b). Representatives of the local business associations confirmed that about 90 per cent of members used the services of commercial banks. Feelings of insecurity about doing so were still identifiable (Interviews: Russian SME, 01.06.2001; Russian SME, 05.06.2001b; see also Broadman and Recantini, 2001). There is still much that needs to be achieved in order to increase consumer confidence in the banking sector. What further impact IFIs and other donors can have remains unclear.

#### **6.7. Donor responses to working in the oblast**

Donors and IFIs working throughout Russia face the problem of pervasive corrupt practices running through most sectors of society. Given that the organisations will not and cannot condone such practices this inevitably presents problems when working in the country.

The government of Leningrad oblast is viewed as being straightforward and generally free of corrupt practices. Their position is probably helped by the fact that areas of industry such as real estate development and the entertainment industry are not priority areas for investment within the oblast. This tends to be concentrated in the city of St Petersburg and is the area that is most prone to 'mafia' influences due to the high level of competition. Despite this general feeling of trust extended towards Leningrad government by the donor community. Donors did stress that while they had not experienced problems with the Oblast Administration this did not mean that they were not anxious and cautious about the use of their funds in the oblast, especially in the light of the history of capital flight from Russia.

Donors suggested that more problems arose when dealing with the private sector, when issues of trust were more firmly under the spotlight as the risks of dealing with companies rather than government were higher due to a lack of accountability. At some point the Russian partner in a project is generally entrusted with funds and it is their responsibility to manage them. The general impression I received was that though the books balanced at the end of a project in some cases there had been some questions over the state of the accounts. The IFIs and other donors are heavily involved at the national level in pushing for the widespread adoption of international accounting standards (e.g. Tacis and World Bank projects for accounting reform) and for strong corporate governance but it is difficult to work out what impact these programmes have had at the local level yet. As donors are cautious and anxious this often sends negative signals to Russian partners who are wary in the first place of dealing with foreign partners.

A real problem that remains, however, is not one that exists directly between donors, and recipients but between recipients, their competitors and the state. Russian businesses can find themselves locked in to a system of corrupt practices, which prejudices their status with IFIs and other donors because of the latter's strict codes of conduct. This is not always because they want to engage in these practices but because there is inadequate protection from being subject to these practices. Again, the issue of socially embedded institutions comes to the fore.

Work in the oblast revealed that issues of corruption and tunnelling are a real impediment to the transformation of the economy towards a true capitalist model and that though well intentioned the projects of many of the IFIs and other donors

simply could not penetrate this problem. It is deeply embedded. However, one area donors and IFIs can work on is trying to lessen the gulf between expectations of Russian partners and themselves. Russian partners often hold false expectations as to what can be achieved through projects and moreover what kind of commitments and efforts they need to make and sustain even after the project officially ends. Donors have identified several causes of these problems.

First, the way in which projects were often 'sold' to Russian partners was the source of the initial false expectations. For example, in the case of the SME regeneration project, total SME (re)generation was not going to be achievable within six to nine months and furthermore required the sustained efforts of the business and government communities. The second problem stems from this. Quite often Russian partners are unaware of exactly what is required of them during and after the project's life. Furthermore, and thirdly, there are often, not only feelings of mistrust and suspicion towards foreign agents, but also the sense that they can benefit as individuals from such schemes, even materially, for example, getting fully paid business trips. These are hard issues to tackle but they need to be if projects are going to make a real impact on the ground. It can be argued that through interaction with IFIs and other donors Russian actors are exposed to best practice, but more often than not, independent actors have bid to run projects on behalf of organisations. This is the case for Tacis projects. This should not necessarily be problematic but it can be if there is insufficient pressure of a 'managerial eye' from the IFIs and donors.

Donors frequently talked of issues of trust and the importance of striking an equitable and sensible balance between being 'parental' and controlling and yet at the same time being respectful and extending trust towards recipients of donor assistance, especially with respect to the handling of funds (Interviews: IFI, 27.04.2001; IFI, 04.05.2001a; Bi-lateral Donor, 16.05.2001; Bi-lateral Donor, 28.05.2001; Bi-lateral Donor, 11.06.2001; Project Officer for IFI, 20.06.2001).

The IFIs and donors fully recognise these problems but added that though optimal conditions for operating do not exist this will not stop them working in the oblast, or in Russia. This is because the IFI and donor community *needs* to maintain a presence in the oblast and Russia. Variations on the statement 'there are more good reasons for us to be working here than not', came out in all interviews conducted with the donor community working in the oblast. It was also maintained that working in Leningrad oblast was easier than many other places (Interviews: IFI, 27.04.2001; Bi-lateral Donor, 16.05.2001; Bi-lateral Donor, 28.05.2001; IFI, 13.06.2001).

### **6.8. Further observations**

Strong feelings emerged from interviews with a range of informants conveying feelings of defiance against the 'we know better than you' attitudes of some of the IFIs working in the oblast. At the theory level they were willing participants and pupils. One real hurdle then for IFIs and other donors working in Russia is the scepticism with which their involvement is greeted. There remains a common perception that there must be something that donors are after, that there are strings attached.

This has lessened somewhat over time in the case of the Leningrad Oblast Administration and related functions as it has been demonstrated through projects that have run over time that this is not necessarily the case. But as far as a large proportion of individuals and businessmen are concerned this suspicion remains, because they see that nothing is given for free. Many businessmen interviewed showed their interest in being involved in projects if it would benefit them personally, for example, having opportunities to travel abroad or to receive personal training (For example, Interviews: Russian SME, 01.06.2001; Russian SME, 23.07.2001; see also Chapter 7). How seriously they take the work of IFIs and other donors remains to be seen.

## **6.9. Conclusions**

Though only a handful of the projects studied have been discussed, those that have are representative of others aimed at influencing the economic transformation process in the oblast. Furthermore, the reactions that they induced towards donor assistance in the oblasts are representative of the reactions provoked through other projects. Donors face key problems in trying to influence processes of change when attempts can only be piecemeal at the oblast level. But the IFIs and bi-lateral donors have chosen to focus activities at the federal level. This explains, perhaps the unexpected dearth of projects conducted in Leningrad oblast in comparison with the number conducted in Moscow in conjunction with federal authorities.

The resounding message from research in Leningrad oblast is clear. Different groups of Russian and business actors hold different opinions as to the worth of

donor activity in the oblast as well as to the worth of individual donors. It is clear that because of its geographical proximity to Europe Leningrad oblast receives comparatively more interest from European donors and in particular Tacis. The projects that have been run have obviously had some impact on the Russian individuals involved but the long-term effects of which are hard to discern, mainly because the long-term effects are dependent on Russian partners maintaining interest and commitment. If the impacts are to reinforce processes of transformation that are occurring spontaneously within the oblast's economy then it seems that they are more likely to be categorised as a success. The Oblast Administration whilst keen to take advantage of donor assistance is only keen to do so when projects are closely aligned with their own agenda for reform and development. A theoretical box, therefore, seems to have been created within which donors can operate. And this box defines the social institutions and practices within which donors can work. Interestingly the work of bi-lateral donors consistently provokes stronger positive reactions and the explanation for this perhaps lies in the willingness of Russian partners to establish stronger business links with European countries.

## Chapter 7

### Identifying oblast responses to donor activity in Sakhalin oblast

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#### Introduction

Located thousands of kilometres east of Leningrad oblast, Sakhalin oblast has received comparatively more direct attention from IFIs and other bi-lateral donors than most other regions in Russia in spite of its geographical dislocation from the mainland and the hive of administrative activity in Moscow. There are simple and obvious reasons for this: Sakhalin oblast holds strategic importance for Russia and other external agents on many fronts. These reasons include: its geographical location as a frontier region on the Pacific rim, and especially the lucrative offshore oil and gas reserves, which are increasingly being exploited by international consortia.

The previous chapter demonstrated what kind of impact IFI and European bi-lateral donor projects have attempted to make and *actually* made in Leningrad oblast and local responses towards these projects. This chapter examines similar processes in Sakhalin oblast allowing for a comparative analysis of the nature and impact of projects in the regions. Many of the same IFIs and bi-lateral donors at work in Leningrad oblast have also run and continue to run projects in Sakhalin. However, in addition too, and in some respect rather than European donors, there is a prominent US interest in the region displayed through the number of projects operated in Sakhalin funded in some way by USAID. There is also a growing Japanese interest.

It has been shown that bi-lateral donors and IFIs have sought, via projects, to promote the evolution of a transparent and investor friendly business environment in Leningrad oblast (especially European-based donors seeking to promote increased trade links between North West Russia and the EU). Similar processes occur in Sakhalin oblast as US and Japanese funded 'development' programmes are prevalent. There is a growing tripartite axis between Sakhalin, Hokkaido and Alaska. There is still a European presence in the region despite Sakhalin's distance from European borders. Notably the EBRD maintains a large commercial presence in the region because of its involvement in one of the oil and gas projects, as well as via its Russia Small Business Fund and its long-term work with Sberbank and the Far Eastern Bank.

There is a discernable difference between the type and duration of projects run in Sakhalin and Leningrad oblast. Research showed that the majority of projects run and funded in Sakhalin are longer term than, for example, the numerous Tacis projects funded in Leningrad oblast. The projects in Sakhalin have had a definite focus on supporting the development of local government operations, the SME sector and entrepreneurial activity more generally. Given the dominance of the oil and gas sector in the region it is not surprising that IFIs and other donors have opted for strategies that will help to boost the economic climate on the island<sup>1</sup>. There will, for example, be many opportunities for new and existing businesses as the oil and gas projects proceed and there is an increased need for infrastructure development, and an expanded service sector. As in Leningrad oblast, it is not uncommon for bi-

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<sup>1</sup> The presumed logic being that this will have positive knock on effects in other spheres, such as being able to help widen the social safety net and building social capital in the oblast.



lateral donors interests to be closely aligned with that particular country's business interests, but it is perhaps more blatant on Sakhalin than in Leningrad oblast.

This chapter further demonstrates that many projects are indeed targeted at changing social practices and institutions so that they begin to 'fit' with a so-called 'desired' model for promoting the solidification of a mode of social regulation, which can support this new regime of accumulation and the interests of international companies. But, yet again, it is clear to see that the Russian economy is one predicated upon *hybridism* and *embeddedness* and it is crucial to recognise that these *processes are enduring* and not merely transitory.

As is the case in Leningrad oblast, there are many different reactions towards IFI and donor activity on Sakhalin. But because of the overtly commercial nature of programmes set against the backdrop of oil and gas development potential, those involved in all sectors of the business community and local government appear to be more positively disposed to donor activity. Furthermore, the less advantageous economic situation on Sakhalin stands as a major incentive for many economic actors to engage with donors. There is a sense that at some level Sakhalin is becoming an increasingly dynamic business environment and that IFI and donor activity is paying off<sup>2</sup>. This of course does not mean that there are not dissenting voices to international involvement in the oblast. However, research showed that there is a general acknowledgement that international involvement is critical to

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<sup>2</sup> Whether this is, or should be the ultimate objective of the IFIs and other donors is questionable. A dynamic and flourishing business environment would, however, suggest that processes of transformation have successfully happened and allowed for the evolution of a mode of social regulation that supports the western capitalist experiences of regimes of accumulation. Therefore, in theory, certain objectives would have been met. The nature of practices and institutions in the business environment and the depth and reality of change might not, however, be as expected.

Sakhalin's development and survival in an otherwise ailing Russian Far East. In order to understand the responses to donor activity it is first important to provide some context in terms of the geography and economic and political development of the oblast.

### **7.1. An economic geography of Sakhalin oblast**

Lying offshore and directly to the east of Kharbarovsk Krai, the territory of Sakhalin oblast includes Sakhalin Island and the Kuril Island chain and the islands of Tyuleni and Moneron (see Map 3) and covers 87 100 square kilometres. It is among the top 25 largest regions of Russia; two thirds of the region is mountainous. Sakhalin oblast was officially defined and integrated as a part of the Russian Federation on January 2, 1947. The capital of the oblast is Yuzhno-Sakhalinsk lying to the south of the island of Sakhalin. The oblast is divided into 17 administrative districts. There are 19 towns and 33 other urban type settlements. Important cities in the oblast in addition to Yuzhno-Sakhalinsk include: Kholmsk, Korsakov, Nogliki, Okha, Poronaisk, Alexandrovsk-Sakhlinsky, Nevelsk, Ulegorsk and Dolinsk.

Sakhalin oblast is part of the Far Eastern Federal district, which includes nine other members: Republic of Sakha (Yakutia), Primorskii Krai, Kharbarovsk Krai, Amur oblast, Kamchatka Oblast, Magadan Oblast, the Jewish Autonomous Okrug, the Koryak Autonomous Okrug and the Chukotka Autonomous Okrug. The Russian Far East as a whole constitutes 36.4 per cent of Russian territory with a population of fewer than 7 million in 2000 (Goskomstat, 2001c). But ever since the mid-nineteenth century, when the boundaries were fixed for what is considered to be the Russian Far East, there has been a continued focus on maintaining political control

in the region for strategic reasons. This in turn has influenced processes of economic development. The territory of the Russian Far East acts as Russia's gateway to the Pacific and the region shares borders with China, Japan, North Korea and the United States.

The resident population of the oblast is approximately 591 000 (Goskomstat, 2001c) (approximately 0.41 per cent of the Russian total). The oblast has a largely urban population; approximately 84.7 per cent of the population lives in urban type settlements. The region has witnessed a steep decline in the population since 1989 when there were approximately 710 000 residents. A substantial proportion of this population decline can be accounted for by decreased militarisation in the oblast, an aging population, as well as other migratory pressures including rising unemployment and falling standards of living. In the 1989 census 81.6 per cent of the oblast population was ethnic Russian (Bradshaw, 2002). Given the historic changes that have occurred in the intervening period it will be interesting to see how these have affected on the ethnic diversity of the population<sup>3</sup>. For example, since the freer movement of peoples has been allowed there has been an increase in the out migration of ethnic Russians and the immigration of peoples of Korean and Japanese descent who hold old family ties with the region.

There are strong historic connections between Sakhalin, Japan and Korea. Among other things, there has been a territorial dispute between Russia and Japan over the ownership of the Kuril Islands. From 1855 to 1945 Japan governed the southern part of the island. Under Soviet rule, from 1945, the island was delimited as being part

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<sup>3</sup> The next census for Russia will be held in October 2002, this will be the first in the history of the Russian Federation.

of Kharbarovsk Krai. Sakhalin oblast's industrial base, focussed around coal, oil, fishing and forestry was established under the era of Japanese governance. Post 1945 under Soviet control the whole of Sakhalin Island was designated as a closed garrison region, at the same time the previously established industrial base was developed further (see Stephan, 1971)

### ***7.1.1. A brief overview of the oblast's economy***

During the Soviet period the Russian Far East, including Sakhalin oblast, served both as a key source of natural resources to satisfy domestic demand and base for the Far East Military district Pacific Fleet<sup>4</sup> (Ryzhkov, 1967 Sakhalinskoi oblasti, 1967). Sakhalin's proximity to northern Japan, the legacy of its disputed ownership and Sakhalin's position as a Russian 'frontier' with the seas of Okhotsk and Japan and the Pacific Ocean off its shores has defined the nature and the extent of the development of the local economy.

It was during the interwar period that coal, oil, pulp and paper industries were developed on Sakhalin (Bradshaw, 2002; Kniazeva, 1960). The Japanese were instrumental in the development of the resource base. Vysokov et al. (1995) have documented how the Japanese extracted and exported more than 48 million tonnes of coal by 1945, as well as 2 million tonnes of oil. Further North on Sakhalin the Soviet government had started the exploitation of oil fields, but following 1945, it is widely felt that the interest in the exploitation of natural resource in Sakhalin waned as the centre of the Soviet nation dominated proceedings (Vysokov et al. 1995: 72).

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<sup>4</sup> The Far East Military Headquarters are located in Kharbarovsk; the Pacific Fleet is based in Vladivostok, while there are also submarine bases located in Kamchatka.

Historically the seas and ocean surrounding Sakhalin oblast have been among the most productive in the world in terms of marine resources. The area around the island is Russia's largest fishing ground. Many valuable species of fish thrive in these waters including: salmon, herring, flounder, mackerel, cod, navaga, rasp and halibut. The shelf of Sakhalin Island and the Kurils is also favourable to the harvesting of crab, shrimp, mussels and other bivalves. In spite of the obvious wealth that oil and gas development bring, fishing and fish processing still accounts for over 40 per cent of gross regional product (Goskomstat, 2001c) and therefore remains of critical importance in the region, at least until there are further developments in the oil and gas sector.

Three sectors of the economy currently account for over 85 per cent of industrial production: energy (40.4 per cent), food (mainly fishing industry) (40.5 per cent) and forestry (4.2 per cent). Statistics show that forestry accounted for 11.7 per cent of total industrial production in the oblast in 1995 (Goskomstat, 1996), more than double what it is today. The other two key industrial sectors have also faced sizeable difficulties.

One of the key problems that the oblast has had to face is its continued isolation from the Far eastern energy grid (Bradshaw, 2001). It relies upon its own coal-based system for energy supplies. However, the system does not extend over the whole of Sakhalin Island and remains highly fragmented. As is common in the rest of Russia, the system still awaits much needed injections of cash to deal with a crumbling infrastructure, rising costs and a long running non-payments crisis. The residents of the oblast have consequently suffered from energy shortages particularly in the

winter months. Of course, the irony of the situation is that there are potentially massive supplies of energy lying offshore<sup>5</sup>. There has been a history of onshore production on the Island but production facilities were damaged in the Neftegorsk earthquake in 1995. Even prior to this the on shore production to the North of the Island had peaked and new investment was needed for new and existing wells to be developed.

Similar investment problems have dogged the forestry sector and because of a lack of investment activity is now restricted to logging operations. The fishing industry also needs new investment but also controls over illegal fishing practices which threatens the fish processing industry as supplies to them are reduced. There are other issues that affect on the potential regeneration of these industries, in particular corruption and local mafia groups who seek to 'control' local operations (see for example, Braguinsky and Yavlinksy, 2000; Broadman and Recantini, 2001), as well as the difficulty of obtaining the correct permits from the appropriate local and federal government departments (Interviews: Business Analyst 22.08.2001; Independent consultant, 27.08.2001).

In 1991–92 the Russian Far East was cut off from traditional suppliers of food products and consumer goods produced in European Russia because economic links were disrupted. A key cause of this dislocation was the cost of facing the full burden of high transportation costs across the country. Therefore, disillusioned with inadequate federal support, the regions in the Russian Far East began exploring economic integration in the Pacific Rim as a potential solution to regional

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<sup>5</sup> For example, all the oil produced by Sakhalin 2 via their Molipaq platform is exported and, in theory the majority of the natural gas will be piped to other international markets.

underdevelopment. While Primorskii Krai took advantage of its proximity to China, Sakhalin has found itself more engaged economically with Japan, more specifically, the Northern most island of Japan, Hokkaido and also with Korea given the ethnic background of a substantial proportion of Sakhalin's inhabitants. In fact, over 350 joint business ventures have been registered in the region, the majority with Japanese partners, then Korean and US companies.

The issues that need to be tackled in relation to Sakhalin's ailing economy and dilapidated infrastructure pivot around the lack of investment in capital stock and infrastructure development. Substantial new investment is a requisite for the oblast economy but, despite numerous promises, there has been a real lack of assistance from Moscow. The local elites in the region, for the most part, therefore, see the offshore oil and gas projects as being a lifeline for the economy that could help provide much needed capital and infrastructure development (Bogdanchikov, 2000; Bradshaw, 1998). The Oblast Administration and Duma are under pressure to assure the best possible contractual agreements with the oil consortia. Consequently the oil consortia have been engaged in protracted discussions with both regional and federal authorities concerning the financial aspects of their projects and the monies and commitments that are due to these Russian actors. It is clear to see that the oil and gas projects are of critical importance to the future of the oblast's economy

#### ***7.1.2. Sakhalin oil and gas projects***

Sakhalin's known reserves of offshore oil are estimated at 1.5 billion barrels. Gas reserves are even more substantial. These facts alone have secured Sakhalin oblast a position on the international stage as major multinational oil and gas companies

have sought to establish consortia to develop the oil and gas potential. The exploitation of the offshore oil and gas fields is of regional, national and international significance<sup>6</sup>. It is hoped that some of the profits generated from operations can be ploughed back in the to the local economy, in particular for infrastructure development (Bradshaw, 2001; 1998; Interview: Oblast Administration, 22.08.2001). Furthermore, the projects could play a part in helping to solve the RFE's general energy supply problems.

There are currently two projects that hold Production Sharing Agreements (PSAs) and a further four in different stages of development (see Table 7.1.). It is clear to see many of the big names associated with oil and gas in the various consortia, for example, Shell, ExxonMobil, Chevron-Exaco and BP. There have been many changes in the membership of these consortia and over the past few years there has been a decrease in the number of smaller companies in the projects. For example, McDermott and Marathon both left the Sakhalin 2 project. This has given the larger multinational companies the chance to expand shares in the projects. However, there have been other new entrants, such as the Indian company ONGC and an increase Russian involvement mainly via Rosneft<sup>7</sup>. Frequent membership changes have had a negative impact on the development of good long-term relations with amongst others the local government and particularly the Shelf Department (responsible for

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<sup>6</sup> The Russian Government has received a bonus of US \$15 million in June 1996 and will receive another US \$15-20 million each time a production date is announced for a specified field. This will be the case for other projects though the figures are obviously negotiable. The Russian Federal and Oblast governments will also get 6-8 per cent royalty per annum when production is under way. From the point at which foreign partners recoup their costs 51 per cent of the revenue will go to the Russians according to a sliding scale. According to PSA law the Russian government will receive a combination of hard currency from royalties and profit taxes in addition to an actual share of production. Negotiations continue between Federal and Oblast governments as to how the royalties will be further divided between the two levels of government.

<sup>7</sup> Federal laws have meant that the multinational oil companies have had to include Russian partners in their consortia in order to be able to proceed with projects.



**Table 7.1. Sakhalin Island Oil and Gas Projects**

<b>Lease Area/Project</b>	<b>Participants/Shareholders</b>	<b>Expected Investment (US \$ billion)</b>	<b>Fields</b>	<b>Characteristics</b>	<b>Status (as of May 2002)</b>
Sakhalin 1	ExxonMobil (US) [Project operator] SODECO (Japan) Rosneft- Astra, SMNG-Shelf(Russia) ONGC (India)	12	1. Akutun-Dagi  2. Chayvo 3. Odoptu	Recoverable gas estimated at 2-3 TCF* Estimates 10 TCF gas na	PSA held 3-D Seismic completed  Seasonal oil production started July 1999
Sakhalin 2	Royal Dutch Shell (UK/Netherlands) [Project operator] Mitsui (Japan) Mitsubishi (Japan)	10	1. Pilton-Astokhskoye  2. Lunskeye	Oil with associated gas  Gas reserves estimated at 19 TCF	PSA held, production targeted for 2005/06  Seasonal production started
Sakhalin 3	ExxonMobil (US) ChevronTexaco(US) Rosneft, SMNG (Russia)  ExxonMobil (US) Rosneft, SMNG (Russia)	15  13.5	1. Kirinskii Block  2. Vostochno-Odoptinskoye, Ayanshskoye Blocks	Reserves of 3.4 billion barrels of oil, 34.3 TCF gas  Not yet surveyed	Currently negotiating PSA, expecting 6 year exploration programme from 2002  Currently negotiating PSA, awaiting 1 approval to be added to 'Law of the Lists'
Sakhalin 4	BP (UK) [Project leader] Rosneft, Rosneft-SMNG	na	1. West Schmidt Block	na	Exploration permit held, no PSA held
Sakhalin 5	BP (UK) [Project Leader] Rosneft, Rosneft-SMNG	na	2. East Schmidt Block	na	Yet to be tendered
Sakhalin 6	Alfa Group (Russia) Alfa-Eco (Russia) Petrosakh (Russia)	na	1. Progranichnyi block		Potential development of acreage without PSA Planned 3-D seismic survey

Sources: Bradshaw (2002), Pacific Russia Information Group (2001), Sakhalin Shelf Department (2001)

\* TCF(Trillion Cubic Feet)

over seeing aspects of the oil and gas projects affecting the oblast) (Bradshaw, 2002). Corporate strategies are also constantly evolving, and are a further cause of instability.

The Sakhalin 1 and Sakhalin 2 projects were the first to use Production Sharing Agreements (PSAs) to begin developing offshore oil and gas reserves. The Sakhalin 1 and 2 projects together constitute an investment of over US \$25 billion. When fully implemented Sakhalin 2 will become one of the largest private investment ventures in Russia (Pacific Russia Information Group, 2001). Financing for the project is coming from both private investors as well as from IFIs (the EBRD, Japanese Export-Import Bank, and the US Overseas Investment Corporation (OPIC)), who have signed loan agreements for approximately US \$348 million. Sakhalin 2 is the most advanced of all the oil and gas projects, the first oil was pumped in 1998, and is a project of the Sakhalin Energy Investment Company Ltd. (SEIC).

Royal Dutch/Shell Group is the project leader and the Chairman of Shell has stated that he 'couldn't think of a gas project more important for Shell'<sup>8</sup>. He added that the Sakhalin 2 constituted a major investment for Shell, as the company seeks to expand the gas element of its portfolio. The company also feels that Russia is the major resource holder of gas in the world and is therefore a place that Shell would 'like to be'<sup>9</sup>. Sakhalin 2 is currently preparing to initiate phase two of its development plans.

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<sup>8</sup> Phil Watts (Group Chairman of Royal Dutch/Shell Group) speaking at the Sakhalin Energy Shareholders Meeting, Yuzhno-Sakhalinsk, July 17, 2001 following the announcement that Sakhalin 2 was ready to proceed with Phase 2 of their development programme.

<sup>9</sup> Shell is increasing its activities with Russian partners. For example, July 2, 2002 Shell, Gazprom and ExxonMobil each took 15 per cent stakes in the US \$5.6 billion project to construct the Trans-Chinese East-West Gas pipeline (China Today, July 2, 2002).

These plans include year round production of oil and gas; an LNG plant and oil export terminal at the south of Sakhalin Island; and transportation infrastructure to move crude and natural gas from the offshore fields in the north of the island (SEIC, 2001).

The various consortia obviously set their own development agendas based on strategic business decisions, but they are not free to operate entirely in the way that they wish to. Production sharing agreements dictate that a supervisory committee closely monitors all decisions that have an economic or environmental impact in the oblast. Sakhalin 1 and Sakhalin 2 have their own supervisory committees made up of 12 members: six from the Russian side (including the Governor of Sakhalin and representatives from the Sakhalin Shelf Department and the federal government, such as the Ministry of Fuel and Energy and Ministry of Defence) and six from SEIC, or from the Sakhalin 1 project consortium. Much time and energy goes into the negotiations that involve the supervisory committee (Interviews, Oil and Gas, 28.08.2001a; Oil and Gas, 28.08.2001b; Oil and Gas, 03.09.2001) and the outcomes are obviously crucial to all parties. Therefore, the oil consortia try to maintain good working relations with local and federal representatives, even though some of their longer-term objectives run counter to their own (Interviews: Oil and Gas, 28.08.2001a; Oil and Gas, 28.08.2001b; Oil and Gas, 04.09.2001). As such then, the progress of the oil and gas projects is dependent to some degree on the local political environment and especially the oblast governor.

### ***7.1.3. An insight into the politics of the oblast***

The political environment of the oblast, as in other oblasts, has a real impact on the overall economic and business environment. It also determines the receptiveness of regional actors towards IFIs and other bi-lateral donors being involved in the oblast's economic and social development. In the Russian context, the politics of Sakhalin oblast are not characterised as being overly radical (Carnegie, 1999). As usual, the main and obvious concerns and tensions revolve around the negotiation of the oblast's relationship with federal government. But there is an added dimension in Sakhalin beyond that which most regions have to face. In short, incomes generated from oil and gas developments are critical to both sets of Russian actors and neither side wishes to get less than they deserve. Issues concerning the 'territoriality' of decision-making processes are therefore at the forefront of local politics. Individuals, particularly the governor, play a key role in the construction of the local political climate.

Igor Farkhutdinov was appointed to be Governor of the oblast in April 1995. He officially requested permission from the Federal authorities to hold direct gubernatorial elections three times before winning a popular mandate on October 20, 1996 (OMRI Daily Digest, 21.10.1996). Farkhutdinov headed the local branch of Our Home is Russia. Chernomyrdin as head of the party at the time and Prime Minister took an active role in Farkhutdinov's campaign. He promised to introduce various development programmes to help the oblast<sup>10</sup>. Farkhutdinov defeated his opponents gaining a plurality of 39.4 per cent of the vote.

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<sup>10</sup> Whether or not Chernomyrdin was able to make good on these promises or not is highly debatable.

Prior to his appointment, and then election as Governor, Farkhutdinov had served as mayor of the oblast's capital city Yuzhno-Sakhalinsk. His predecessor Krasnoyarov, the oblast's governor since 1993 was forced to resign under a cloud of allegations that he misused federal aid intended for the victims of an earthquake in the Southern Kuril Islands in 1994. Farkhutdinov, on the other hand drew considerable praise for his handling of the May 1995 earthquake in the city of Neftegorsk in northern Sakhalin. He has since been re-elected to office for a second term in October 2000.

Farkhutdinov has seized upon the development of the oil and gas projects as a way to help the regional economy and has set about trying to secure any benefits, financial or otherwise that he can. In addition to working with investors related to the oil and gas projects, Farkhutdinov has also sought federal subsidies from Moscow, as well as trying to establish long-term economic ties with nearby Japan and South Korea (Carnegie, 1999). Farkhutdinov has therefore established something of a reputation in Moscow for being fairly vocal on issues concerning legislative changes, and issues affecting not only Sakhalin oblast but also the RFE. Political analysts in Moscow suggest that the reputation is not necessarily a bad one, but that Farkhutdinov is known to peddle the same agenda time after time, which does not always help him to be seen in a positive light within the Duma or by the Kremlin (Carnegie, 1999; Interview: Political Analyst, 24.07.2001). Sakhalin oblast, like many other regions, has signed a power sharing treaty with Moscow, which has been reviewed<sup>11</sup>. This has been a further source of political tension between the region and Moscow as the terms of this have been renegotiated.

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<sup>11</sup> As many of the power sharing treaties/agreements contradict the Russian constitution President Putin established a commission on June 26, 2001 to review their utility (Izvestiya, June 27, 2001).

Farkhutdinov has sometimes found himself at loggerheads with Federal government on matters other than those relating to oil and gas projects. For example, he was one of the Governors involved in a large-scale economic revolt against Moscow in 1997. He supported for a time the oblast Duma's vote to discontinue any contributions to the federal budget. The vote had been cast as Duma representatives felt that federal transfers to the oblast had not been occurring causing delays in wages, pensions and other social payments. In an about turn, however, Farkhutdinov called on the assembly to revoke this ruling after the government made good on some of its financial obligations to the oblast (RFE/RL Newslines, 13.03.1997). This did not win Farkhutdinov support from the Oblast Duma.

This is just one of the many incidents that have gone some way to souring relations between Farkhutdinov and the Oblast Duma, establishing a reputation among the deputies that he is prone to pandering to Moscow. Other incidents include some controversy about the lack of transparency in Oblast Administration accounts (Sakhalin Times, August 16-30, 2001). This has meant that along with other allegations the governor and the local administration have far from an untarnished reputation in terms of participating in, or condoning corrupt practices. Furthermore, the Governor's seeming reluctance to take decisive action following various recommendations by the Duma, for example, concerning improving local housing stock and social infrastructure development, has not enhanced his reputation as an effective or decisive local politician (Sakhalin Times, January 10-24, 2001).

Clearly the negotiation of Sakhalin's relationship with Moscow is one of the most important factors determining the oblast's future (Bradshaw, 2002). But exactly

what levers the Oblast Administration can use to ensure its needs are met in this process are difficult to determine. As the multinationals focus more of their efforts in Moscow in order to speed things up on Sakhalin the Oblast Administration is struggling to maintain its share of 'power' (Interviews: Oil and Gas, 28.08.2001, Oil and Gas, 31.08.2001; Oil and Gas, 03.09.2001). Aside from the oil and gas sector, however, other sectors of the economy remain firmly in the clutches of relatively few local actors (Interviews: Business Analyst, 22.08.2001; Independent Consultant, 27.07.2001; Oblast Administration, 29.08.2001).

The political climate in Sakhalin is strongly influenced by politics in Moscow (Carnegie, 1999). The Kremlin and Federal Duma play direct roles in mediating national interests concerning the region, as does the Presidential Representative for the RFE. General Konstantin Pulikovskii was appointed by Putin to be Presidential representative to the Far East District. By his own admission Pulikovskii has had limited success in fulfilling his designated role in the region. There remains a real lack of coordination between the federal agencies based in the federal district. Pulikovskii has gone on the record as saying that he had to take on some of the responsibilities of the leaders of one region or another and this complicated issues and meant that he has had to spend time on things other than his tasks (*Izvestiya Tikhookeanskoi Rossii*, May 25, 2001; Wishnick, 2002). Farkhutdinov has gone on the record as saying that as far as he is concerned:

'Pulikovskii was engaged in the analysis of the regional legislation in 2001. In my opinion, the Far East has passed all this quietly. And the charter of the region is harmonised with federal legislation. It is good. Thus the representative does not try to rule the economy of Sakhalin oblast, because this is my area. Certainly, if I need help I turn to Konstantin (Pulikovskii) and I am always met with understanding and support. I hope that our working relationship continues in this way'

(Igor Farkhutdinov, Interview November 23, 2001, Information Agency NefteGaz.Ru).

November 1, 2000, Pulikovskii created a Committee on Regional Development, to coordinate the activities of the regions within the district of the Far East in key sectors, including, for example, foreign trade, energy, transportation and fishing. But it seems that Pulikovskii is struggling to confront the challenge of managing the regional association led by Kharbarovsk Krai governor Viktor Ishaev (RFR, December 6, 2000). The implementation of the new development plan for the region will be a test of the strength between the federal district and the regional economic association. In response to Pulikovskii's moves, Sakhalin Governor Farkhutdinov has been using the strong foreign interest in the oblast's offshore oil and gas resources to lobby the Kremlin and the State Duma to approve measures necessary to move forward the energy projects.

It is no surprise that the Sakhalin Oblast Administration wishes to maximise its income from the oil and gas projects. At the same time, there is a difficult relationship between the federal and regional authorities as the latter do not trust the former to hand over the monies that they are entitled to:

'There is a real concern that the federal administration is planning to limit the profits which are re-distributed to the region. There is a dangerous tendency to centralise profits into the federal budget, and we are fighting to make sure that we receive the portion of the profits that has been promised to us through our agreement with the federal government. We hope that our rights will be preserved, since we have the support of President Putin and Vice-President Kasyanov, who understand that the majority of work with these projects is done by our regional administration (Galina Pavlova, Head of the Sakhalin Shelf Department, July 16, 2002)<sup>12</sup>.

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<sup>12</sup> Transcript of interview is available from <http://www.winne.com/Interviews/pavlova.htm>, last accessed 15.08.2002



The residents of Sakhalin naturally want assurances that the revenues will be used in projects, which will benefit them, especially in terms of helping improve standards of living (Akha and Vassilieva, 1999), which are generally low (Goskomstat, 2001c). Generally within Russia, there exist feelings of suspicion towards, not only local and federal governments but also towards IFIs and donors (Ledeneva, 2001). However, in Sakhalin there are different reactions to the work of such organisations. Perhaps it is because it is widely accepted that if Sakhalin is to manage economically in the future it is dependent on international agents to play a role. The overt involvement of IFIs and donors in projects related to the economic development of the region is welcomed.

## **7.2. The nature and extent of donor assistance in Sakhalin oblast**

Since 1995, Sakhalin has consistently been among the top ten Russia regions attracting FDI (Bradshaw, 2002; Goskomstat, 2001a). This is easily explained in terms of the foreign capital that has been invested in the oil and gas projects. It is therefore no real surprise that Sakhalin oblast has also attracted much interest from IFIs and bi-lateral donors who seek to promote Russia's integration in the international economy, as well as furthering the interests of the foreign parties which fund them.

In comparison with Leningrad oblast, the region receives more attention from Japanese and US donors<sup>13</sup>. However, the region plays a major role in the EBRD's loan portfolio. The EBRD tries to spread its operations over as many regions as

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<sup>13</sup> The US and Japanese presence in Sakhalin is best illustrated by the existence of dedicated trade council offices in Yuzhno-Sakhalinsk and the suggestion that the US Consulate will establish a small office on Sakhalin Island as passenger traffic between the US and Sakhalin increases as the oil and gas projects progress.

possible despite its new commitment to step up its activity at the federal level, mainly in Moscow. It has a dedicated permanent office in Vladivostok from which most projects in the RFE are managed. Several EBRD projects are discussed below they include: the EBRD's involvement in the Sakhalin 2 oil and gas project, projects in the banking sector involving Sberbank and the Far Eastern Bank and SME development through the Russia Small Business Fund.

The EBRD is also looking to become involved in developing the construction industry and, therefore, suitable dwelling spaces. This is to be done through a system of equity financing. They are looking to be involved in projects on Sakhalin Island on the proviso that EBRD funds constitute a maximum of 35 per cent of the total value of the project.

Other European actors active in the region include the British Council. A Russian-British Centre opened in Yuzhno-Sakhalinsk in May 1999. The Sakhalin Oblast Department of Education, Culture and Sport, and the British Council run the centre and it receives additional funding from BP. In fact it is BP's presence in the region that was the key factor in establishing the centre in the first place (Interview: Oil and Gas Company, 03.09.2001). At the present time, the centre focuses on providing English language materials to teachers and students as well as promoting British culture; there is no other British donor activity in the region, though this might change as BP's presence becomes more permanent.

American government departments such as USAID, the State Department and the Department of Commerce fund the majority of US projects/operations conducted in

Sakhalin. The American presence is readily explained because of the oblast's proximity to its own borders and the desire to promote US business interests in the region. It is felt among some that Sakhalin could be the 'new Alaska' (Interviews: Business Analyst, 22.08.2001; Trade council, 23.08.2001; Independent consultant, 27.08.2001; Oil and Gas company, 03.09.2001; Oil and Gas company, 04.09.2001). The USAID has been involved with the Department of Commerce in opening the American Business Centre (ABC) in Yuzhno-Sakhalinsk. It has also been involved in co-funding projects aimed at helping the Oblast Administration improve their transparency of their procedures, as well as the establishment of the Sakhalin Development Agency. The USAID has also co-funded the American Russian Business Training Centres in the oblast and the Russia-Sakhalin Regional Micro-Credit programme.

The Japanese government has also been involved in the regional economy in a similar manner, its interests being both strategic and commercial. The predominantly government-owned Mitsubshi Corporation has a sizeable interest in the Sakhalin 2 oil and gas project. Beyond their involvement in a specific oil and gas project, the government is actively supporting the expansion of Japanese business interests in the region especially in light of the potential market for involvement in the infrastructure development plans. For example, the government and business community of Hokkaido have established a training centre in the mould of the American Russian Training Centre, where courses in accountancy, strategic planning and other basic business skills are offered for a nominal fee.

In addition to this, the Hokkaido Business Centre has recently been established, which aims at facilitating Russo-Japanese business partnerships as well as providing important information to existing and potential investors in the region. Research revealed that several groups of Russians reacted differently to Japanese involvement in the regional economy in comparison with, for example, US actors (Interviews: Business Analyst, 22.08.2001; Oblast Duma, 24.08.2001; Russian SME, 02.09.2001). This might of course have something to do with the historic dispute between Russia and Japan over the legitimate ownership of the oblast but it seems it also has something to do with matters of trust.

One thing that most of the projects have in common, and that is different from the bulk of projects run in Leningrad oblast, is the longevity of them. Many projects have been funded since the mid 1990s and continue to receive funding. Changes to the amount of USAID funding to the region are expected under the Bush Administration and it is likely that this will take the form of a reduction (Interviews: Bi-lateral donor, 21.11.2001; Business Analyst, 22.08.2001). However, USAID still intends to maintain a strong presence in the region and the decision to reduce spending in the region in the medium term is perhaps more to do with the already successful establishment of an American presence in the region despite the withdrawal of US interests from Sakhalin 2 (Interviews: Business Analyst, 22.08.2001; Trade Council, 23.08.2001; Independent Consultant, 27.08.2001). In other words the general feelings seem to be of wait for oil and gas developments and to then consolidate what has already been established.

The EBRD typically engages in projects for the long-term. The reasoning behind this being that it takes time and commitment to instigate positive change. Of course, another reason for longer-term commitments, for example, in terms of the leasing scheme and the training centres is that the oil and gas projects themselves operate over the long term. The governor and local administration are conscious of time and the speed at which material benefits come from the oil and gas projects and are therefore impatient (Igor Farkhutdinov, July, 2002<sup>14</sup>). There is local pressure for the projects and the associated growth and wealth to begin sooner rather than later; the oblast economy to a great extent depends on this to secure its future financial stability and viability.

### **7.3. Responses to donor activity at key sites of regulation and governance**

Since the early 1990s the Oblast Administration has recognised that Sakhalin needed to be exposed to the international arena if it was to cope with the pressures of transformation and its seemingly increased dislocation from mainland Russia and the hub of commercial activity and growth in European Russia (Bogdanchikov, 2000). From the outset of its own 'transition' experience, the Oblast Administration has courted foreign involvement in the oblast, especially in the form of FDI. However, this has been at some cost, and they have tried to use the existing legal framework and subsequent amendments to it, to support their own agenda and try to cut the best deal for Sakhalin and to preserve their own interests.

Any foreign donor activity, which does not trespass on the authority of local government, has generally speaking, been welcomed (Interviews: Bi-lateral donor,

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<sup>14</sup> See interview with Igor Farkhutdinov at <http://www.winne.com/interviews/sakhalin.htm> accessed 15.08.2002

23.08.2001; Oblast Duma, 24.08.2001; Oblast Administration, 29.08.2001). A common response to such questions suggested that most Russian actors were aware that there were limited resources available for things other than the absolutely essential and therefore alternative sources of funding were useful to help develop certain sectors of the economy. The local administration, however, prefers to avoid interference in their activities and inevitably focuses on fulfilling its own agenda.

### ***7.3.1. The Oblast Administration: its policies***

Naturally the progress of the oil and gas projects dominates the political and economic agenda on Sakhalin, however, the decisions and progress ultimately lies in the hands of the oil and gas consortia themselves. So, there are many other issues, which are of critical importance to the local administration, not least the crucial (re) development of the oblast's inadequate infrastructure.

According to representatives of the Sakhalin Oblast Administration (Interviews: Oblast Administration, 22.08.2001; Independent Consultant, 27.08.2001; Oblast Administration, 29.08.2001) the following projects have 'special priority', whether they can/will be realistically implemented or not is a different matter:

- Construction of an oil and gas pipeline running from the offshore fields in the north to Prigorodnoye to the south of the island,
- Construction of a gas liquefaction plant also in Prigorodnoye, to process natural gas for export,
- Development of the port facilities in the south of Sakhalin Island (for example, in Korsakov and Kholmsk) to allow for larger vessels to dock there and therefore allow for increased traffic to and from Sakhalin,
- Construction of technological business parks in the Katangli and Val urban settlements near to the offshore oil and gas sites to the north of the island,
- Construction of housing in Yuzhno-Sakhalinsk, Ohka, Katangli, Val and Prigorodnoye (SMNG is currently developing a construction programme for

Ohka and Nogliki where the company already owns over 50 per cent of the real estate,

- Upgrading of the TETS-1 power plant and the Yuzhno-Sakhalinsk sewage plant as well as the development of a centralised heating system on the Island.

The above list is ambitious in its scope; the projects listed are neither small nor cheap. Money would need to be found from somewhere. The general expectation is that money from the infrastructure development fund could be used to fund some of the projects. But even a cursory glance at the above list shows that there is little priority attached here to improving the social situation for many of the residents, in terms of healthcare facilities, education or large scale housing re-developments. Duma representatives were quick to bemoan this fact (Interviews: Oblast Duma, 24.08.2001; Oblast Duma, 14.09.2001). However, an analysis of the development fund's expenditure to date shows that money has actually been used to help try and alleviate poor social conditions. Just how the balance between the different priorities of officials, local politicians and residents will be managed in the future with larger sums of money at stake is a contentious issue.

Another preoccupation that some local politicians seem to have is the desire for Sakhalin to become a free economic zone again. Sakhalin was declared a free economic zone for a brief period from 1990. The idea to reinvent the free economic zone has been mooted for quite some time now but as yet no real plans have come to fruition and it is debateable as to whether this is really in Sakhalin's long term interests (Igor Farkhutdinov, July 2002<sup>15</sup>; Interviews: Oblast Administration, 22.08.2001; Oblast Duma, 24.08.2001; Oblast Administration, 29.08.2001).

According to Boris Tretyak (then Chair of the Oblast Duma) the Russian President

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<sup>15</sup> The transcript for the interview can be accessed at:  
<http://www.winne.com/Interviews/sakhalin.htm>, last accessed 15.08.2002

approves of the creation of a free economic zone in Sakhalin (Sakhalin Times, July 5, 2001). There has been no further word on this situation and interviews with members of the Economic Development Committee of the local administration suggested that such an idea is always discussed because of Sakhalin's outlying position, for example, a little like Kaliningrad in the West. But this does not mean that this should be either a priority or something to rely upon for Sakhalin's future.

It is clear to see that the progress of the oil and gas developments, and associated activities were judged to be the most important concern for the local administration. All of which suggests that, foreign investment projects are heralded as the key to Sakhalin's survival.

### ***7.3.2. Investment Policy in the oblast***

The Oblast Administration is fully aware that it needs to address infrastructure problems and to support key sectors of the regional economy (for example, timber processing and fishing) (Interviews: Oblast Administration, 22.08.2001; Oblast Administration, 24.08.2001, Independent Consultant, 27.08.2001). But, as already indicated, Oblast Duma deputies, are anxious to focus attention and investor support on areas concerned with more social issues, such as housing and social subsidies, health care and education. The result of protracted discussions between the administrative bodies has been the introduction of complicated local legislation. The bottom-line being that foreign investors are 'requested' (though perhaps required would be a more appropriate word), to finance the development of the region's infrastructure as well as taking some responsibility for financing environmental



protection. The money from investors is to be managed through the Sakhalin Development Fund (Northern Economics Inc.,1999).

The Sakhalin 1 and 2 consortia are committed to financing the Sakhalin Development Fund as their operations progress<sup>16</sup>. It is mandated that the total contributions they will make to the Fund will approach US \$100 million over a five-year period (SEIC, 2002<sup>17</sup>; Interviews: Oblast Administration, 29.08.2001; Oil and Gas Company, 28.08.2001; Oil and Gas Company, 03.09.2001). The Oblast Administration have been determined to ensure that the oblast benefits from the development of the oil and gas fields by the international consortia, rather than just seeing profits shifted abroad or to Moscow. Money in the fund is already being used to improve the Island's social and economic infrastructure, more projects are expected in the future as more money filters in to the Fund. Interviews with representatives of Sakhalin 1 and Sakhalin 2 projects confirmed that the consortia were in favour of this scheme if tangible results were visible in the medium term. It is of course in the interests of the projects for there to be infrastructure developments in the region for the projects benefit directly from this, not only in terms of for example, the provision of key utilities and support industries but also things such as housing for employees and good transport connections to name but two examples. In reality then, money from the Fund is being used to plug holes in the oblast budget, in order for the regional government to make progress with essential infrastructure improvements.

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<sup>16</sup> At the end of 1999 SEIC (Sakhalin 2) deposited a third payment of US \$20 million into the Sakhalin Development Fund. SEIC has also started to pay quarterly payments of US \$4 million into the Fund as part of its reimbursement package for previous Russian research and exploration. The reimbursement will be divided between oblast and federal authorities.

<sup>17</sup> 17 Information accessed from Sakhalin Energy website:  
<http://www.sakhalinenergy.com/projects/benefits>, last accessed 16.08.2002

While there is a commitment from the consortia to support the Development Fund, through the PSAs, some members of the Oblast Administration expressed feelings of consternation towards Sakhalin 1 who despite declaring the commerciality of their venture have not as yet paid any monies to the fund (Sakhalin Times, 16.08.2001). Representatives of Sakhalin 1 acknowledged their non-payment but reiterated that the payment to the fund was not overdue due to the fact that commerciality of the Sakhalin 1 project was only declared in October 2001. Tension over the money demonstrates just how much the local administration is relying on the money from the oil and gas companies.

### ***7.3.3. IFIs and the Oil and Gas Projects***

The most direct involvement of an IFI in the commercial oil and gas projects is by the EBRD. It has been involved in the Sakhalin 2 oil and gas project since 1997. The EBRD stepped up its involvement in Sakhalin oblast and the oil and gas projects in 2001 when it signed a loan agreement with Rosneft-Sakhalinmorneftegaz (SMNG). The US \$90 million corporate loan, repayable over eight and a half years, has been granted to support SMNG's investment programme aimed at maintaining stable production and enhancing its financial position. More specifically the loan is intended to provide financing that would enable the company to: continue drilling at the Odoptu field (part of the Sakhalin 1 project), modernise existing production and facilities, which includes constructing a pipeline to Kharbarovsk Krai, implement the Environmental Action Plan, satisfy working capital needs and enhance the company's liquidity (EBRD Project document for Rosneft-Sakhalinmorneftegaz, 2001). The chief Financial Officer of Rosneft has stated that:

**‘The loan is a crucial element of Rosneft’s co-operation with the international financial community and its programme of ensuring access to medium and long-term financial resources. It will serve as a solid basis for further co-operation between the EBRD and Rosneft’ (Anatoly Baranovsky, Rosneft, EBRD Press Release, June 29, 2001).**

The overall aim in terms of the ‘transition impact’ of the project is expected to enhance the corporate governance standards of both SMNG and Rosneft, in particular their financial and organisational transparency, in line with not only international standards but also along lines of ‘best practice’ models (EBRD, 1997:1). One of the other main aims that the EBRD fosters is to improve SMNG’s attitude towards issues concerning environmental protection and then to help them translate these in to practice.

The importance that the EBRD has attached to environmental issues is not something totally new. It has been on their policy agenda for some time, given that it is a remit of their founding charter. However, the priority attached to these issues over the past few years might be a direct response to allegations and protests from environmental groups who have criticised the EBRD and for example, the World Bank for not placing environmental issues high enough on the reform agenda. For example, the Sakhalin 2 project’s development of the Piltun-Astokhoskoye oil and gas field sparked much controversy in 1997<sup>18</sup>. The key question was whether or not the EBRD was in fact condoning illegal environmental practices by loaning money to the Sakhalin 2 project. If so this would do little to suggest that the EBRD was trying to lead by example and encourage adherence to the federal law.

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<sup>18</sup> In June 1997 the EBRD voted to approve a loan of US \$116 million for the Sakhalin 2 project.

'Theoretically, the EBRD provides financial support to operations consistent with all the existing national environmental legislation/standards and EBRD environmental requirements. Also the EBRD claims to deal with responsible transparent companies that ensure high quality of operations. However, Sakhalin 2 project proves that there can be deviations from this policy. The inconsistencies and deficiencies in environmental materials submitted by Sakhalin Energy to the Russian Federation and the EBRD may have negative environmental implications' (Baranova, 2000:4)

The EBRD, under much pressure from Russian and international groups suspended the loan and recommended that public hearings be held before and after the project, taking into account the federal environmental impact statement. The following statement summarises the main findings of the enquiries<sup>19</sup>:

'First of all it should be emphasised that some critical components of environmental assessment remained incomplete. According to the Russian legislation<sup>20</sup>, financing and fulfilment of any works on the project on the territory of the Russian Federation is allowed only in the event of positive conclusions of State Ecological Expertise. In the case of Sakhalin, in 1993 the Expert Commission of the State Ecological Expertise of the Russian Ministry of Environment gave a negative conclusion for the feasibility studies prepared for the Piltun-Astokh and Lunskeye offshore oil and gas field. However, from 1992 SEIC has been actively performing exploration surveys and construction works on Sakhalin shelf without a legal permit for such activities' (Baranova, 2000: 4-5).

Analysts at Bankwatch (see Baranova, 2000) argue that on the basis of an analysis of the EBRD (and incidentally the IFC's) portfolio of lending to the Russian Federation it is possible to see that the more attention is paid to meeting its financial and economic goals in attracting more investments in oil and gas operations than to improving environmental practices. While the EBRD clearly has environmental goals outlined in its policy frameworks these are not fully reflected in the Russian oil and gas-lending portfolio.

<sup>19</sup> For further discussion see: Melkov, 1998; Lawn et al. 1999

<sup>20</sup> See Ministerial Regulation 222 (Ministry of Environment, 1994)

In the project reports for the EBRD's latest lending programme to SMNG it is clearly stated that comprehensive environmental assessments are mandatory and that the EBRD places environmental issues at the top of the agenda. It is possible to argue that whatever commitments the EBRD, or for that matter SMNG make, there are always going to be calls from NGOs and protestors for them to do more. The bottom line is that any development of oil and gas fields is going to have a negative impact on the environment. However, the affects of this should be minimised as much as possible. A key issue that remains, however, is to what extent institutions such as the EBRD who have now put environmental issues at the top of their agenda can really affect upon oil and gas companies in the long term; the various oil and gas companies have very different cultures towards environmental issues.

Further to this particular incident were interventions from other organisations such as the group 'Civil Responsibility', led by activist Mark Kuperman who was also head of the Sakhalin branch of the State Anti-Monopoly Committee. This small group, in fact wrote to the EBRD urging them to go ahead with the financing of the Sakhalin 2 project as they felt that it was impossible to guarantee the absolute environmental safety of any project. In fact following reassessment the EBRD approved the loan at the end of 1997 (Vladivostok News, January 12, 1999).

One clear tension that exists is between environmentalists, including other groups such as Sakhalin Environment Watch, Greenpeace, and the oil and gas consortia. But there is also a history of bad feeling between local government and the activists. For example, it is well known that Farkhutdinov and speaker of the Sakhalin Duma, Boris Tretyak have sent a letter to the EBRD board of directors protesting

environmental organizations' interference with the oil projects. The activists see the Governor and his supporters on the other hand as trying to constantly thwart the work of public organisations, sacrificing, as they see it, all for the promise of money from oil and gas developments.

#### ***7.3.4. Restructuring local industrial enterprises***

As yet, the oil and gas companies are not the mainstay of the local economy, though the local content clauses of the PSA<sup>21</sup> will provide many opportunities for enterprises in the future. Furthermore, given that a large percentage of profits will be repatriated by the oil and gas companies, the profitability and efficiency of local enterprises remains important to the future of the local economy. Statistical data released in 1999 and 2000 revealed that less than half of all enterprises in the region were making any profit (about 45.6 per cent) (Sakhalin, 2001). The sum of balance sheet losses for all companies in the region exceeded profits by five times. There is obviously some truth in these statistics, but allowances for misreporting should also be made. So, while a number of local enterprises are inefficient, increases in the rate of taxation are a major cause of large reported losses. It is common for Russian businesses to increase expenses by all means in order to minimise tax payments. The underreporting of revenues is also common. Issues of misreporting are crucial to understanding the embeddedness and hybrid nature of the social practices and institutions that continue to dominate the Russian business sector (for a further

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<sup>21</sup> 'Russian content' refers to the level of contract expenditures that must go to 'Russian' companies over the lifetime of the oil and gas projects. A Russian company by terms of Production Sharing Law is a company that is at least 50 per cent Russian-owned. Sakhalin 1 has a target of 70 per cent Russian content and Sakhalin 2's PSA requires 70 per cent Russian content. In 1999 the Federal Duma passed an amendment to the Russian Production Sharing Law that requires all future PSAs to include an 80 per cent Russian content requirement.

discussion of these issues and the wider implications see Chapter 8; see also OECD, 2002; Motorin, 2000).

A report in the Sakhalin Times (June 7, 2001) showed that 50 per cent of state enterprises in Sakhalin oblast were on the verge of bankruptcy. According to a representative of the Sakhalin oblast, Yevgeni Yuriev, this means that only 50 per cent of state enterprises work effectively and make any form of profit. In 2001, 11 933 state enterprises were registered. The majority of enterprises that are running at severe losses are in the health care department, road department, agriculture and printing.

What is clear, however, is that state owned enterprises have not fully undertaken the restructuring process for by now they would be fewer in number. This is a common problem throughout Russia and is not specific to Sakhalin. Unless invited to do so, IFIs and other donors are unable to become directly involved in this process of restructuring. Therefore, they typically pay more attention to strengthening the investment and business environment, theoretically acting as a catalyst to more far reaching changes within the economy as a whole and indirectly the forced restructuring of existing inefficient enterprises (see Broadman, 2002; FIAS/World Bank, 2001; World Bank, 2002a; 2002b).

#### **7.3.5. Strengthening the investment and business environment**

An influential project that was run in Sakhalin entitled 'Strengthening the Investment and Business Environment' was organised and run by an independent

consultancy<sup>22</sup>; they received funding from different sources including USAID and the local administration. Ultimately, the project sought to strengthen the role of the private sector in the oblast as well as to find ways of attracting foreign and domestic capital and technology that are of use to local enterprises. The project involved working directly with the Sakhalin Administration, the Duma local businesses and business associations as well as private and government organisations located on the west coast of the USA. Certain members of the local administration were enthusiastic supporters of the project, which meant that from the outset many parties were positively disposed towards the project. This inevitably made the job of the consultants easier, but this was not the only factor.

The foreign consultant running the project has been a permanent resident of Sakhalin for over a decade and is heavily involved in the business community. The consultants could therefore draw on relationships of trust and friendship that had been developed over many years and this was a key factor leading to the 'success' of the project (Oblast Administration, 29.08.2001; Business Association, 13.09.2001b; Business Association, 14.09.2001). Possessing a direct relationship with Russian parties and also having some sense of 'ownership' of the problem makes a difference. In contrast, this is something that, more often than not, Tacis projects, for example lack, personal involvement and commitment. There can obviously be a conflict of interest if involvement is too strong and it leads the project leaders away from the project goals.

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<sup>22</sup> The project was initially run in the period 2000-2001. Following the success of the first phase the project runs on and will do so until all the objectives are met. Future funding of the project is unlikely to come from USAID (Interview: Independent Consultant, 27.08.2001).



The main tangible output of the project is a 'Draft Sakhalin Investment Strategy' for the oblast (Carana, 2001). The Investment Strategy formalises all that the local administration has been looking to achieve, but also addresses the needs of local businesses. The strategy is being disseminated to the larger communities around the island in the form of workshops. The workshops were actually conducted in conjunction with the Russian American Business Centre-Sakhalin (see section 7.3.6.). In addition to this the consultants are providing assistance to the task force appointed by the Governor to facilitate the process of reviewing and making recommendations on the Investment Strategy (Interviews: Independent Consultant, 27.08.2001; Oblast Administration, 29.08.2001).

The consultants have also worked more with the local administration to extend the diagnostic research previously undertaken in the project. The product of this research was the foundation of the 'Sakhalin Investment Promotion Agency', which was declared active on August 2, 2001. The Director, Oleg Korniu, said that the agency was created to develop state policy on the investment climate, to search for potential investors and to help investors with solving different problems regarding their investments (Sakhalin Times, August 16, 2001). One aim of the agency is to try to change the common perception that the investment climate is unstable, particularly as far as foreign investors are concerned (Interview: Oblast Administration, 29.08.2001).

In practice the agency will aim to provide relevant information to potential foreign and domestic investors, this will be very similar to the service offered by the American and Hokkaido Business centres. Of course, the local government

organisation should in theory be able to provide more direct access to the relevant individuals who make decisions about permits etc. via this 'one stop shop'.

While the creation of such agencies is laudable, I think that the preoccupation with trying to convince investors that it is safe to go ahead and invest and that they can be 'guided' through the complex registration process, for example, reveals the real state of one aspect of the mode of regulation. Both those conducting research as outsiders to the situation, and those working for local government seem to be tacitly suggesting through the creation of these schemes and agencies that the only way to make it work is to work *within* the *existing* system in order to successfully attract foreign companies (see Broadman, 2002). This further demonstrates that even when there is a high level of IFI and bi-lateral donor and foreign investor activity in a region, it does not make a *decisive* impact in terms of instigating any form of wholesale change to the dominant mode of social regulation. Their activities do make an impact but this impact is 'contained' within the existing paradigm for the most part.

The 'Strengthening the Investment and Business Environment' project also involves ongoing work with the Business Associations to help them to increase their level of constructive dialogue with the Oblast Administration. This also means that, at least theoretically, they should be more involved in the overall development and realisation of the Sakhalin Investment Strategy. Just what input they will have in practice remains unclear (Interviews: Independent Consultant, 27.08.2001; Oblast Administration, 29.08.2001; Business Association, 1309.2001a; Business

Association, 13.09.2001b)<sup>23</sup>. In addition to this large project that involves engaging with many different groups of Russian actors, there are many others, which are funded by US government sources.

### ***7.3.6. Bi-lateral donors, the investment and business environment***

There are a handful of long-term 'development' projects run in Sakhalin that are funded from the US. They all focus on the development and transformation of the business community and the training of local entrepreneurs and workers. In the future, it is likely that there will be more projects directly targeted at training the labour force to work in different functions of the oil and gas companies but until the consortia make further progress and get closer to needing a local labour supply these projects will remain in the pipeline. The American Business Centre located in Yuzhno-Sakhalinsk represents one of the most prominent signs of US interest in Sakhalin.

American Business Centres (ABCs) were introduced, as part of the Gore-Chernomyrdin process, to provide a so called-'soft landing spot' for US business people wanting to find Russian business partners. The ABC offers a partnering service and communications and business support (Interview: Trade Council, 23.08.2001). In addition to giving legal advice regarding among other things the registration process for US companies wishing to operate in Sakhalin the centre's employee's work closely with the Oblast Administration to ensure good working relations and to project a positive US image and presence in the oblast.

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<sup>23</sup> See section 7.4. for detailed discussion of the evolution of business associations and the SME sector.

Within the ABC is a representative of the US Department of Commerce's BISNIS programme. The function of BISNIS is to provide trade and business information for Russian and US companies about business conditions in Russia and about potential partners. Of course, given its funding source in the US, the service is really geared towards supporting the expansion of US market operations in Russia<sup>24</sup>. The main function of BISNIS is to monitor the political and economic situation in the relevant region and to feed that back to businesses and decision makers in the US via bulletins and reports. This service, funded by the US government, is considered to indirectly provide support to the oblast by stimulating increased interest in the region but as the title of the organisation suggests, the motives are commercial not developmental.

In 2000, the State of Alaska received more than US \$750 000 from US federal government to continue initiatives in the RFE that would assist Sakhalin to make the transition to a free market economy as well as creating jobs for Alaskans<sup>25</sup>. The USAID funded projects that were funded, for a two-year period, under the umbrella of this grant included: the development of the Sakhalin Development Agency (SDA)<sup>26</sup>, the Fund for Future Generations<sup>27</sup>, workforce development projects and environmental management training. The broad spread of projects including others

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<sup>24</sup> BISNIS has facilitated approximately US \$2.4 billion worth of US exports and overseas investments (BISNIS, 2002).

<sup>25</sup> Press Release from the office of the Alaskan Governor, July 12, 2000, available at: <http://www.gov.state.ak.us/00179.html>, last accessed 16.08.2002

<sup>26</sup> The SDA was first discussed at conferences in 1999 in Moscow and Washington D.C. and is designed to provide infrastructure financing and loan guarantees to economically viable projects.

<sup>27</sup> This project was requested by Sakhalin officials to help create a fund similar to that of Alaska's permanent fund. The project is not only aimed at providing for the future but also using the Alaskan example of the way in which financial agencies such as the Municipal Bond Bank and the Alaska Industrial Development and Export Authority (AIDEA) have created and managed separate funds for investments, savings, infrastructure, development and financing.

funded by USAID relies on the previous experience of those engaged in oil and gas developments. Therefore, at least at their inception Alaskans and other American citizens who had specific experience ran these projects. The Sakhalin Development Agency and The Fund for Future Generations having been set up, now await injections of cash from the oil and gas consortia, this will only happen once production is in full swing. However, the forward planning has gone a long way to reassure many local residents and the local administration that the oblast will benefit from the exploitation of the natural resources.

Perhaps one of the biggest and best known of the US funded projects in Sakhalin is the creation of the American Russian Training Centres. Their role is to conduct educational training programmes to support the development and existence of the business sector. The centre in Yuzhno-Sakhalinsk gained its current status as far back as 1993 and has grown significantly in terms of the scale of its operations since then; there are now four centres in the oblast. The centre receives funding from USAID and works in partnership with the University of the State of Alaska, the Russian partner in the scheme is the State University of Sakhalin.

The stated aim of the centres is to aid the development of the small business sector in Sakhalin oblast by offering training programmes and offering consultancy services to businesses. The ultimate aim is to stimulate the much needed economic development of the region, an essential part of this is supposedly the need to change the social practices and institutions that determine the manner in which business can and is conducted. One could argue that part of the motivation for donors seeking to

stimulate the growth of the business community could be related to the law requiring a certain percentage of 'Russian content' in the oil and gas projects.

This can be argued on two counts, first, that because of the Russian content requirements there needs to be a new wave of businesses that grow to be able to participate in the oil and gas projects and therefore, ensure their progress. Second, by stimulating the emergence of businesses that operate according to western standards of 'good practice' safeguards the interests of the oil and gas companies but also makes it easier for joint ventures to be established between, for example, US and Russian companies.

The courses are proving to be very popular; from 1998 to 2001 the five-week courses on offer were oversubscribed (Interview: Training centre, 07.09.2001). As the centre did not engage in a heavy marketing campaign, individuals felt that this interest was representative of a genuine interest from small business owners to help their businesses grow and expand. During the courses students are taught by specialists who have some experience of working in the business environment and they have the opportunity to draw up business plans, learn about accounting practices (western standards), they also learn about communicating and negotiating with partners. Officially the centres are still using US specialists to teach on the courses, but in reality the centres are using Russian academics that have little or no practical experience. This is mainly due to reductions in funding for the centre from USAID. This might pose a problem in the future as teaching standards have the potential to fall, only because the individuals now teaching do not necessarily have practical business experience.

It is estimated that over 50 per cent of people participating in courses at the centre already have their own business, businesses from the fishing, timber and bread making sectors are particularly well represented. Over 50 per cent of those taking courses are interested or involved in the 'supply' side of the economy. The majority of students, over 80 per cent fall within the 30-45 years age bracket. What long term benefits the courses have is difficult to say as the centre does not follow up the success of individuals that took the courses.

The availability and quality of labour is an important issue that is being addressed by the oil and gas companies. Researchers employed by the American Russian Training Centre, in recent projects, have found that there is a real need to raise the skill base of the population. But the first issue that really needs to be tackled is the attitude of workers to work and the need to change perceptions of what this involves, to bring them more in line with what will be expected by western companies. The training centre is, therefore, being seen as one of the many possible educational places that can be involved in this process of trying to change social attitudes and practices.

There is an obvious Alaskan interest in Sakhalin oblast and the University of Alaska has been involved in developing a US Department of Labour Training Project, which is targeted at increasing business opportunities specifically for Alaskan oil field companies. The University of Alaska together with its American-Russian Business Training Centres in the RFE and the Department of Labour are planning to finance a special two-year programme for around 135 Russian specialists in Sakhalin and the RFE. It is envisioned by the team that these specialists would

contribute to the Russian content of Alaska contractors vying for contracts in connection with Sakhalin offshore projects, in particular utilising Alaskan experience in module construction has been highlighted.

The oil companies recognise that effective training programmes will be of critical importance to the future success of the oil and gas projects and are therefore making plans to fund major retraining schemes. But retraining only goes some way to encouraging individuals to rethink their attitudes and work ethic. Exactly how this can be achieved remains the subject of intense discussion. Money is, of course, an incentive but this is unlikely to be enough.

Another way that bi-lateral donors are trying to influence attitudes to work, business and the law is to try to involve as many entrepreneurs in collective credit schemes that offer the chance to learn about 'best practice'. The Russia-Sakhalin Regional Micro-credit programme funded is by USAID and ACDI/VOCA<sup>28</sup>. This programme is aimed at providing a sustainable credit facility for Sakhalin entrepreneurs and small businesses. The programme offers two types of lending services: group and individual. Entrepreneurs with no collateral to offer join through groups of 5-10 people whose collective responsibility serves as collateral for the loan. Group loans range from a minimum of US \$500 to \$5 000. Individual loans are available from US \$1 000 to \$15 000.

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<sup>28</sup> ACDI/VOCA is an organisation, which combines the Agricultural Cooperative Development International (ADCI) and the Volunteers in Overseas in Co-operative Assistance (VOCA). It receives its funding from USAID. It was initially aimed at helping the agricultural sector but has since expanded the scale of its operations to other sectors of the economy.



Furthermore, the programme, like many others run in Sakhalin, offers business based training and consulting activities to its clients. The number of loans disbursed to June 2001 was 458 and the loans granted were for over US \$1.1 million. Given the growth in demand for the loans, the project has received additional funding to be able to open branch offices in Korsakov and Kholmsk. The Micro-credit officers have estimated that through the programme about 2 000 jobs have been created or sustained.

Another form of micro-credit financing available to entrepreneurs in the region is via Leasing schemes. Delta Lease Far East was initially set up as part of the Russia Investment Fund and has since become a privately run business (interview: Leasing Company, 17.09.2001). In simple terms, Delta Lease Far East purchases equipment needed by businesses following a stringent selection process and then leases this equipment to them over a period of three years. At the end of the three-year period the business has paid enough via its lease agreement to buy the equipment outright. Due to the commercial nature of the scheme today and the lack of bi-lateral funding stringent selection criteria also apply to this scheme, as is common in the formal banking sector. This means that while there is much interest in the scheme only 2-3 applicants are successful each year (Interview: Leasing company, 17.09.2001).

The SME sector is not growing as fast in the RFE in comparison with for example the Northwest district, and it only accounts for 4 per cent of all SME activity in Russia. As of July 2001 there were 4551 registered SMEs in Sakhalin, up 14.3 per cent from 1999, and now over 41 per cent of the local population are employed in this sector (Goskomstat, 2001c). The SME sector in Sakhalin is obviously growing

with the support of such credit schemes but gaining access to training facilities and credit are just a few of the problems that entrepreneurs face. For example, obtaining and renewing permits is a perennial problem that most face, as well as dealing with the other swathes of red tape and bureaucracy. In response to this several business associations have emerged in the oblast.

#### **7.4. Business Associations and the SME sector**

Increasingly business associations are playing a more active part in defining economic activity in the region, beyond the oil and gas projects. There remain several sectors of the economy where new entrants are not welcomed, namely the hotel and entertainment industry<sup>29</sup>, and the fishing and fish processing industry. Business associations are less common in these areas, or are more exclusive and self-protectionist by nature. The following Business Associations have been formed within the last five years in the oblast (see Table 7.2.).

The Sakhalin Association of business people with 700 members is the main business association on Sakhalin and seeks to address the main issues that the SME sector faces. As a group the business associations have a certain power and that is important because otherwise this sector is in danger of being overlooked (Interview: Independent consultant, 27.08.2001; Business Association, 14.09.2001). While the oil and gas business is important, 95 per cent of the resident population in Sakhalin are currently employed outside this sector. The federal government has also taken an interest in the SME sector on Sakhalin.

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<sup>29</sup> For example, there is an ongoing dispute over the ownership of the Santa Resort Hotel. The local court has ruled that the Japanese owners are indeed the legitimate owners of the resort but the Russians who have taken control of the hotel refuse to abide by the court ruling. The stalemate persists.

**Table 7.2. Business Associations in Sakhalin Oblast**

<b>Business Association</b>	<b>Membership</b>	<b>Details</b>
Association of Fishermen	122 companies	Planning a strategy for development, provides economic and legal support to its members
S.I.B.A. (Sakhalin International Business association)	No registration of members	Discuss important issues of relevance to expatriate community
Korsakov Association for Small and Medium Businesses	Informal organisation, therefore no registration of members	Aim is to improve business climate in the area; provides legal support to its members
Union of Fishing Farms and Companies	25 companies	Development of fishing industry; provides marketing and consulting services; raising finance for vessel construction
Forestry Workers Association	Na	Aim is to protect local forestry company interests; provides support, and consultancy services
Association for Russian and Foreign Investors	Informal organisation	To help companies with registration, legal and tax advice,
Association for SMEs, Kholmsk District.	34 members	Supports local businesses

Source: Carana Corporation, 2001

Tension between the business associations and the local administration is common. In a visit to the island last year, federal auditors organised meetings with business associations to ask them what more could be done to encourage growth and more transparent business practices in the oblast. It has obviously come to the attention of Moscow that this sector is sometimes overlooked by the local administration as they focus their efforts on oil and gas projects<sup>30</sup>. As a direct result of the visit the local administration has been pushed by Moscow to improve their relationship with this sector. For example, on the recommendation of the auditors, an office within the local administration opened within a month of the visit, it is dedicated to filtering the requests and complaints of the SMEs. Representatives from the Business Associations felt this was at least a further step in the right direction (Interviews:

<sup>30</sup> Putin has specifically highlighted the need for Russia to support the growth of the SME sector, see Chapter 8

Business Association, 13.09.2001a; Business Association, 13.09.2001b). It would be wrong to portray the relationship between the SME sector and the local administration as a purely hostile one. The effective collaboration in the 'Strengthening the Investment and Business Environment' project demonstrates this. It seems that 'official' policy is not the key cause of tension but rather the inconsistent and arbitrary rules that certain departments exact on the SME sector, seemingly at their whim.

Representatives from the SME sector suggested that the projects funded by USAID and other sources have gone a long way to stimulating the continued emergence and solidification of the business associations. But now they have their own momentum. There is recognition that all is not going to change overnight and it would be naïve to think that just because many have attended the business and accountancy courses that even the fresh new entrepreneurs are automatically going to try to conduct business in a perfectly legal business. To some it seems this is just not feasible (Interviews: Business Analyst, 22.08.2001; Russian SME, 07.10.2001; Russian SME, 10.09.2001; Business Association, 14.09.2001).

### **7.5. Banking sector and legal sectors**

As was the case in Leningrad oblast, the evolution of the banking and legal sectors is crucial to the overall transformation of social practices and institutions. The RFE, as a whole has a reputation for harbouring lawlessness and is commonly characterised as a quasi 'Wild-East'. This might be justified to some extent, however, Moscow, for example, remains the place in Russia where the most crime and corruption occurs (Izvestiya, 04.07.2001). Sakhalin's position as an outlying

region of the Russian Federation does mean that certain individuals or groups of people take advantage of the comparative freedom from Moscow; this inevitably has its roots from Soviet times.

### ***7.5.1. The legal sector***

Legal issues relating to the development of the oil and gas developments are of critical importance in the region . In particular the complicated PSA legislation is the most hotly discussed topic. It is the PSA laws that are determining the progress of the oil and gas projects in the region and reform in this area and increased transparency and trust in the PSA regime to some extent sets the tone for other legal issues pertinent to the Oblast and Russia as a whole. The PSA regime is, however, for the most part determined in Moscow, demonstrating yet again how closely the region's 'development' is dependent on Federal policy.

Many have highlighted the fact that it is commonly felt that the lack of an effective PSA regime is a key-limiting factor to the development of the oil and gas projects in Sakhalin (Bradshaw, 2001).

'The PSA regime consists of the PSA legislation itself, which was amended and approved in early 1999, and a set of normative acts (so called "enabling laws") that actually implement the PSA law. In particular, these normative acts ensure that the PSA legislation is compatible with other laws, such as the laws on taxation, sub-surface rights and so on. At present there are twelve laws that need amending' (Bradshaw, 2001:1).

The adoption of crucial normative acts is still needed so that the 1999 enabling law can be adopted. In fact both consortia are concerned about the lack of movement in dealing with normalisation and stabilisation issues. Sakhalin 1, for example, has

submitted nine Normative Acts for Federal government approval that are necessary to implement their PSA, the State Duma has made similar recommendations. A key problem is that PSA laws seem to be made on top of constantly shifting ground.

‘The current unstable legal and fiscal environment in Russia means that the PSA regime is trying to be implemented in a constantly changing environment. Each major reform initiative, such as reform of the tax code, requires a re-working of the PSA legislation. Furthermore, there is a complex set of vested interests each of which has a different attitude towards the role of the PSA in Russia’ (Bradshaw, 2001:1).

Problems with the existing PSA regime are further exacerbated by Ministries disagreeing amongst each other as to amendments and in some cases control of the regime, or parts of it, which further stifles progress. For example, the Ministry of Fuel and Energy is far from happy that the Ministry of Trade and Economic Development has taken over the role of managing PSA regimes for Sakhalin (TIA Ostrova, July 18, 2001).

Both Sakhalin 1 and 2 as holders of PSAs have been vocal in their desire for a more streamlined approval process. In fact SEIC is pushing for some kind of ‘single window’ through which certifications and approvals would be made. The recommendations SEIC make go as far as to suggest the existence of a top tier agency to oversee the development of the approval process as the PSA legislation evolves. Some form of second tier of authority would have the responsibility of approving design and construction details. It is very common within Russia for federal, regional and district authorities to all grant different approvals. This naturally causes large-scale inefficiencies in the use of both time and money. For example, SEIC was required to obtain over 600 approvals for the first phase of its Sakhalin project. This meant dealing with 129 different approval bodies, 16 at the

federal level, 23 within the oblast and 90 at the district level where operations were to have an impact. Phase two alone requires under the current system over 3 000 different approvals.

It is possible to argue that such attention to detail on the Russian side demonstrates the evolution of a mode of regulation that takes account of the social costs of the oil and gas projects. However, in reality it seems that everyone who can is keen to get in on the act of being able to give approvals because in some circumstances this can be lucrative (Interviews: Business Analyst, 22.08.2001; Oil and Gas Company, 28.08.200a; Oil and Gas Company, 31.08.2001). It is not the case that the oil and gas consortia are succumbing to paying bribes in order to get these approvals, though they might be under considerable pressure to do so. Representatives of Sakhalin 1 were anxious to make the point that they do not under any circumstances engage in corrupt practices and that they do not condone such activity. But in having to make concessions, maybe in order to gain approvals, they might for example, agree to repair roads that are theoretically suffering from increased wear and tear because of the increase in traffic as a direct result of a consortia's operations. Consortia are therefore in reality having to offer a few token carrots as they negotiate their way through the lengthy approval process. Just as the World Bank project in Leningrad Oblast found and the 'Strengthening the Investment and Business Environment' project in Sakhalin, the civil service and their embedded practices need to be overhauled.

On a different scale of operation the local legal environment in Sakhalin is far from tightly and effectively regulated. For example, in the business community there is

some confusion as to the legality of the 'one stop registration' process that the Head of the Department for Foreign Economic Relations has set up. He has gone on the record in an interview for the Sakhalin Times as saying that: 'when it comes to the registration of companies, my signature is the one that counts. They don't have to bribe me or go to Moscow, it all happens here' (Vadim Rukavets, Head of the Department for Foreign Economic Relations, Sakhalin Times, July 5, 2001). In his interview he stressed that it is very important that Russia simplifies the registration procedure and that Sakhalin is setting a good example. 'In the morning the company applies, in the afternoon it has its registration. We give a temporary document and in one month the company will have permanent registration (Rukavets, Sakhalin Times, July 5, 2001). It is likely that once Ministries in Moscow are fully aware of this situation in Sakhalin then the 'permit shop' will be promptly closed. But as investors need to obtain a number of permits, including many from local authorities, not just Moscow, the confusion as to how to proceed legally persists. The decision to act within or outside the law pervades every aspect in business for new and existing entrepreneurs.

Within the existing business community the tax police found 118 violations of tax legislation in Sakhalin oblast, 95 per cent of the 128 checks. In some cases, the fraud actually involved sizeable sums of money, amounting to 217 million rubles in total (US \$7.36 million<sup>31</sup>). Most violations were found in the fishing industry, the production and circulation of alcohol, the energy sector and also in some areas of foreign economic activity. The head of the federal tax police Arkadiy Levashov believes that fraud in Russia has become increasingly refined (Sakhalin Times, July

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<sup>31</sup> Calculated at an exchange rate of 29.5 rubles to US \$1



19, 2001). Gaps in legislation also make it difficult to take criminals to court, but more often than not cases never reach a courtroom because of some kind of pay-off. Another problem is that commercial banks, working with international codes of conduct, are not allowed to divulge information about their clients unless there is a criminal case against them. Interestingly the head of the Federal Tax Police in the interview asserted that gradually larger companies are becoming more law-abiding, particularly those with some kind of well established foreign partner.

The current ABC Director has stated that:

‘The rule of law has to be strengthened to combat crime and corruption and create a fair playing field for business. The administration is trying hard, but more can be done. The governor has to show that the money that comes in is properly used, will benefit the entire local community, and will be invested wisely for the future of Sakhalin’s economy. We don’t want short-term gains or something analogous to asset stripping here’ (Jeff Valkar, ABC Director, quoted in Sakhalin Times, July 19, 2001).

This is an area, that as yet, the IFIs and other donors have not engaged in. There are programmes and projects run at the Federal level (see Chapter 8) but it is clear to see that in a location such as Sakhalin, thousands of miles from Moscow, there remains a spirit of working outside the law. For as the saying goes ‘what they can’t see won’t hurt them’.

### **7.5.2. The banking sector**

Today foreign investors in Sakhalin use international banks and not Russian owned Banks<sup>32</sup>. This is not uncommon throughout Russia. But the point illustrates the continued perception that Russian banks are not 'safe' and the preference to keep capital outside of Russia. The EBRD has been heavily involved in trying to assist in the transformation of the banking sector and to build consumer confidence in Russian banks (see Chapter 5). The Far Eastern Bank is one of the largest banks in the RFE and along with Sberbank is one of the banks to have been involved in the EBRD's banking sector reform programme.

The success of the continuing relationship between the Far Eastern Bank and the EBRD is demonstrated by the EBRD using the Far Eastern Bank as a quasi-branch office as part of its Russia Small Business Fund programme. Lending is a traditional priority among the Far Eastern Bank's activities and has continued to grow since a recovery from the 1998 financial crisis. For example the credit portfolio of the Bank has increased by over 40 per cent since 1999 (Far Eastern Bank, 2001).

The Far Eastern Bank has had a limited amount of interest from companies seeking credit from the Russia Small Business Fund<sup>33</sup>. This has much to do with the stringent criteria for the approval of loans and the importance attached to transparent and accurate accounting procedures. There are of course other reasons, which specially include the general suspicion still held towards banks following the

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<sup>32</sup> Oil and gas companies did use the services of Russian banks prior to 1998 but in the financial crisis the Russian banks located in Sakhalin went bankrupt.

<sup>33</sup> The Russia Small Business Fund represents an integral part of the EBRD's portfolio in Russia. The fund is designed to support the development of small and medium sized enterprises. The programme made up of three parts: a micro-credit facility, small business loan facility and business consulting services (see Chapter 5).

1998 financial crisis (Interviews: Commercial Bank, 30.08.2001; Commercial Bank, 05.09.2001). This is gradually being abated by continued stability in the banking sector. The proof of which is an increased interest in consumers looking for personal loans (an increase of 25 per cent in FY 2000). But again the problem of security remains a key issue and one that will not be solved quickly. The majority of individuals and entrepreneurs cannot provide the necessary guarantees, which the banks need. A direct result of this is the growth in small-scale credit and leasing schemes.

Other sources of credit are available to entrepreneurs from the Sakhalin Small Business Credit Society. With three permanent offices in Yuzhno-Sakhalinsk, Kholmsk and Korsakov the operations of the society are expanding rapidly. Over the past three years over 790 loans have been granted (Interview: Credit Agency, 17.09.2001). The following quotation gives an insight as to why the scheme is turning in to such a success for local entrepreneurs who perhaps run the very common roadside kiosks:

‘The first loan enabled me to pay a lease so that now I can enrich the assortment and expand the kiosk area. What I especially like in the SSBCS is a stepped lending mechanism used by the Society. For me, it means a regular source of funding and, what is especially important, ability to plan my business and be sure in the future. It’s really great that my group and I have an opportunity to obtain credits through the SSBCS and to go through all the lending steps. Later on, I may have a chance to get an individual loan’ (Tamara, owner of a trade in spare parts business).

The big difference between these type of credit societies and commercial banks is that there is the opportunity for group lending, meaning that individuals who cannot offer collateral to guarantee their loan at a commercial bank still have the

opportunity to do so if they work with others to apply for a loan. In addition to this the credit societies promote educational programmes running in parallel with the disbursement of loans. In basic terms this means that entrepreneurs are being guided through the process of either setting up or expanding a business.

I would suggest that it is because of the small scale and grass roots nature of these schemes that individuals feel more in control and sure of their own position within the scheme. Feelings of trust are greatly enhanced by Russian 'ownership' of the schemes. It is easy to discern real enthusiasm for these schemes as the growth in interest and commitment to them has positive knock on effects not only for new members as the schemes expand but also for existing participants (Interviews: Russian SME, 07.09.2001; Russian SME, 10.09.2001). Together they seem to be making a difference in terms of the expansion of the SME sector and therefore, their political clout in the region.

#### **7.6. Donor responses to working in the oblast**

Research showed that the majority of groups welcome donor activity in the region, which inevitably makes it easier for IFIs and bi-lateral donors working in the oblast. IFIs and donors are keen to maintain a presence in the oblast, in particular the EBRD and US and Japanese, though a long-term presence will inevitably be determined by the progress of the oil and gas projects. It is not surprising to note that the length the projects have lasted have enabled IFIs and donors to establish good working relationships. The locals reciprocate the commitment extended by international actors, particularly those from the private sector. Yet, an air of

suspicion towards international actors still remains; residents still want reassurance that they are the ones who ultimately benefit from such activity.

### **7.7. Further observations**

The period of field research uncovered more NGO activity in the Sakhalin oblast than in Leningrad oblast. For example, the Eurasia Foundation is especially active in the region and in 2001 alone awarded three grants to organisations within the region, each of which was at least US \$30 000<sup>34</sup>. Prior to these grants being awarded one project that was run and sponsored by the Eurasia foundation seems to have been incredibly successful in many ways. The individuals involved were highly motivated as a team and therefore pushed the project to its maximum.

In the small town of Aniva in Sakhalin, the Municipal Enterprise Youth Centre Leader created a centre to improve entrepreneurs' access to legal and tax information via a series of round table discussions and training seminars to promote SME development and in doing so attracted the attention of the mayor and local municipality. The success of the project had positive knock on effects in terms of developing the support of the local administration further as well as enabling the centre to receive yet another grant from the Eurasia Foundation.

The business 'incubator' which has been set up with the aid of this grant focuses on providing financial resources for start-up businesses. The stability provided by the centre has also meant that ACDI/VOCA has assigned a part time credit specialist to the incubator. The centre is being heralded as a model for the region and continues

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<sup>34</sup> The grants were awarded to: Sakhalin Regional Branch of Public Organisation MANPO, Nogliki District Administration of Sakhalin oblast and to the Autonomous Public Organisation "Sakhalin Initiatives".

to influence the activities of the business community in this part of the oblast (Interviews: Training centre, 07.09.2001; Business Association, 14.09.2001; Leasing Company, 17.09.2001a). Further proof of its real success will be in its continued existence.

In a relatively small and concentrated business community in Sakhalin it is easy to see that certain individuals play a key role in the overall socio-economic development of the region. The oil consortia, for example, have used individuals' personal experiences in other roles to enhance their relationships with local government. Two of the past three Directors of the ABC are now key personnel working for the oil and gas projects in the region. They are using the contacts and reputations they established in this position to good effect in their new roles. In such a concentrated business environment the importance of personal contacts and reputations should not be underestimated. Senior Representative for BP, Dinty Miller in an interview for the Sakhalin Times gave the following response to the question why he stayed in Sakhalin:

'I had experience very few people had. I understood the system and the challenges. I didn't want to trash that expertise. Relationships are very important in Russia and I had years of relationship building. I know a lot of people that have put so much sweat in getting things done here, they want to see how it is continuing. I feel the same. This is going to be the most interesting period in the history of Sakhalin' (Dinty Miller, interview in Sakhalin Times, August 16, 2001).

IFIs and bi-lateral donors need to show the same determination if they are truly to make an impact. In a lot of projects in Sakhalin they are. This is apparent and it is paying dividends.

## 7.8. Conclusions

Oil and gas projects or the development of the SME sector in Sakhalin have been targeted as the main spheres of activity for IFIs. This concentration of attention, coupled with the fairly contained business community means that they are likely to have had a more direct impact than for example those working in Leningrad oblast. This has of course much to do with the duration of the projects as well; the majority are longer-term than in Leningrad oblast. But Sakhalin is different from a lot of regions in Russia, it has oil and gas resources and therefore the international community is interested in the progress of the region. The citizens know this and have responded in some areas with a heightened entrepreneurial spirit. This is a commonly held perception:

‘This place has huge potential. It’s going to snap or go. I believe it will go. I have seen several boom environments. You always have some growing pains; crime follows money for example and pressure will be put on the infrastructure and community services. I think the good is going to overwhelm the bad. The projects are going to hire a lot of people; anyone that wants a job should be able to get one. The multiplier effect could be three to six times. Because Sakhalin is relatively small, the impact of the [oil and gas] projects is bigger here than it would be in other places. The people of Sakhalin deserve a little prosperity’ (Dinty Miller, Senior Representative BP, Interview in Sakhalin Times, 16 August, 2001).

Crime is rife and social practices and institutions remain highly embedded in society. Despite the best efforts of international actors in the oblast, Russian entrepreneurs, the community they seek to work with the most are still locked in to a system based on ‘working’ the system. However, the relationship between international actors and the private sector is generally positive in Sakhalin oblast. International involvement remains unwelcome in areas that are typically dominated by old established networks of local

actors. They include some departments of the local administration, local state enterprises and a handful of areas in the private sector, the hospitality, fishing and forestry sectors. International actors, including IFIs and other donors, are not seeking to become involved in these sectors for obvious reasons but it does mean that a substantial sector of Sakhalin's local economy remains firmly embedded in its own institutions and practices. How this will change is unclear.



## Chapter 8

### **(Re)Creating 'appropriate' institutions in the Russian Federation: combating (dis)incentives and exclusion**

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#### **Introduction**

The previous case study chapters demonstrated that indeed, *institutions matter*. Ultimately the work of IFIs and other donors is focussed towards their (re)creation in a manner that is compatible with supporting the so-called 'desirable' regime of accumulation. Field research revealed that, in spite of the efforts of IFIs and other donors, the highly embedded nature of social practices that have developed through and since Soviet times present real obstacles to Russia's full transition to a blue print model of a market economy and associated mode of social regulation. Such transition is unlikely to ever occur, but transformation towards an ever more hybrid form is a real process in Russia.

Institutions and social practices are evolving in their own way. But analysts are increasingly arguing that Russia's weak institutions are mostly to blame for the lack of a full economic and social transition (Hanson, 2002; Lynch, 2002). I argue that, based on evidence gathered in the field, the presumption that institutions are weak, merely because they do not support the desired regime of accumulation is misleading. In fact, so-called 'market distorting' institutions are too strong. But in order to be able to assume such a position involves accepting a different conception of the term 'institutions'. Institutions in this case should be seen not as just physical entities but rather constituted by the social practices that define everyday life (see Chapter 3).

Institutions in Russia, as have been demonstrated in the previous case study chapters, are in fact *strong* and *enduring*; this is the real problem that reformers face (see also Braguinsky and Yavlinsky, 2000). These socially accepted everyday practices stand as the major impediment to deep seated and effective pro-market reform. Perhaps one of the most common and problematic processes is the dominance of informal relationships over formal institutions and the rule of law (Ledeneva, 2001).

This chapter links the insights gleaned via research in Leningrad and Sakhalin oblasts with the work of IFIs at the Federal level, while at the same time highlighting some salient points, which characterise the Federal attitude towards the promotion of institutional change. There are two important themes that have emerged through conducting field research, which are critical to an analysis of the processes of institutional change and consequently the work of IFIs in Russia. First, the prevalence of *incentives to circumvent* the system is pervasive; there are real *disincentives* to radically altering the practices of everyday life (see Braguinsky and Yavlinsky, 2000; Broadman, 2002; Broadman and Recantini, 2001; Carlsson et al. 2001; Gaddy and Ickes, 1998a; 1998b). Second, part of the explanation for these processes lies in the *exclusion* of individuals from experiences of 'best practice' or exclusion from circuits of capital and/or circles of influence and power (see for example, Hellman et al. 2000a; 2000b; North, 1990). This exclusion acts to promote feelings of mistrust and scepticism concerning the tangible benefits of working within the emergent system, as well as a lack of commitment to reform.

The generation of incentives and disincentives as well as processes of exclusion occur at a variety of scales. The previous case study chapters highlighted the processes at the regional or local level but they are also prevalent at the federal level.

### **8.1. Promoting long-term regulatory change: IFIs working at the Federal level**

Following the introduction of the Gref programme, the Putin administration's concerted efforts to regain control of the regions, as well as the IFIs' belief that legislative reform and institution building should be conducted at the federal level, has meant that there is even more reform effort concentrated at the federal level (World Bank, 2002c; World Bank, 2001b; Interviews: Bi-lateral donor, 11.06.2001; IFI, 13.06.2001; Russian Ministry, 15.06.2001; IFI, 17.07.2001; IFI, 19.07.2001). While there have been a number of individual successes of assistance programmes in Russia, officials have acknowledged that progress toward reaching a broad programme of goals has been limited (GAO, 2000; Stiglitz, 1999; Interviews: IFI, 15.11.2000; IFI, 22.11.2000; IFI, 27.10.2001b; IFI, 13.06.2001; Russian Ministry, 16.07.2001; IFI, 19.07.2001).

The premise lying behind increased activity at the Federal level is the belief that 'good'<sup>1</sup> policies/codes/laws are essential for Russia's transformation (see for example the White Paper on Corporate Governance in Russia, OECD, 2002b). Legislative changes are made at the federal level so it is obviously the place to focus activities if this is the priority of IFIs. This concentration of efforts was first clearly stated in the World Bank Development Report for 1996 and in spite of all that has

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<sup>1</sup> Just what constitutes 'good' policies and codes is highly debateable especially in light of the latest western corporate scandals involving ENRON, Xerox and WorldCom (Vuillamy, 2002).

happened since then, this belief remains at the core of at least World Bank and IMF activity to date<sup>2</sup>. Yet there is a clear acknowledgement of the problems of history and geography that can hinder transition efforts, which should have not been a revelation to those engaged in mediating transformation processes, but it seems that in part it was:<sup>3</sup>

‘The report’s core message is that firm and persistent application of good policy yields large benefits. But the report shows that history and geography matter: that what leaders can accomplish, or even try to accomplish, is strongly shaped by the inherited structure of the economy, by administrative or institutional capacity, and by the ways in which the political system mobilises and channels public opinion’ (World Bank, 1996:5).

I argue that the work of IFIs and other donors is severely constrained by the realities of uneven development and the embeddedness and hybrid nature of social practices and institutions, not just from the previous Soviet system, but also from the ‘transition years’. It is clear that change has to occur within and cannot be successfully imposed from ‘outside’ the mode of social regulation. Those that are to instigate real and long-term change must *own the motivation and incentives to change* (see Braguinsky and Yavlinsky, 2000; Broadman, 2002; FIAS/World Bank, 2001). This has finally been taken account of by IFIs and donors (World Bank, 2002a; 2002b).

Proof comes in the latest policy documents for the World Bank relating to planned future activities in Russia and the portfolio of projects being run suggest that there is a gradual acceptance of these facts, however they have been interpreted (World

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<sup>2</sup> More recently the EBRD voiced its commitment to helping with the construction of a corporate governance code for Russia (EBRD, 2001b).

<sup>3</sup> Given that other IFIs and bi-lateral donors pay great attention to the policy shifts from Washington based IFIs it can be argued that policy shifts from these institutions are somewhat mirrored in policy changes and shifts in focus from these other institutions and donors.

Bank, 2002c). The new country assistance strategy allows for a gradual shift towards a more flexible World Bank support programme. Advice is to focus on systemic and institutional reforms with an emphasis on public sector institutions and accountability, improving the investment environment as well as strengthening the social safety net<sup>4</sup>. World Bank programmes for the most part are now centred round the Russian government's own programmes (Lavrentieva, 2002; World Bank, 2002d). Putin has made it clear that Russia is capable of determining her own future and that she should be left to do so (Putin, 2002). Perhaps this offers some relief to IFIs and other donors who are left frustrated having worked in Russia for over a decade now with mixed results.

#### ***8.1.1. IFI projects run at the federal scale***

To enter into a detailed examination of all IFI run projects at the federal scale would be a Herculean task, therefore the aim here is to highlight some key issues that emerge from several projects examined. The policy frameworks for the IFIs examined were discussed in Chapter 5, as well as general details of the portfolio of projects operationalised in Russia since 1992.

The World Bank has been one of the most active IFIs working at the federal level (GAO, 2000: 14). The following table of World Bank projects details five main project areas that have been running since 1994 when the World Bank commenced its operations in Russia.

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<sup>4</sup> Strengthening the social safety net is of critical importance to Russian citizens but is an area that has not been dealt with in this thesis for reasons of space but also because the essential focus of the work is concerned with examining the role of IFIs in mediating change to the mode of social regulation, taking a political economic focus.

**Figure 8.1. Examples of World Bank projects in the Russian Federation:**

Project Name	Details	Implementing Agency	Estimated Cost (US \$ million)	Project Status
Management and Financial training project	Increase quality and supply of skills necessary for transition; increase management capacity especially in the public sector	Russian Training Foundation	51.4	Closed: 15/12/1994-01/11/1999
Fiscal Federalism and Regional Fiscal Reform Loan (FFRFRL)	Clarify expenditure responsibilities; create a transparent and effective fiscal environment	Russian Ministry of Finance	na	na
Financial Institutions Development Project	Strengthen private and public financial institutions; improve accountability and regulation	Russian Ministry of Finance, Central Bank of Russia	389.4	Active: 19/05/1994-31/12/2002
Legal Reform Project	Strengthen the legal system; update practices (computerisation); media and education campaigns	Russian Foundation for Legal Reform (RFLR)	100	Closing: 13/06/1996-30/06/2002
Capital Market Development Project	Advise on the development of the private securities and insurance markets	Securities Exchange Commission	106.8	Active: 30/05/1996-30/06/2003

Source: World Bank (2002); Fieldwork (2000-2001)

The table of projects clearly displays the World Bank Group's commitment to establish *physical institutions* that can underpin successfully transformation processes and introduce new legislation. Since the mid 1990s, and even more so in recent years, the World Bank has identified the clarification of the legislative environment as well as the need to promote codes of conduct and good practice as imperative to support any other initiatives that are being taken in terms of promoting further reforms (World Bank, 2002b; 2000a; Interviews: IFI, 09.11.2000; IFI 15.11.2000; IFI, 13.06.2001; Russian Ministry, 15.06.2001). Previous attempts to encourage greater accountability and regulation were not entirely successful and the World Bank has recognised that deeper, more intractable social practices lie at the root of these problems (Broadman and Recantini, 2001; Hellman et al. 2000a; 2000b).

For example, the Financial Institutions Development Project (FIDP) has undergone massive restructuring throughout its lifetime. Initially it was hoped that the majority of goals concerned with strengthening private and public institutions would be readily achieved following the privatisation process and that the Ministries and Agencies involved in the process would metamorphose on the basis of good advice and a blueprint model for change (World Bank, 1994: 4). However, the real impact that the World Bank and the IMF were able to have was limited (GAO, 2000; World Bank, 2002d; Interviews: IFI, 13.06.2001; Russian Ministry, 15.06.2001; Russian Ministry, 16.07.2001; IFI, 17.06.2001). The majority of institutions were resistant to change and have not in some instances acted on the advice of IFIs. It can be argued that in the past there has not been enough pressure for incentives to change. However, under the Putin administration it seems that pressure is being exerted in many areas (Putin, 2002). Exactly what role IFIs can and should play in creating these incentives to change is a contentious issue. But whatever stance is taken, it is clear that from the outset it was debateable what impact the IFIs could have in this area without the full commitment of the majority of reformers. Ultimately IFI activity has been dependent on the willingness of all those engaged in the reform process, at many scales, to radically alter the social practices and institutions of daily life in Russia.

The majority of World Bank efforts are concentrated in the public sector; especially in Moscow based Ministries and Agencies (World Bank, 2002d). As previously shown (see Chapter 5) the IFC, the World Bank's sister organisation, works in both the public and private sectors but more in the latter at the federal level. For the purposes of discussion, some of these projects are examined below.

Initiatives run by the IFC at the federal level include:

- Development of the Financial Leasing Sector, Leasing Development Group (Funded by DFID Technical Assistance Trust Fund and the Canadian Development Agency),
- Medium Bank Re-engineering and Investment Promotion (Funded by DFID through IFC's Technical Assistance Trust Fund),
- Improving Corporate Governance (Funded by Dutch Ministry of Economic Affairs and the State Secretariat for Economic Affairs of Switzerland),
- Agribusiness Project (Funded by the Dutch Ministry of Economic Affairs).

The activities of the Leasing and Development Group are fairly representative of the rest of the projects the IFC manages. There are four key areas of activity within the scope of the project: advocating legal and regulatory reform, training professionals and potential lessees on aspects of leasing operations, conducting public education campaigns through the media and its own specialised publications on leasing and its benefits, and facilitating investment in the sector (IFC, 1997<sup>5</sup>). The team running the project is based in Moscow and consists of lawyers, economists and financial analysts (IFC, 1997<sup>5</sup>).

To date the Leasing Group has proposed amendments to the Law on Leasing and the Tax Code. The group was successful in mobilising government and industry support for the amendments. The State Duma adopted the amendments to the Tax Code, and the amendments to the 'Law on Leasing' are being reviewed in a second reading by the State Duma (Moscow Times, 14.11.2001). In addition to this, seminars and training programmes have been run, a bi-monthly journal with over 2 000 subscribers has been launched, consultancy services have been offered to over 100 companies per month, a web site has been set up, which has received over

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<sup>5</sup> See further details on the World Bank Group in Russia's website: <http://worldbank.org.ru/eng/projects>, last accessed 19.08.2002



4 000 hits per month on average and finally market surveys have been conducted (IFC, 2002; Interview: IFI 19.07.2001). It is, as always, hard to assess the impact that the project has had but the burgeoning leasing sector in certain regions in Russia is testimony to the popularity of the leasing schemes (IFC, 2001:5). Fieldwork demonstrated that a well-developed leasing sector is emerging in Sakhalin oblast, for example, with assistance from donor activity.

Generally speaking, it is widely felt that progress is being made in the SME sector by IFIs, but legislative changes and confusion remain the biggest barrier to a clearly defined regulatory environment and one that is policed uniformly (Broadman, 2002; FIAS/World Bank, 2001; Interviews: IFI, 17.11.2000; IFI 27.10.2001b; IFI, 04.05.2001; Russian Partner to IFI 21.06.2001; IFI, 17.07.2001; IFI 19.07.2001). Of course, IFIs and donors can only give advice and propose amendments to legislation they cannot enact it.

In the private sector it has been demonstrated (see also Chapters 6 and 7) that there is a two-pronged approach to promoting private sector development. The EBRD, as has been shown, is particularly active in this area, trying to improve technical capacity, as well as providing access to capital. Considerable resources are devoted to an intensified programme of policy and technical assistance work and second, making investments in the real sector and technical assistance to the Banking sector that should potentially be in a position to support an emerging SME sector.

A further dimension is the work on promoting corporate governance standards (see section 8.2.2.). As has been shown in the previous case study chapters, it is very

difficult to judge how widespread and deeply these changes have been accepted. Essentially many facets of the Russian economic system remain contradictory, as a result of partial reform, and also open to multiple interpretations. Even where legislation has been reworked and clarified there remain the practices of negotiating ways around the legislation (Carlsson et al. 2001; Gaddy and Ickes, 1998; Hellman et al. 2000a; Iakovlev, 2000).

For example, in spite of all the activities of IFIs and other donors working individually, collectively or in cooperation with federal or regional authorities to try to improve the business climate especially conditions for SME development and the basic market institutions they have sought to promote and develop remain immature and fragile.

‘To date the development of these market institutions to take the place of central planning remains nascent – especially in regional markets, where day to day business transactions are conducted. This is the principal factor making the costs of doing business in Russia excessively high and impeding enterprise formation (Broadman, 2002:2).

Evidence collected via field research leads me to agree with Kontorovich (1999) and Broadman (2002) that on one level small firms still suffer under the current legislation and this is indeed impeding the evolution of robust market institutions. However, I would go further in suggesting that even where market institutions do exist there remains the fundamental problem that they suffer constantly under the current legislation because the latter is arbitrarily enforced<sup>6</sup>. As yet, IFIs and other donors have had very little impact in improving this situation, mainly because in many respects they are powerless to do so. But I would argue that they are not just

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<sup>6</sup> The enforcement of new tax laws is a case in point (see OECD, 2002a)

powerless to do so because of the nature of their working relationships with their Russian partners, but because the greatest impediment to such changes is the dominance of highly embedded social practices and institutions, which condone these processes. Their impact is, however, more noticeable in situations when they have been *asked* for technical assistance and have given it. For example, this is evident in the development of the relatively new SME sector of the economy (see Chapters 6 and 7).

In the past some reform areas were off limits to IFIs and other donors, such as civil service reform. But more recently, there has been initial and dialogue between Ministries and the World Bank on the key issue of civil service reform, previously judged by the government as too sensitive for Bank involvement. The World Bank group also believes that increasingly government institutions, including some major regional administrations are beginning to play important roles in fighting corruption, this means that eventually these actors might be more positively disposed towards working with IFIs because in theory there would be fewer things for them to try and 'hide' or 'protect'. Whether the increased campaign to tackle corruption and civil service reform can be directly attributed to IFI projects or advice is difficult to tell. It is clear however, that the government has responded to investor pressure to clean up the situation and President Putin has publicly singled these issues out as ones to tackle. I would argue, especially in light of the comments made by Putin (2002) that a major incentive to change and engage in civil service reform for Moscow based ministries as well as civil service functions in the regions is the prospect of WTO accession as well as agreements made with the EU.

'World Trade Organisation [WTO] membership should be an instrument to protect the national interests of Russia in the world markets and a powerful external stimulus for the solution of the tasks that we have to solve anyway. ...It is necessary to strengthen the state structures, which must help the domestic producers adapt to the new conditions of work, to review the existing measures for state support for entrepreneurship. ...Each WTO member country, in the matter of ensuring trade interaction and resolving disputes, has thousands of people working on these issues but in the Russian state apparatus this problem is dealt with by several tens of officials. Where the specialists are needed we have a shortage of them. Where we do not need them they are enough and spare (Vladimir Putin, State of the Nation Address, April 18, 2002).

There has also been a round of intensive discussions about public expenditure issues between the Government and the World Bank Group and IMF (World Bank, 2002c). The Ministry of Finance has sought a substantial programme of support from the World Bank in this area. Over the period 2001-2002 the Bank is working with relevant Ministries on systemic issues, expenditure efficiency management and public administration reform (World Bank, 2002d; 2001b). The increased interest from Ministries to receive technical assistance from the IFIs would suggest that they are making some headway with their agendas. The difference today, from say 1995, however, is that the Russian partners seem more in control of their own destiny and while listening to the advice of their western partners will be sure to maintain the Russian interest (World Bank, 2002d; Interviews: Russian Ministry, 15.06.2001; Russian Ministry, 16.07.2001).

## **8.2. Russian commitment to regulatory changes**

Of course, the commitment of the Kremlin, Federal Duma and State Ministries and Committees is crucial to the success of IFIs working at the Federal level. Putin's formal acknowledgement that one of the most essential needs was to change the

system by which state institutions operate because the cumbersome and ineffective state apparatus is blocking progress. This is no small task.

'We are used to complaining about Russian bureaucracy which is numerous and slow. The criticisms are absolutely justified. The main problem is not the number of these structures, but that their work is poorly organised. The present functions of the state apparatus are not geared to solving strategic tasks. And the knowledge by officials of the modern science of management is still very rare. I have already spoken about the need for an administrative reform. It must result in a state adequate to our times and goals faced by our country. And the state apparatus must be effective compact and performing' (Vladimir Putin, State of the Nation Address, April 18, 2002).

It can be argued that the Gref programme is the central policy statement of the Putin administration, one that is focussed on Russia's transformation in to a more efficient and competitive economy, and really marks the point to which Russia has been transformed. The programme named after the influential government minister German Gref was agreed in 2000 after prolonged debate (Russia Journal July 1-7, 2000). The 100 listed initiatives span issues such as tax and tariff reforms, budgetary reform, de-regulation, reform of the natural monopolies, reform of the financial sector, improved management of State Property, an overhaul of the housing and welfare systems and the strengthening of private property rights. Since the programme was launched tax reforms have been passed and a new land code has passed through the Duma and come into force (Pravda, 30.10.2001), further de-regulation is afoot and Putin's personal intervention into the reform of the natural resource monopoly Gazprom lends further weight to the argument that real progress is being made (Moscow Times, 01.06.2001). At the same time, however, there are concerns as to the long-term impact these reforms will make and just how readily they can be enforced and taken up by Russian citizens.

Putin, throughout his term of office to date, has been insistent that further reforms were needed for Russia and that Russia should become more deeply integrated in the world economy. Yet he argues that Russia must follow its own path of development, instead of importing 'alien' models. He believes in a strong and comparatively independent Russia: a Russia that negotiates its own position in the global economy. This point of view is again clearly demonstrated by this excerpt from Putin's address to the nation:

It [the WTO] is neither an absolute evil nor absolute good. Nor is it a reward for good conduct. The WTO is an instrument. Those who can use it become stronger. And those who cannot or do not want to use it, and who do not want to learn, who prefer sitting behind a fence of protectionist quotas and duties, are doomed, absolutely doomed in strategic terms. We are already there, in this world trade, but we have not been given access to formulating its rules. This leads to conservation of the Russian economy, to lowering its competitiveness. WTO membership is to become an instrument of protecting Russia's national interests on the world markets. (Vladimir Putin, State of the Nation Address, April 18, 2002).

While talking about a strong and independent Russia, albeit one that gains WTO membership, the Kremlin is gradually eschewing further assistance from IFIs and other donors. It appears that the Kremlin's priority is certainly not to appease IFIs and donors, though it seeks WTO membership, and it seems that assistance is now viewed as incidental to Russia's own transformation (Putin, 2002).

On the one hand this can be viewed positively in terms of the IFIs having achieved their objectives and set Russia on its own path for reform. On the other hand, such a positive interpretation presumes that the activities of IFIs have both been effective and positively received. The more likely reality is that, bar IMF lending to prop up the Russian economy and a handful of large scale lending projects to help with the

reform process, Russia has always been in a position of control in terms of determining her own destiny. Incentives to promote further reforms have come along with the opportunity to join the WTO in the future, not because of carrot and stick policies of IFIs. The reins are being firmly held by the current Presidential administration. Putin (2002) has spoken about the need for state regulation of the economy, policies to stimulate key branches of industry and action to stamp out crime and corruption. There is obvious tension between the Kremlin's support for market reforms, including further deregulation and liberalisation and the importance attached to the re-centralisation of political power.

However, some feel that the Kremlin has been sending out mixed messages on the future direction of the country (Brown, 2001; Delyagin, 2001; Lapidus, 2002; Nicholson, 2001; Interviews: Political Analyst, 29.11.2000; IFI, 27.10.2001a; Political Analyst, 24.07.2001a; Political Analyst, 24.07.2001b). It has thrown its support behind economic reform proposals that should help improve the climate for business. However, Moscow, for example, has continued its engagement in the war in Chechnya and the development of new laws giving extensive rights to security services to apprehend and detain anyone who is thought to be a threat to Russian society. There is a worrying increase in the use of arbitrary power.

'If, in fact the priority for Putin and the administration is to modernise the economy... to compete in the modern economic system and participate fully in the system of the industrial democracies, then you're going to have to ensure that this rule of law is the principle of the future. I think arbitrary authority here is a continuing problem, whether it's in private hands or public hands. It's why I think the issue probably for the next decade to watch, if we're really going to see where this society is going, is what happens on the judicial reform and the seeming effort to create a new set of norms in which laws and predictable norms are going to guide the actions not just of individuals but also of public officials. Many of the ideas that are held by some of the elements who think of

control as the ultimate real problem here are running for a 1930s economy but they're just not going to work in the year 2002' (James Collins, Former US Ambassador to Russia, St Petersburg Times, July 10, 2001).

In June 2001, the State Duma tentatively approved a bill to overhaul the judiciary, which has remained largely untouched since Soviet times. The judicial reform programme would grant judges, for example, greater independence, curb prosecutors' powers and institute trial by jury throughout the country. Supporters of the reforms claim that they will also help even the legal playing field for business and private citizens. However, the control over law enforcement is an area of dispute between the centre and the regions (see Solomon and Foglesong, 2000). So, in addition to changes in the tax code enforced from Moscow the regions face radical changes to the way in which they control judicial procedures.

Putin stated clearly in his State of the Nation address that he and his team understand the situation and what needs to be done, the basic and underlying problem is that everyone has to comply with the legislative reforms:

'A stable legislative base represents one of the factors ensuring the competitiveness of the Russian economy. It is true to say that the country's legal system is in a formative stage. We now have to adopt many laws to adapt ourselves faster to the changing economic and social conditions. However, this must serve as an excuse for the fact that laws that go on the statute books all too often contradict one another and, once in force are not observed and are subject to constant changes, sometimes even before they come in to force (Vladimir Putin, Presidential State of the Nation Address to Russian Parliament, April 18, 2002).

Of prime concern to all economic actors is the standardisation of legislation and eradication of all possible legal contradictions that leave loopholes and grey areas. It was shown in Chapter 7 that the complicated PSA laws are one of the biggest



obstacles to the progress of the oil and gas projects and the economic development of Sakhalin oblast. While the oil and gas companies and the local administration can apply pressure, real progress can only be made in Moscow and this requires the commitment of the Kremlin, Federal Duma and all the Ministries and Agencies concerned with PSA law (Bradshaw, 2002). But the mass of bureaucracy often means that simple decisions take months to be made and even then there remains the issue of enforcement. In order that incentives to continue circumventing the system are reduced Putin is trying to encourage greater transparency within the bureaucratic maze in the first instance.

For example, in a move to increase transparency within government all 59 federal government agencies were to create their own internet sites by the end of 2001 (Moscow Times, 20.07.2001). The government sites which are theoretically updated on a daily basis are to contain all legislation that the ministry or agency is involved with and all documents relating to changes with it. It is thought that Putin, Gref (Economic and Development Trade Minister) and Leonid Reiman (Communications Minister) are behind the move. The programme is also part of Gref's eight year \$2.62 billion Electronic Russia Programme, which includes putting tax forms on line and installing computers in schools and universities. Improving transparency is an important step forward but ultimately the policing of the adherence to reforms and legislative changes lies in the hands of the enforcement agencies.

But law enforcement agencies, though given increased responsibility, will not necessarily be able to overcome the phenomenon of the oligarch (see Kryshatanovskaya, 1997; 1996), which is the most visible manifestation of an

intractable problem; the entwining of the private and state sectors in all aspects of Russia's political economic system. This is a problem that can only be tackled via serious structural reform and a rejection of current social practices. There is of course the danger that if the balance between law enforcement and reform is not carefully monitored then over zealous law enforcement could end up being a substitute for reform. In fact it is possible to argue that there is already plenty of evidence of this, for example, simply by looking at the actions of the tax police in Russia (Ananina, 1998).

### ***8.2.1. Reform at last? The 'clean up' at Gazprom***

June 2001 was in theory a pivotal moment for monopolies, good corporate governance, law enforcement and reform in Russia. This was the time when Putin was instrumental in the sacking of Rem Vyakhirev from the position of Chief Executive of the gas giant Gazprom<sup>7</sup>. As was previously noted in Chapter 3, this debacle sparked concern about the lack of de-politicisation of economic life in Russia (The Russia Journal June 1-7, 2001). Putin seemed to have placed Gazprom high on the list of reforms, sending out the signal that reform of the natural monopolies is necessary. If that doesn't occur then economic reforms are stalled and piecemeal in affect. Putin's actions concerning Gazprom generally sent out positive signals to observers. First, efficient resource allocation in the Russian economy was shown to be a priority. Second, the Kremlin's appeared to be committed towards promoting good governance. However, it should be noted that Rem Vyakhirev though sacked from the position of Chief Executive was later made Chairman of the Board for Gazprom. So, while Vyakhirev was reprimanded for his actions, in many

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<sup>7</sup> Gazprom accounts for approximately one quarter of the world's natural gas supply (see: <http://www.gazprom.ru/eng/about/>, last accessed 20.08.2002)

ways it merely constituted a rap over the knuckles. Corporate governance remains a key issue for investors, domestic and foreign as well as IFIs and other donors working in Russia (OECD, 2002b: 2; see also Broadman, 1999; Troika, 2001b).

‘...Russia has a strategic goal – to become a country that makes competitive goods and renders competitive services. All our efforts are committed to this goal. We understand that we have to solve questions pertaining to the protection of owner’s rights and the improvement of corporate governance and financial transparency in business in order to be integrated into world capital markets’ (Vladimir Putin, October, 18, 2001)

### ***8.2.2. Corporate Governance***

The following hypothetical scenario helps to explain the Russia problem and poor corporate governance in simple terms. An investor buys 10 percent of a company that owns 100 bars of gold. The investor assumes that they own 10 of the bars of gold. But the management of the company secretly sells 20 bars of gold to friends and relatives at a price well below the market value. The original investor has become the victim of bad corporate governance, losing 20 per cent of the value of the original 10 per cent stake. In most countries the investor would try to take legal action via the judicial system or official regulators but in Russia the legal mechanisms remain weak and ineffectual and there is little way to redress the injustice. Furthermore, the effectiveness of the judicial system to rectify the situation has in the past varied considerably among the regions (see Bradshaw and Hanson, 2000).

The EBRD announced in May 2001 that their plans to draft Russia’s first Corporate Governance Code were going ahead as the project team had been selected. ‘[The idea is] to develop a code of rules, regulations and proposed legislative amendments to help bring corporate governance in Russia in line with top international practice’,

the EBRD said (Press Release from EBRD, May 2001). The EBRD is helping the Federal Securities Commission (FSC) draft the code. It is felt that this could be one of the single largest reform projects conducted in Russia to date, especially in terms of the potential to increase investor confidence, which should ultimately affect economic performance. The EBRD is not the only institution or donor funding the project. The OECD, IFC, Japanese Government and a private law firm are involved in the financing too.

There have been reports that there is already opposition to the code (St Petersburg Times, May 29, 2001). Many Russian businesspeople feel that those involved with foreign investors are pushing through the code and that it will cost too much money to set it up properly. This is one of the major barriers that reformers face. Attitudes need to change. People have to understand that there is long-term benefit because immediate benefits and cost savings will not be abundant. I would argue that it is far too soon to tell whether good corporate governance has actually taken root, or if good behaviour campaigns are just a public relations technique. Until appropriate laws are passed, existing ones clarified and then uniformly enforced then the disincentives to work within the legal framework will persist and informal relationships will dominate formal ones. The fact of the matter is that Russian businesses need to be able to see financial benefits from exercising good governance (Braguinsky and Yavlinsky, 2000; Broadman and Recantini, 2001; Hellman et al. 2000b; OECD, 2002a; 2002b).

### 8.3. Institutions, (dis) incentives and exclusion

According to the Sociological Centre of the Russian State Service Academy, over the past decade the shadow sector of the economy has quintupled, currently accounting for 50 per cent of Russia's GDP (*Argumenty I Fakty*, May 6, 2002)<sup>8</sup>. It remains true that it is hard to distinguish 'grey' business from legal business: commonly any enterprise has a 'grey' component. In response to the question 'Is your enterprise currently able to work without violating laws and other regulations?' 81 per cent of respondents answered negatively and only 15 per cent of business owners answered positively. This is not a particularly positive result for those looking to see deep regulatory changes within Russian society, or for companies that are seeking to work transparently and fairly within the existing legal framework, for example, those that seek assistance from IFIs such as the EBRD.

In a similar vein, the State Statistics Committee always faces the problem of having to make substantial adjustments to allow for economic activity in the shadow sector. But it is difficult to know how to adjust. For example, manufacturers of television sets reported to the Statistics Committee that they sold 597 000 televisions in 2001. It transpired that consumers bought nearly 3 million. The official figure therefore needed to be increased by over five times. According to further calculations of the Sociological Centre a third of Russian family spending bypasses the official economy (*Argumenty I Fakty*, May 6 2002). Overall the 'grey' economy amounts to over US \$40 billion per annum, which is as much as the Federal budget. The Centre's research suggested that in the next ten to fifteen years there would be a negligible improvement in the situation. Again, this research suggests that the

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<sup>8</sup> This estimate is higher than the OECD's of just under 40 per cent (OECD, 2002). The Moscow Financial Academy (May 2002) has released its own estimate of the size of the shadow economy, which is 40 per cent.

incentives to work beyond the system remain stronger than the disincentives to do so, almost suggesting that such practices have been embodied and accepted within everyday social practices and institutions.

One of the biggest reform issues, and one that highlights the embedded nature of social practices to date, is that of tax (OECD, 2002a: 46). When the government pushed through a major tax reform package last year, with advice from IFIs including the World Bank, which among other things imposed a flat rate of income tax at 13 per cent, the hope was that this would encourage people to legalise their incomes. The new tax code has been in operation since the start of 2001<sup>9</sup>, and although it is generally simpler, compliance is not expected to be near 100 per cent, as large percentages of the population continue to hide details of their real incomes<sup>10</sup> (BOFIT, 2002)

A common perception that has emerged during the 'transition years' is that bad laws, or lack of them, are the root cause of many of Russia's enduring problems (for example see: Hellman et al. 2000a; 2000b; Johnson et al. 2000; Pannier, 1996; Putin, 2002; Schleifer and Treisman, 2000; Solomon and Foglesong, 2000; UNCTAD, 1999b; World Bank, 2002a; 2000a). It is possible to spend time examining the differences in laws between Russia and those that have 'got it right' in the West. But it is clear that Russia faces problems with those laws that mirror those of the western advisors that have recommended them.

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<sup>9</sup> There are over forty different taxes that can be collected within Russia, they are Federal, Regional or Local taxes. The main taxes of principal concern include VAT (regular rate – 20 per cent, special goods – 10 per cent), tax on profits (regular rate – 35 per cent, but not all necessary business expenditures are deductible) and personal income tax (flat rate – 13 per cent).

<sup>10</sup> Statistics concerning tax reporting following the introduction of the tax code were not officially available at the time of writing.

The basic facts are that laws are usually written by people who try to reflect in them various norms and socially accepted institutions and processes, which are accepted by the majority of those that will be governed by them, such ideas date back to Greek and Roman law, which is widely recognised as the basis for the bulk of European and western laws more generally<sup>11</sup>. This is also why laws change; laws need to keep pace with a changing and constantly evolving society. But if the majority of Russian's are *not ready* or *predisposed* towards the enactment of these laws then the laws are likely to be ineffective (Rose, 1998). Such an argument pulls into focus the notion of a law based civil society. It has been argued (Lin, 2001) that the development of Russian civil society has been shaped by the broader set of political opportunities and constraints *unique* to the national context in which this society was embedded. Such uniqueness and embeddedness suggests from the outset that new laws are most effective when they evolve through the dominant mode(s) of social regulation, not when they are imposed from outside the system.

If this is true then the application of different 'cultures' of law from American or European sources are likely to have mixed results. The IFIs and other donors seeking to engage in the reform of the legal system in Russia bring with them their own cultures of law derived from their own cultural biases. For example, the American law culture is one based on litigation and lawyers doing most of the work; this is only possible because of the long-term evolution of complex sets of legal processes. It is possible to argue that Russia is not in a position to try and copy such practices overnight. Boris Kagarlitsky has argued strongly that western laws are not

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<sup>11</sup> See Barry (1969), Feinberg and Gross (1990), Taylor et al. (2001) for general introductions to the Greek philosophers and Roman law, and Zimmerman (2001) who explore the relationship between Roman law and contemporary European law and the civil traditions today.

a cure for all that ails Russia (St Petersburg Times, May 4, 2001). In the following quotation he speaks from his own personal experience:

'No one ever dreamed of passing a law for no other reason than because a similar one was on the books in, say, China. It is a fact that the more our [Russian] lawmakers try to adopt all sorts of 'civilised' documents to regulate all aspects of our life, the more corruption we see. In such cases it is impossible to obey the law without going against the very nature of our social fabric and, of course, it is impossible simply to ignore law. The result is corruption. Corruption is a type of compromise, a bridge between our official ideology and the reality of life here. Of course tolerating corruption is no answer, because it pushes aside any respect for legality' (Boris Kagarlitsky, St Petersburg Times, May 4, 2001).

Russian legislation remains very complex and frequently contradictory (Broadman, 2002; OECD, 2002a; 2002b). In fact it sometimes seems as though the general ideology is for laws to be written to cover almost every activity that people might want to perform, instead of being limited to those activities, which the states want to prevent.

Feelings of exclusion and the dominance of disincentives to work with the new system have arisen from a general disillusionment with the reform process (Braguinsky and Yavlinsky, 2000). 'The economic system largely collapsed and social protections are a chimera of the past. For a people long accustomed to the granite like immobility of state structures in the USSR the disappearance of [aspects of] the state in the Russian successor has created great confusion and uncertainty' (Alexander, 1998:415). This has in turn meant that:

'The way that the State apparatus is organised at present, unfortunately promotes corruption. It is not that we are not trying to clamp down on it, I would like to stress that, but corruption is a direct consequence of the restriction of economic freedoms. Any administrative measure can be surmounted by a bribe. The higher the barrier, the greater the bribe and the more highly placed the official taking it' (Vladimir Putin,



**Presidential State of the Nation Address to Russian Parliament, April 18, 2002).**

The IFIs have made the fight against corruption and tunnelling one of their priorities in recent years and have consequently funded much research in to the extent and nature of the processes (see Broadman. and Recanatini 2001; Hellman et al 2000a; 2000b; Johnson et al. 2000). This research has provided some interesting evidence to analyse but the findings will not be much of a surprise for Russian actors. It seems that beyond backing any moves to combat such activities the IFIs are powerless to do much more in this area.

The bottom line is that despite setting stringent criteria for recipients of assistance, for example the EBRD in giving its loans to the SME sector, the recipients are for the most part operating in a business environment where it is almost impossible to avoid some form of corrupt practice (OECD, 2002a: 81). Of course, in setting such criteria the IFIs and donors are going some way to encouraging recipients to work within the law. This is also something that the Russian government is actively promoting:

**'We must put a stop to the pointless competition between the people and the authorities when the authorities conceive the laws and the people invent ways of getting round them. People's creativity must be steered not into so-called optimisation of tax dodges, but into the development of their own ventures based on use of those standards which you and I propose to them... Business as a whole and small business in particular, have a huge number of complaints about unjustified administrative pressure, above all by supervisory bodies and inspectorates. There are thousands of bodies accredited to do this – that's no exaggeration – thousands of commercial bodies are making a living out of inspections. The fines they apply, just like bribery, are a huge burden, which oppresses businesses' (Vladimir Putin, Presidential State of the Nation Address to Russian Parliament, April 18, 2002).**

The arbitrary workings of inspectorates were indeed shown to be a problem that businesses faced in the regions. Such processes are commonly characterised as a form of corruption, which is one of the most powerful incentives to work in grey areas. Corruption is a word that almost certainly comes into any discussion about the Russian economy and is one of the root causes for many of the economic processes being hybrid in form within the economy in Russia (Gaddy and Ickes, 1998; Hellman et al. 2000a; 2000b; Luneev, 1996; World Bank, 2000a). The real problem is that corruption affects growth and investment, making its eradication important for the long-term development of the Russian economy (Broadman and Recanatini, 2000). Corruption, as has been demonstrated throughout this thesis is an inherent cause of instability and without concerted efforts to combat it the Russian economy will remain one characterised as 'high risk'. The IFIs firmly believe that a well established set of market institutions, with clear and transparent rules and fully functioning checks and balances including strong enforcement mechanisms and a competitive business environment will all help to reduce processes of rent-seeking and therefore incentives for corruption (World Bank, 2000a).

Of course, in this post Enron, WorldCom era it has been clearly demonstrated that strong enforcement mechanisms and a competitive business environment do not prevent companies engaging in corrupt practices. Furthermore, it is clear that international accounting companies who have been associated with recent western corporate scandals are heavily involved in the reform process in Russia. The IFIs and other donors have used them to work, for example, with Russian ministries, while at the same time they have Russian clients. This means that there is of course

the potential for conflict of interest. The IFIs might now be forced to address this issue.

Designing and implementing effective mechanisms is thus the challenge for reformers. But I argue that the fundamental problems remain which stand to impede the best efforts. With all the best intentions reformers will find it difficult to implement and enforce legislation because the Russian economy is at the present time one reliant upon the grey economy for any sense of stability, everyday practices reinforce this. There is a virtual economy (see Chapter 3; Carlsson et al. 2001; Gaddy and Ickes, 1999; 1998a; 1998b). This is not a new phenomenon either. The command economy functioned as it did with the assistance of an active and sizeable shadow economy<sup>12</sup>. The social practices are highly embedded. It would be interesting to survey Russian citizens to see whether they truly thought that far reaching changes would be possible and or desirable. For, if reforms cannot always be successfully imposed from above then the impetus for change needs to come from the grass roots. But, there is a lack of faith in the integrity of the system and those controlling it. This means that the system continues to be open to abuse and legislation can be arbitrarily enforced at whim. Moreover, ways of working around processes imposed from the federal level are likely to be circumvented in order to protect personal interests.

A key issue that requires attention is how federal reforms are translated to the regions and enforced effectively and fairly. It has been demonstrated in Chapters 6 and 7 that while the regions share everyday practices there are also distinctive

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<sup>12</sup> This links back to issues discussed in Chapter 3 concerning the 'virtual economy'.

elements to local modes of social regulation, especially with respect to local reform issues. Despite the introduction of the Presidential representatives to monitor among other things compliance with federal laws in the regions, Moscow will have a hard task to alter the different practices of everyday life in the 89 different federal subjects. A question to pose over the coming years will be: can/will the Russian state 'accommodate' local modes of social regulation, which embody the local practices of everyday life and in particular different strategies to cope with the transformation process. It has been clearly demonstrated that the Putin administration is striving for a coherent and stable Russia, which does not necessarily mean that local modes of regulation will be accommodated officially. Furthermore, in concentrating their efforts at the federal level IFIs and other donors are to a large extent leaving this question untouched, which might prove to be a mistake. It has been shown that the prevalence of *disincentives to change* remains a key problem for Russian reformers and IFIs working in Russia. But, related processes of *exclusion* are also instrumental in deepening social and economic cleavages in Russia as regions are excluded from circuits of power and capital.

#### **8.4. The Realities of Regional Uneven Development**

Even though of late, there has been an increased focus to work at the federal level it would be wrong to think that most of the IFIs or other donors have adopted a truly regional approach to their operations since 1991 (Interviews: IFI, 09.11.2000; Bi-lateral donor, 11.06.2001; IFI, 13.11.2000; IFI, 19.07.2001; Academic/Consultant, 26.07.2001). In fact, it appears that previously regionally-orientated programmes were run more out of experimentation or the perceived existence of reform minded governors and regional administrations, the notable exception being the EBRD (see

Chapter 5, and Map 5). Working in the regions has therefore been somewhat piecemeal.

Unsurprisingly, this has meant that those regions that have been designated 'priority' regions by Moscow for assistance and attention have benefited more, not least in financial terms from such a position. Regions that can be considered as priority regions include those that have consistently been among the top ten recipients of FDI<sup>13</sup>, those that hold lucrative natural resources and those in strategically important geographical locations (Federal Duma, 12.06.2001; Russian Ministry, 16.07.2001; Academic/Consultant, 26.07.2001). Of course Sakhalin, for example, benefits from two of these assets, though it seldom appears to be a priority area, for example, in terms of the importance attached to reworking the complex PSA laws in Moscow. Exactly how the regions are offered 'priority' is unclear but the Governors of each region are under close scrutiny from Moscow and at the same time are likely to enjoy better access to decision makers (Interviews: 15.06.2001, Russian Ministry; Political Analyst, 24.07.2001a; Political Analyst, 24.07.2001b).

Giving priority and more assistance to some regions rather than others is an awkward, though sometimes strategically good, decision. As Putin seeks to regain control of the regions following the geographical fracturing of the Yeltsin era, his administration has sought to stamp out the uneven playing field that the different power sharing agreements promoted (see Chapter 3 and Nicholson, 1999). But Moscow faces the problem of how to manage those regions to which they would

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<sup>13</sup> Head of the new State Investment Agency Sergei Tsakunov announced that the government has a list of target regions they want to see more investment and growth in as well as a list of those they would not recommend to anyone. He announced that the targeted regions were to be Tomsk, Nizhny Novgorod, Moscow and Leningrad oblasts (St Petersburg Times, April 10 2001).

like to offer more assistance, or deal with differently because of the region's individual predicaments; all of which needs to be done without contradiction, which would cause instability to the integrity of the Russian Federation.

One initiative of the Putin government is to redistribute money from rich regions to poorer regions (EWI, Russian Regional Report September 5, 2001). Naturally, this policy angers the better off regions who now face having to make larger contributions to the federal budget to help out the ailing regions. Coupled with this are the recent changes to the tax code. The new tax code means that the regions have to surrender all of the VAT revenues they collected to the federal authorities (OECD, 2002a: 160). In theory, the regions should be able to make up this loss when they collect other taxes, but in reality these other taxes are harder to collect (EWI Russian Regional Report, September 5, 2001). Furthermore, with income tax dropped to a flat rate of 13 per cent Governors have witnessed a further drop in revenue (OECD, 2002a: 160). All these factors combine to make the regions more dependent on Moscow.

If the plan to redistribute funds is effective, in the long term, then the processes of uneven development might be curtailed to some extent but this change is not going to happen overnight. The OECD (2002a: 172) has concluded that 'the strategic vision presented in the new government programme for the development of fiscal federalism until 2005 is quite promising. But the elaboration and defence of many specific measures to achieve this vision remain to be accomplished'. For example, unless enforcement of the new tax code is stringent the regions will maintain local and regional informal budgetary activities, such as the use of various money

surrogates (tax offsets, debt offsets, bills of exchange and barter) (OECD, 2002: 166), reinforcing the deeply embedded social practices of circumventing the state and its requirements.

Incentives in regional and local organs remain highly distorted because the *reality of regional uneven development acts as a disincentive* for some regions to adhere to federal laws. Presidential representatives report that only 2 per cent of regional laws do not comply with federal legislation (Levada, 2001). This is probably true but this statistic is less significant than it suggests. In reality many of the laws that violated federal legislation were merely declaratory and had little to do with the way things worked. Changing the laws that did not comply with federal legislation was mainly symbolic and has not changed the way things work dramatically (see Orrtung, 2001).

The case study chapters demonstrated that each region finds its own ways of coping with the exigencies of the processes of transformation, integration into the global economy and uneven development. Leningrad and Sakhalin oblasts both focus on foreign investment as their lifelines; so much local effort is focussed on the promotion of the regions as attractive places to invest with seemingly transparent and well-defined business practices. The IFIs and donors working in the regions have seized upon these efforts as the focus for many of their projects. Each region has adopted a different strategy best suited to their individual situation and in light of the natural resource or location advantages they can offer. Leningrad oblast was shown to be a region that has taken a more tortoise like approach to adjusting to its predicament following the collapse of the Soviet Union. The message within the

oblast and the North West region more generally is that this is a region that has sought to set its affairs in order and tried to operate in as an efficient and transparent manner as the prevailing bureaucratic system allows.

Sakhalin oblast in contrast has certainly been successful in attracting much foreign attention because of its oil and gas supplies but has to a large extent relied on this to keep the region's economy afloat as more traditional industries suffer with increased exposure to international competition and an crumbling infrastructure. The focus on the oil and gas industry has meant that many other areas of the local economy and regulator environment have been relatively neglected. Of greatest importance to the development of the oil and gas projects is the clarification of PSA law, but this is something that has to be done in Moscow, in theory leaving the local administration free to tackle important local issues, which are of concern, for example, to local investors and the struggling SME sector. In spite of pressure from Moscow to do something to alleviate the situation for the SME sector (Putin, 2002), the local administration remains preoccupied with oil and gas. Key individuals, including the Governors of the regions, play an important role in defining the politics of the regions and the manner in which the regions respond differently to processes of uneven development and their relationship with Moscow.

In following Russian Government policy and aligning their own programmes to fit with it, IFIs and other donors are in fact reinforcing the uneven development of the regions. Working at the federal level is of course important in terms of influencing and advising on large scale reform programmes such as the corporate governance programmes, but these need to be reinforced at the regional scale otherwise the



situation of instigating legislative change only for it to be circumvented and open to regional interpretation will persist. Field research confirmed general perceptions that individual actors and groups of influential actors are critical in mediating processes of change or embeddedness in the regions, just as they do at the federal level, despite efforts to reduce this in Russia.

### **8.5. Actors, networks and transactors**

In order for change to occur and social practices and institutions to evolve there has to be an impetus to do so from somewhere (see Altvater, 1998; Amin and Hausner, 1997). In Russia, it has been demonstrated that there not only has to be grass roots commitment to changes, but that the push also needs to come from within the bureaucratic system. If citizens are to respect new legislation and comply with it in everyday practices then it is important that those that are making the laws are seen to be engaged in non-corrupt practices, promoting 'good practice'. The same of course should be the case for IFIs and other donors working in Russia, or those representing their interests and managing their projects and monies. It is common for IFIs and donors to enforce strict codes of conduct for apportioning monies within their own organisations and for those representing them beyond their institutions.

Wedel's (2000a; 2000b) identification of transactors and the processes of transactorship throw into question the manner in which certain activities of IFIs and bi-lateral donors have been managed. As was demonstrated, there is controversy concerning the way in which influential individuals siphoned off US government funds the mid 1990s. If the allegations are true, then it is hard to see how IFIs and

donors were promoting 'good practice' themselves<sup>14</sup>. Furthermore, as these activities allegedly involved high ranking Russian reformers it is clear to see that from the outset the tone for reform that was set was one predicated on 'working the system' in the first place.

It is hard then to justify to Russian citizens how money that was loaned has been used for their long-term benefit and just how worthwhile the projects of IFIs and other donors have been and could be. This is a problem that IFIs face at the grass roots level, not within Moscow so much. Even if all the allegations are unfounded and reputations remain in tact, the very fact that such issues have come to the fore suggests that there are at least grounds for suspicion, which in its very self does not promote feelings of complete confidence and trust in parts of the reform process.

As previously discussed in Chapter 3, the reform process was for the most part of the 1990s mediated by a handful of individuals, which has had the knock on effect of excluding many from having a direct engagement in the process. But a further theme that emerged from the field research was that only a handful of the same individuals are directly engaged at the policy making level in determining the working relationships between IFIs and donors and Russian actors at the Federal level. Similarly, at the regional scale there are many different groups and individuals involved in projects, however, these projects are run or researched by a small group of the same individuals time and time again. This has the positive effect in some cases of there being consistent application of certain methods and attitudes but it also means that the sphere of influence of the IFIs and donors and the

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<sup>14</sup> It is however worth noting that there has been no record of suspicious activities within any of the major IFIs though by default of their involvement with certain influential individuals they are connected with the processes of transactorship.

widening of the circles of direct involvement are contained. The IFIs and donors are frequently speaking of building and nurturing social capital<sup>15</sup> but in reality some of their activities have the effect of excluding many individuals from such processes.

The danger, I would argue, in restricting the circles of inclusion is that not only are many potential enthusiasts excluded but also some actors involved in the circles of inclusion are pursuing their own agendas and have vested interests, for example, particularly consultancies who rely on projects as a source of income. Regardless of whether or not motives are entirely beyond reproach, a real problem is that this situation further fosters feelings of mistrust from citizens and perceptions are important.

I would further argue that *ownership* is the key to any project's success. The more people that own the motivation for a project, and are accountable for its progress, the larger the circles of inclusion. For example, the success of the EBRD's commercial projects in the SME sector and with some major enterprises can be attributed to the necessary commitment and involvement of Russian actors in the process. The incentives to participate in a positive manner far outweigh the disincentives and the costs of participating are high.

Bi-lateral donors have focussed on 'cost sharing' as a mode of running projects and increasingly this will be the way that more IFIs, including the World Bank and Tacis, will run in the future (Interviews: IFI, 17.07.2001; IFI, 19.07.2001; Bi-lateral donor, 31.07.2001; IFI, 20.09.2001). The issues of ownership, cost sharing and

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<sup>15</sup> For discussions about building social capital in Russia and Russia's transformation from an anti-modern to modern society see Rose (2000) and Rose (1998) and Rose et al (1997).

inclusion are ones that have come to bear throughout the research. Once acknowledged as important to determining the success of IFI and other donor projects, as well as the reform process more generally, the more likely there will be a faster evolution of social practices and institutions. But I would reiterate that any changes are naturally hybrid in form and manner given the prior circumstances that in part provide the foundations and impetus for change.

#### **8.6. Making a difference: shifting the paradigm?**

The challenge of Russia's transition was enormous and greater than generally appreciated by the West (GAO, 2000; World Bank, 2002b). In hindsight, expectations within Russia and among IFIs and other donors of achieving quick and pre set results were unrealistic (GAO, 2000). Some aspects of transition assistance that the international community identified early on as important proved to be difficult to provide and have continued to be real obstacles to IFIs and other donors achieving their aims. The IFIs' and donors' expectations that reforms and advice would be accepted and readily implemented proved to be unfounded and have consequently had to shift the focus of their efforts. It is a fact that the transformation of the Russian economy and growth of a democratic society required grassroots support and the development of different institutions and social practices and enforcement processes. Limited progress has been made in achieving reform in areas where there has not been substantial commitment and ownership from the Russian Government, including the individuals and institutions with the authority to influence outcomes.

The Russians government's recent development of a long-term economic programme demonstrates its capacity to evaluate and debate seriously the economic policy choices the country faces (OECD, 2002). Donors can take some credit for assisting in the development of this capacity, but the impetus has in the first place come from Russian actors. Russia's transition path has been made harder by the concentration of power and income in certain well-established networks of economic and political actors. Attempts to instigate further systemic changes have also been frustrated by the large civil service (Putin, 2002).

In trying to tackle the unwieldy bureaucratic system in Russia it seems that the answer has been to combat this by creating new agencies to act as mediators between the original ministries or agencies and economic actors. For example, in Sakhalin there has been the creation of the Sakhalin Investment Promotion Agency and, in 2001, a similar one at the federal level has been launched in Moscow. The main aim of these centres is to help prospective and existing investors understand the complexities of the Russian bureaucratic system. Perhaps in the long-term these agencies will act as another mouthpiece, speaking on behalf of those they represent.

The recent World Development Report (2002) tackles head on the issue of institution building and its role in any development process. I would again argue that while I agree that the market institutions are weak in Russia all institutions are not. On the contrary, many *existing institutions are too strong and enduring* and this has remained the biggest obstacle to IFIs, donors and reformers working in Russia. Furthermore, institutions can be understood as much more than physical entities but

also as being constituted by social practices. The World Bank is promoting the following conception of how to build 'appropriate' institutions.

'Institution building is generally a cumulative process, with several changes in different areas building up to complement and support one another. It is important to find areas in which to go forward; changes in one area can build pressures for change in another. Not all reforms are politically difficult for all countries. And the nature of what *is* difficult changes over time... Four main lessons emerge for institution building. The first two are about supplying effective market supporting institutions. But supplying institutions is not enough. People must want to use them too. Thus, the second two lessons are also about creating the demand for such institutions and about promoting the forces for change (World Bank, 2002: 2).

Institution building is indeed a cumulative process and pushing for changes in certain areas in Russia has presented more problems for IFIs and reformers than anticipated. The nature of what is difficult does alter somewhat over time but I argue that in Russia some of the essential problems remain the same and have evolved through and since the Soviet system. These institutions are unlikely to evolve further unless there are incentives to do and disincentives not to, this will be the catalyst for further change (see for example, Braguinsky and Yavlinsky, 2000; Broadman, 2002; Hellman et al. 2000a; 2000b). Therefore, creating demand for such institutions is crucial, but this requires the will of the majority and this is hard to achieve but one step forward is to reduce the numbers of those excluded from, for example, decision making processes and circuits of capital. This is again something that IFIs and donors have tried to achieve in some cases but have had limited success because of the duration and nature of projects.

### ***8.6.1. Mixed results for IFIs working in Russia***

Many analysts and officials, including Russian sources have taken issue with certain aspects of IMF programmes run in Russia. Opinions range from those who think that the exchange rate policy it supported was inappropriate to those who believe that the IMF was too soft in enforcing the conditions of its lending programme (GAO, 2000). Policy advice has, however, been taken in many instances and acted upon by successive Russian governments. World Bank officials have characterised the success of World Bank Programmes in Russia as mixed but overall disappointing<sup>16</sup>.

According to World Bank assessments at the end of FY2000 73 per cent of the projects in the Bank's Russian portfolio were rated as satisfactory<sup>17</sup>. This figure increased to 84 per cent in FY2001. In fact World Bank assessments suggest that portfolio quality now exceeds the peak levels recorded prior to the August 1998 crisis and has exceeded targets set for the portfolio up to 2001. This achievement was the direct outcome of: the restructuring and cancellations of parts of investment projects amounting to approximately US\$ 1 billion since 1999, a concerted effort by the Russian Government to satisfy conditions to upgrade a total of 12 projects, and the closing of four unsatisfactory projects. Similarly the IFC has restructured two large problem projects and written down others that were becoming increasingly problematic.

The EBRD has also rated the success of its projects as mixed (GAO, 2000). The best results have been achieved in areas of small business development and other

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<sup>16</sup> For a detailed discussion of this viewpoint see the World Bank (2001b).

<sup>17</sup> Representatives of the World Bank Group conduct project ratings internally.

projects involving working with the SME sector. The financial crisis damaged many projects in the financial sector and the EBRD has enjoyed only limited success in the promotion of the restructuring of large firms. Field research revealed a very positive disposition from Russian actors towards the work of the EBRD, though there was mention of instance of project overlap and replication between institutions. Other IFIs and donors face this perennial problem too.

The EU's Tacis programme has also faced mixed results. A common perception among the donor community would be that more often than not Tacis projects are inadequately focussed or realistic in the first place. This is a criticism that Tacis has faced and sought to defend itself from. In March 2000 a EU report on its technical assistance programme for Russia gave high marks for education and training projects, but lower marks for enterprise restructuring and building market institutions.

Mixed results have been achieved within Russia as far as IFIs and other donors are concerned. Fieldwork showed that projects geared towards promoting commercial aspects of the Russian economy were well received. For example, leasing schemes to help the SME sector and loan schemes for small and medium sized businesses are growing in many regions in Russia. Projects aimed at helping big businesses develop their activities in Russia have also had some success, though it can be argued that the major companies would have sought to enter the Russian market anyway. For example, consider the EBRD's involvement in the Sakhalin 2 project or the World Bank's loan to Ford to start up operations in Leningrad oblast. A trend emerges that suggests projects geared towards and aligned with the commercial



objectives are well received in Russia and likely to be deemed a success. But projects aimed at changing the mode of social regulation, social practices and institutions that are constituted by them frequently meet with resistance from certain groups of actors within the economy.

### **8.7. Conclusions**

The dominance of embedded social practices and the existence of disincentives to change thwart many of the efforts of IFIs and donors to instigate wholesale change and reform. Furthermore, IFIs and donors face the real problem of working with fragmented modes of social regulation throughout the regions. There are many aspects of everyday practices that remain common among the regions, but over time each region and key economic and political actors within each region have adopted different strategies and priorities for reform. This means that in reality there are a wide variety of regulatory and institutional canvasses on which the IFIs and other donors are seeking to mitigate change.

In following the line of federal government and reducing the level of donor activity in the regions the IFIs and donors are certainly not helping combat processes of uneven development across the regions. In fact, it can be argued that the policies of federal government and IFIs and other donors does very little to promote incentives to change as the numbers of those excluded from policy making decisions and project activity increases. The abundance of disincentives to change and high levels of exclusion ultimately mean that institutions and social practices that are deemed 'desirable' or 'appropriate' by IFIs and other donors are unlikely to be realised in

the near future unless they can be overcome with the emergence of stronger incentives.

## **Chapter 9**

### **Conclusions: theorising transformation and the role of international financial institutions in forming a new mode of social regulation in Russia**

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#### **Introduction**

This thesis has examined the context for IFI involvement in Russia and the role that IFIs have played in mediating transformation processes. Furthermore, it has explored theoretical debates concerning the nature of transformation processes and highlighted several key processes that dominate and characterise the Russian system, most notably hybridism and embeddedness. The application of Western based theories of regulation and governance has provided a different way of thinking about the transformation of the Russian economy, yet one that ties in with the most recent theoretical deliberations. More specifically, using the conceptual apparatus of regulation and governance theories has pinpointed the critical role that institutions and social practices play in determining paths of transformation.

It has been shown that these social practices and institutions have indeed played a critical role in Russia's transformation; in terms of creating a hybrid form of a market economy, as well as accounting in part for the continued uneven development of Russia's regions. These facts, coupled with the application of policy frameworks, has meant that IFIs have had limited success in mediating Russia's transformation according to blueprint models for change. Furthermore, IFIs have shown limited interest in the regional dynamics of transformation and the embeddedness of local social practices, which has served in part to reinforce if not deepen the socio-economic cleavages among Russia's regions.

### **9.1. Theorising transformation: bringing regulation and governance to the fore**

Attempts to theorise about processes of transformation in Russia have traditionally revolved around notions of a Washington and latterly post-Washington consensus (Williamson, 1999; 1990), the four pillars of transition orthodoxy (stabilisation, liberalisation, privatisation and internationalisation) (see Chapter 3; Lavigne, 1999), and the triple transition of political, economic and social life (Offe, 1991). It is only more recently that debates concerning the importance of embedded social practices and the persistence of the virtual economy have come to the fore (see, for example, Gaddy and Ickes, 1999; 1998; 1998b; Carlsson et al, 2001). The application of regulation and governance approaches has provided a means of examining processes of transformation in which social practices and institutions are given centre stage.

The aim of regulation theory, as previously stated, is to examine the 'transformation of social relations as it creates new forms, which are both economic and non-economic, that are organised in structures and themselves reproduce a determinant structure, the mode of production' (Aglietta, 1979: 16). As such, this is what many transitologists and economists examining transformation processes are trying to understand. But, of course an important issue is to what extent this theory, previously applied to advanced capitalist economies, can travel to Post-Soviet space. I have argued in this thesis that the conceptual apparatus of this theory does travel. Furthermore, applying these theories beyond the space of advanced capitalist economies has provided the opportunity to open up these theories to include the theorisation of geographies of transforming economies. These economies are becoming fully integrated into the global economy and this has implications for

advanced capitalist nations, not least in terms of the future of dominant global discourses of regulation and governance (see Section 9.2).

A tenet of regulation theory is that regulation (or *régulation*) can imply more than that stemming from judicial or political processes, its broader meaning spans that of the variable pattern of cultural, political and economic institutions (Aglietta, 1979). If IFIs fully recognised, and used, this wider conception of the term 'regulation', as well as the manner in which processes of change and transformation are mediated, then this would have implications for the way in which they try to mediate these processes of change. Moreover, using a regulation approach to examine processes of transformation in Russia leads me to concur with Goodwin and Painter (1995: 342) that:

‘There are tendencies towards effective regulation that are partly the products of strategic action undertaken by individuals and institutions. Equally there are counter-tendencies operating to disrupt the reproduction of the capitalist order. The regulatory process is the product of the interaction of these forces... (.) A regulation theory that treats regulation as process is able to deal rather more subtly with temporal and spatial variability.’

This thesis has clearly demonstrated, via the regional case studies, that there is considerable spatial and temporal variability with regard to processes of regulation and governance in Post-Soviet Russia. In fact, Putin's drive to exercise increased federal authority over the regions is testament to the strength of regionally generated counter-tendencies that are the product of locally embedded and institutionalised social practices. These variations can be subtle and are contingent on many processes intersecting at a variety of scales. The marriage of regulation and governance approaches allows the theorisation of these processes of transformation

to be nuanced enough to take due account of the complexity and contingency of multiple relationships and processes intersecting through space and time.

If IFIs, or even federal government, are to try to steer processes of change then it is necessary for them to fully understand processes of governance and regulation and how they are (re)produced. This has implications for the way that they can guide or 'govern' these processes in Russia. It has been shown, as Hunt and Wickham suggest (1994), that objects of governance in Russia can only be known through attempts to govern them. In other words, effective modes of regulation or governance cannot be identified a priori, which brings into question the merits of advocating models for change, which do not take account of the reality of embedded practices and institutions. Moreover, there are going to be different responses to change both spatially and temporally.

## **9.2. The Russian experience: (re)spatialising regulation and governance**

As mentioned in the previous section, this thesis has aimed at widening regulation and governance debates, which are dominated by studies of advanced capitalist economies. Applying these approaches to the examination of transformation processes in Russia has highlighted the critical role that the mode, or multiple modes, of social regulation play in transformation processes at any scale. Moreover, the simultaneous application of both regulation and governance approaches has reinforced Jessop's (1997) claims that the two theories work well together. The objects that they seek to identify and examine are intrinsically bound together and contingent.

If regulation theory aims at developing 'a historically and geographically grounded account of the development of capitalism' (Painter and Goodwin, 1995: 337) then it should be applicable to the transforming economies. After all, these economies are experiencing the intense evolution of capitalist processes, meaning that they can be considered as potential subjects of study in terms of the evolution of capitalism.

I have argued in this thesis that geography matters when examining processes of regulation and governance. The spatialisation of these approaches, especially regulation theory, is important on two counts. First, it has been shown how local modes of social regulation can co-exist and evolve within a single economic system, in spite of concerted federal efforts to standardise social practices and institutions. Multiple modes of regulation co-exist within the bounds of the Russian economy, the differences can be marked or subtle and the processes of regulation and governance that define them are contingent on multiple processes and relationships intersecting through space and time. This argument goes some way to refuting criticisms that regulation theory does not take due consideration of the spatiality of the transformation of social relations. Second, multiple modes of regulation for capitalist/transforming economies exist at a variety of scales, not just the sub-national, but the global too. So, although there is a dominant discourse, which informs the regulation of the global economy, there are multiple modes of regulation competing with the dominant structures. These multiple modes cannot be constructed as a binary challenge between capitalism, or the advanced capitalist economies and communism. The modes of regulation are more complex and fluid than this. A question that remains is: to what extent are dominant global discourses of regulation and governance challenged, or reinforced by Russia's evolution

towards its own form of a market economy? This would be an interesting area for future research.

In addition to spatialising regulation theory this thesis has sought to highlight the critical role of the mode of social regulation in transforming social relations that are both economic and non-economic. Evidence from Russia's transformation experience, highlights the way that without regulation, processes of capital accumulation would collapse through their own contradictions. Furthermore, if stable or expanded accumulation occurs, it does in part as a result of regulation that is not presupposed by the accumulation process itself (Painter and Goodwin, 1995: 337). Again this has implications for those seeking to control processes of change or introduce a new way of capital accumulation.

### **9.3. Problems with 'transition': hybridism, embeddedness and institutions**

It has been demonstrated throughout this thesis that the embeddedness of institutions is a critical explanatory factor in understanding transformation processes in Russia and the point at which Russia stands today. But, important too are the highly variable intersections of spatial and temporal forces/processes, which affect on any location. The path of transformation has been shown to be determined to a large extent by the range of options available in any given space and time.

The hybrid nature of the Russian economic system is real and the virtual economy real. Gustafson (1999) has suggested that the process of nomenklatura acquisition of productive assets in Russia is not only symptomatic of Russia's confused and 'uncontrollable' transformation, but also is also a key factor facilitating the



persistence of anti-competitive practices. The evolution of a so-called 'crony capitalism' has in part characterised Russia's transformation. The IFIs and donors working in Russia have recently targeted tunnelling, corruption and corporate governance issues as priority areas for themselves and federal government. The adoption of Western standards of transparency and 'best practice' has been deemed a necessity for Russia's continued transformation and integration into the global economy, not least in terms of WTO entry. Recent projects aimed at exploring and tackling these issues have focussed on problems caused by unwieldy bureaucratic systems, the dominance of well established and closed social networks, and social practices.

Creating more 'appropriate' institutions and social practices to support the existence of a more 'desirable', stable and transparent economic climate, however, remains problematic. There is resistance to change, especially among those who have profited politically, economically and socially from existing processes and institutions. Those previously excluded from circuits of capital and influence, welcome the changes for the most part, but in the mean time many have learnt to 'work within' the current system and the virtual economy.

Models of best practice are being drawn up and advocated in Russia with the assistance of Western advisors. However, in the wake of multiple Western corporate scandals, just how effective these models and codes are, in the first place, is debateable. Unless there is a willingness to comply with standards, codes of conduct will be meaningless. Compliance with standards relies on there being effective processes of regulation and governance that support implementation and

monitoring. This involves both dominant social practices supporting a legal framework that has the capacity to enforce standards and regulations. In order for social practices to support law enforcement the latter has to be perceived as fair and consistent. Another key problem is that relatively small groups of actors and particular social networks, active at a variety of scales, have played critical roles in mediating transformation processes in Russia. However, these networks appear to have been tightly formed and regulated meaning that the majority of Russian citizens have to a large extent been excluded from circuits of capital and influence. This has served to reinforce processes of exclusion, as well as misgivings about the processes of 'steering' change in Russia.

Overall I have concluded, as many previously (see for example, Stiglitz, 1999), that IFIs have neither focussed soon enough on the importance of institution building nor recognised early enough the complex and strong and pervasive nature of informal personal networks, which have hindered attempts at reform in Russia. More specifically, it has been demonstrated that IFIs and donors faced, and continue to face to a large degree, substantial barriers in implementing programmes in Russia due to: political and economic instability<sup>1</sup>, a widespread lack of commitment to reforms, the rise of powerful interest groups, limitations in the design and implementation of assistance programmes and in some cases limited institutional capacity. The IFIs have also paid little attention to the impact of their programmes on the continued uneven development of Russia's regions.

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<sup>1</sup> Admittedly 'instabilities' have lessened to a large degree under the Putin administration.

#### **9.4. The impact of IFIs and donors in Russia's regions**

Evidence from research in Leningrad and Sakhalin oblasts showed that IFIs and donors have focussed, in many instances, on making the investment climate more transparent and attractive to foreign and domestic investors. The motivation behind involvement in the regions was shown to be a mixture of philanthropy, and representing the economic interests of those that fund them. The two regions examined were shown to be attractive to investors because of their geographical locations and/or natural resource advantages, as well as being governed locally by leaders specifically courting foreign involvement in the region's development in bids to secure the future of each region. Leningrad oblast was shown to have adopted a different strategy from Sakhalin oblast to attract international attention. Successive Governors of the region have sought to improve the investment climate in order to attract investors. Sakhalin on the other hand, has focussed on the benefits that its natural resource advantages, in the forms of oil and gas, will bring. While attempts to improve the investment climate, at the local level, have been made such efforts have not been as concerted as in Leningrad oblast. It was further demonstrated that Russian responses to donor activity were generally more positive when the recipients could see that they benefited economically from working with IFIs and donors. This is not surprising.

However, the lack of regionally targeted assistance programmes and the concentration of donor efforts in regions that have reform minded leaders, and/or a previous history of working relationships with donors, means that those outside of the 'loop' remain excluded from such circuits of capital and assistance. This has implications for the continued uneven development of Russia's regions and the

deepening of already existing socio-economic cleavages. The geography of donor assistance, which has been concentrated in a handful of regions over the past decade (see again Map 5), and now increasingly in Moscow, coupled with the Russian Government's own policy towards levelling out the uneven development among Russia's regions, means that problems of uneven development are certainly not going to change overnight.

It is a fact that the two regions examined are seeking to gain a foothold on the international stage in economic terms. Global forces are influential in the evolution of these regional economies. However, the evidence gathered through field research has reinforced the contention that locales should be seen as more than just the product of global forces. It has been clearly demonstrated that Russian regions are generators of processes of transformation, regulation and governance, mainly in direct response to coping with the exigencies of transformation. Though there is increased exposure to and integration of global processes, there are different 'local' responses to such forces. Responses to these processes elicit the evolution or generation of processes, which reinforce or challenge them.

#### **9.5. Conclusion : a direct response to the aims of the thesis**

In this thesis, I have used IFI and donor experiences, as well as the responses to IFI and donor activity as a way of identifying and accessing dominant processes of regulation and governance at the regional and federal scales. I have highlighted the importance of recognising the embeddedness of social practices and institutions when trying to theorise about transformation processes in Russia. Moreover, these regulatory processes, institutions and social practices and norms that constitute

regulation cannot be identified a priori. This has real implications for those seeking to 'steer' processes of change. The dominance of disincentives to change and processes of exclusion are powerful factors influencing processes of regulation and governance in Russia. Finally, I have demonstrated how processes of regulation and governance, mediated by actors both internal and external to Russia, at a variety of scales, intersect and affect the uneven development of Russia's regions. It cannot be said that there is one coherent mode of social regulation that is developing within Russia. There are, for example, strong regional differences, between responses to dealing with the exigencies of the transformation process. Explanations for these processes do not just lie in the regions' relationships with federal government, or on the industrial legacies of the Soviet era but also on individuals, social networks and practices and the different geographies of economic regulation.

Policy analysts and observers of Russia, following the 1998 financial crisis and the emergence of physical proof that Russia had not evolved along her 'expected' transition trajectory have argued about 'Who lost Russia?' I would suggest that it is not a question of 'who' lost Russia - no one ever 'had' or 'owned' her. She is finding herself, and that process of finding, regulating and governing cannot be pre-determined or engineered externally.

## **Appendix A: IFI and Donor Projects Studied**

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### **Federal Level**

International Monetary Fund lending to the Russian Federation (IMF)

Financial Institutions Development Project (World Bank)

Legal Reform Project (World Bank)

Financial Leasing Section (IFC)

Corporate Governance programme (EBRD)

Banking Reform Project (EBRD)

### **Oblast Level**

#### **A. Leningrad Oblast**

World Bank Credit Line to Ford Vsevolozhsk (World Bank)

Administrative Barriers to Investment in Northwest Russia (FIAS/World Bank)

Enhancing 'Synergy' between St Petersburg and Leningrad oblast (Tacis)

SME focussed regeneration programme Podporozhye district (Tacis)

Baltic Port Development Programme (Tacis)

Enhancing the SME sector in Leningrad oblast – support for business associations (DFID/Tacis)

#### **B. Sakhalin Oblast**

Russia Small Business Fund (EBRD)

Banking Reform Project with the Far Eastern Bank (EBRD)

Sakhalin 2 Oil and Gas project (EBRD)

Strengthening the business environment (USAID)

Sakhalin Investment Promotion Agency (USAID)

American Business Centre and BISNIS in Yuzhno-Sakhalinsk (USAID)

American Russian Training Centres (USAID)

Micro-credit programmes (USAID, ACDI/VOCA)

## Appendix B: Interviews November 2000- October 2001

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Location/Date	Organisation for which interviewee works
<b>Washington</b>	
09.11.2000	IFI
13.11.2000	IFI
15.11.2000	IFI
17.11.2000	Political Analyst
20.11.2000	Country Representative to IFI
21.11.2000	Bi-lateral Donor
22.11.2000	IFI
28.11.2000	Bi-lateral Donor
29.11.2000	Political Analyst
30.11.2000	Academic
<b>London</b>	
27.10.2001a	IFI
27.10.2001b	IFI
<b>Leningrad oblast</b>	
19.04.2001	International Accountancy Firm
20.04.2001	Oblast Administration
26.04.2001	Local Academic
27.04.2001	IFI
03.05.2001	Oblast Administration
04.05.2001a	IFI
04.05.2001b	International Law Firm
08.05.2001	Foreign Investor
09.05.2001	Trade Council
10.05.2001	Foreign Investor
11.05.2001	Trade Council
14.05.2001	Commercial Bank
16.05.2001	Bi-lateral Donor
18.05.2001	Commercial Bank
28.05.2001	Bi-lateral Donor
01.06.2001	Russian SME
05.06.2001a	Russian SME
05.06.2001b	Russian SME
06.06.2001	Oblast Duma
19.06.2001	Russian SME
20.06.2001	Project Officer for IFI
20.06.2001	Russian partner to IFI
21.06.2001	Russian partner to IFI
22.06.2001	Project Officer for IFI
23.07.2001	Russian SME
30.07.2001	Oblast Duma
31.07.2001	Bi-lateral Donor
31.07.2001	Diplomatic community

**Moscow**

08.06.2001	Bi-lateral Donor
11.06.2001	Bi-lateral Donor
12.06.2001	Federal Duma
13.06.2001	IFI
14.06.2001	International Law Firm
15.06.2001	Russian Ministry
16.07.2001	Russian Ministry
17.07.2001	IFI
19.07.2001	IFI
20.07.2001	European Business Club
23.07.2001	International Law Firm
24.07.2001a	Political Analyst
24.07.2001b	Political Analyst
25.07.2001	International Accountancy and Consultancy Firm
26.07.2001	Academic/Consultant
27.07.2001	International Business Monitor

**Sakhalin/Vladivostok**

22.08.2001	Business Analyst, Donor-funded organisation
22.08.2001	Oblast Administration
23.08.2001	Director, Trade Council
23.08.2001	Bi-lateral Donor
24.08.2001	Oblast Duma
24.08.2001	Oblast Administration
27.08.2001	Independent Consultant/Investor
28.08.2001a	Oil and Gas Company
28.08.2001b	Oil and Gas Company
29.08.2001	Oblast Administration
30.08.2001	Commercial Bank
31.08.2001	Oil and Gas Company
02.09.2001	Russian SME
03.09.2001	Oil and Gas Company
04.09.2001	Oil and Gas Company
05.09.2001	Commercial Bank
06.09.2001	International Law Firm
07.09.2001	Russian SME
07.09.2001	Training Centre
10.09.2001	Director, Trade Council
10.09.2001	Russian SME
12.09.2001	Training Centre
13.09.2001a	Business Association
13.09.2001b	Business Association
14.09.2001	Business Association
14.09.2001	Oblast Duma
17.09.2001	Leasing Company
17.09.2001	Credit Agency
19.09.2001	Project Officer IFI
20.09.2001	IFI
20.09.2001	International Law Firm



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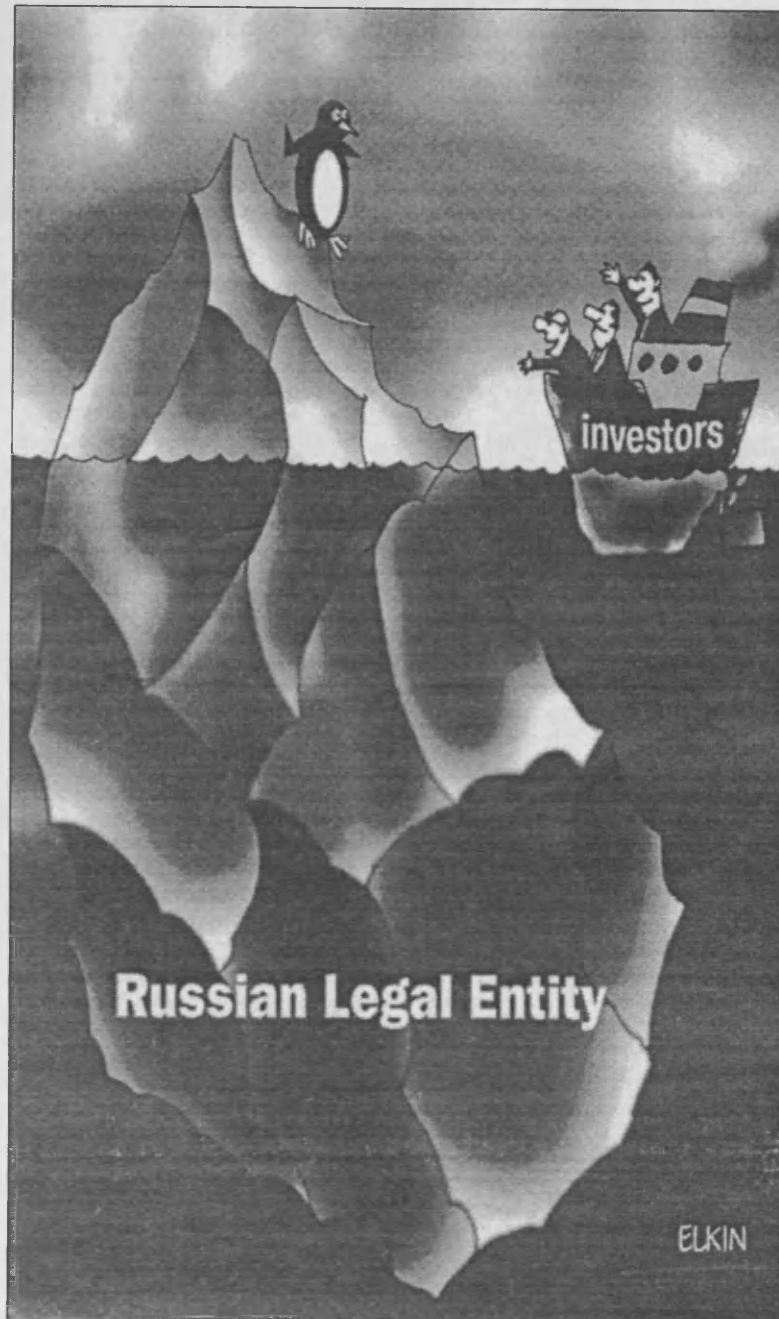
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