

POLITICAL RISKS OF WESTERN COMPANIES IN A TRANSFORMING COUNTRY. EVIDENCE FROM RUSSIA UNDER THE THIRD TERM OF PUTIN

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Abstract

Foreign companies are said to form an integral part of the economic landscape in their respective host country. With regard to countries in transition, Western enterprises have to face specific risks and obstacles related to the current stage of the democratic and economic development. They are, just as those domestic firms, harassed by political risks such as corruption, political favoritism or legal uncertainty.

This paper is drawn on the evidence collected during a field study conducted between March and September 2014 in Austria and Russia. The author conducted 24 qualitative interviews with Austrian business representatives operating in Russia and Russian experts on business environment.

The results of this study can be used for the improvement of the understanding of specific business conditions ruling in Russia. The paper can be considered a valuable foundation for further in-depth research both on the political risks and individual factors

Keywords: business environment, coping strategies, international business, political risks, russian federation

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1. Introduction

After the breakup of the Soviet Union, Russia as its main successor for many years seemed for many scientists to be on a path to Western-style democracy and free market economy. Two decades of transformation show that many informal institutions inherited from the Soviet period are still present in the political and economic life of the country. The transformation process, however, changed their character and scale.

This article discusses political risks faced by Western businesses in Russia. My purpose is to demonstrate the impact of informal institutions embedded in the political-institutional

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frameworks of a state on business development, especially in case of Western enterprises. The aim lies at searching for answers to the following research questions: In which ways can the Russian business environment characterized by neopatrimonial practices and how do Western enterprises react on such system. The latter question looks at coping strategies introduced by them in order to adjust to Russian market conditions.

There is a wide range of studies on individual informal factors which characterize a neopatrimonial system such as patron-client relationship, various forms of corruption or the lack of rule of law. The impact of informal institutions within such a system on international business has not been addressed yet. This article tries to bridge this gap by offering a multidisciplinary, comprehensive approach.

Firstly I will present literature review and methodology. The second part consists of a detailed case analysis of consequences of on political risks on Western firms in Russia. The final part will outline coping strategies adopted by these companies attempting to deal with the business environment they operate in. At the end of this paper, I will try to sum up the most relevant findings.

2. Conceptual framework: Political Risks and Neopatrimonialism

So far, there no accepted universal definition of political risk in business administration has been established, let alone a list of indicators. However, despite the proliferation of definitions and theoretical concepts, there is at least a common understanding. Agarwal and Feils (2007) describe political risks as the consequence of possible interference with business operations of external agents like the government. In search of matching ideas which may be suited to be applied for transition countries, we may find the concept of neopatrimonialism, mainly used in political science.

It analyzes the coexistence of formal and informal institutions within a political system (Bratton & Van de Walle, 1997). Its initial application in the 1970s refers to developments in Africa but has been used over time with reference to other regions. Neopatrimonialism describes a type of a system in which the tradition of patron-client networks is interrelated to some kind of rational-legal structure of bureaucracy. Formal structures and rules do exist, although the separation of the private and public sphere is not always observed in practice (Erdmann & Engel, 2007, p. 105). This situation creates uncertainty for stakeholders. Under a neopatrimonial

organization, “people have a certain degree of choice as to which logic they want to employ to achieve their goals and to best realize their interests”.

Informal institutions come into being both when formal institutions do not function properly and where formal institutions work effectively. In cases when informal institutions coexist with ineffective formal institutions, the first are supposed to substitute or compete with the latter (Helmke & Levitsky, 2004, p. 729).

Although the concept is still underdeveloped and ill-defined due to a lack of coherence, some factors such as corruption, rent seeking, patron-client relationships and legal uncertainty are widely used to describe this phenomenon. These informal factors are embedded in the political system but due to the interplay between politics and economics they mainly tend to influence the latter.

This paper focuses on the informal institutions in a neopatrimonial system and their consequent impact on the operational environment of Western companies. Informal institutions are “mainly unwritten, socially shared rules and procedures, which are put into social live, distributed and implemented “outside of officially sanctioned channels” (Helmke & Levitsky, 2004, p. 725). They might include corruption, personal networks; clientelism and patronalism (Helmke & Levitsky, 2004, pp. 727-729).

Corruption is an umbrella term which covers various aspects such as collusion, cronyism and nepotism, fraud, gifts, hospitality, lobbying, abuse of power or office and influence peddling (cf Shekshnia et al., 2014, p. 5). This broad understanding can be found in the widely cited definition by J. Nye (Nye, 1967, p. 419).

According to this author, corruption is a behavior which deviates from formal duties or rules of conduct governing the actions of an officeholder because of their private motives such as wealth, power, or status. This pattern can be detected in various forms, i.e. bribery, nepotism and misappropriation. The first practice is always of monetary nature, the last two can also have a non-monetary character.

The definition has a very broad scope in terms of types of corruption forms and gains. For this paper, I have adopted a narrow understanding, which is limited to monetary nature of corruption acts. Systemic corruption means that politician and officials use their authority in order to sustain their status and private wealth.

Taking into account importance of the non-monetary aspects of relations within informal institutions, the term of “systemic favoritism” is to be introduced and consequently applied. Systematic favoritism describes the systematic use of public office to foster the interests of the patron himself and/or his clients, while impeding initiatives by actors who are no part of this network.

3. Literature review

There are a few relatively recent publications, which pay attention to the interrelationship between political and economic spheres in Russia using a neopatrimonial prism (cf. Ledeneva, 2013a; Robinson, 2013). The concept of patrimonial capitalism applied by Robinson can be seen as a variant of Weber’s patrimonialism and neo-patrimonialism in the economic sphere (Robinson, 2011, p. 4). Ledeneva analyzed the nature, norms and methods of informal governance under Putin drawing on this concept (Ledeneva, 2013a, p. 1136). Both studies have been very important for the practical shaping of this paper.

If we take a broader look on the relevant literature relating to the interplay between politics and economics in Russia without direct reference to the neopatrimonial concept we may observe different lines of research. Scientists elaborating on transition or area studies have noted the existence of a variety of informal practices, including the corruption of the public sector and informal networks of ruling elites. With regard to post-communist informal state institutions, which generally also cover corruption and patron–client relationships, there is a bulk of existing literature.

A lot of attention has been paid on one particular informal institution: corruption. This instrument is widely discussed as a practice present in the bureaucracy and the political system (Anderson, 2012; Hanson, 2013; Leslie, 2012). Business corruption constitutes a theme in many very interesting analyses (c.f. for instance Ledeneva, 2011; Mommsen, 2012). Denisova-Schmidt (Denisova-Schmidt, 2010) describes the role of public administration and personal networks in corruption acts of foreign companies.

Interpersonal networks such as patron-client ties within political and economic elites have been another popular topic for research on informality and informal institutions. Krystanovskaya and White (2013) have analyzed the networks within the ruling elite and state networks. Ledeneva has authored a study on the informal practices within public administration (Ledeneva, 2013) and Hanson has dealt comprehensively with networks in domestic business-state relations (Hanson, 2013). Some scholars sought to define the dominating players in the state-business

interactions and showed a change in this relationship from state capture to business capture (c.f. Yakovlev & Zhuravskaya, 2004; Yakovlev, 2006).

ys Methodology

This paper presents the findings of a field study conducted by the author between March and September 2015 in Russia and Austria. The selection of qualitative approach was justified by the sensitive character of the research problem. This method helps me to investigate “how” questions of my project.

Based on an extensive literature review I designed a questionnaire and consequently a category system. The interviews were semi-structured and conducted by the virtue of guidelines. The questionnaire was my guideline for conducting them. Expert interviews were selected as data collection method. One to one interviews conducted in a confidential manner provide access to information that otherwise would not be accessible.

The author has contacted roughly 200 Austrian companies registered in Moscow and 10 scientists, journalists and NGO activists. Interview partners were recruited by targeted selection by applying the position technique, the scientific respondents by using the reputation technique. The criteria of selection of business interview partner were the size of the company and the line of business. The aim was to reach a broad involvement of a wide range of various types of enterprises.

Representatives of Austrian business were invited to contribute to the project on the political-institutional framework for business activities. The Russian scientists, journalists and representative of NGOs were directly asked to share their relevant knowledge in their field of expertise. Both groups were approached by guaranteeing strict confidentiality and were asked the same categories in the questionnaire. The interviews were conducted orally by using sensitive words such as corruption. Due to the promised confidentiality I codified firms as numbers in increasing order.

The collected data result from 24 qualitative interviews conducted with managers of Austrian companies on their operations in Russia and Russian experts from academia, journalism and NGOs on the general business environment. The business interview partners represented a wide range of sectors and companies from SMEs to large enterprises (e.g. construction sector, high-tech equipment, steel constructions, etc).

The interviews were mostly conducted in person allowing for a broader conversation on the topics of interest. They helped the author gain more insights into the structure and workings of informal institutions in Russia. The language used was of the choice of the respective vis-à-vis: English, German or Russian. The 20 face to face personal interviews were supplemented by 4 telephone and Skype interviews. They lasted on average one hour. 20 interviews are recorded, 4 respondents preferred not to be recorded. Concerning the latter, I was able to take extensive notes.

After data collection, the interviews were transcribed in full in original languages. The category system guided me through the analysis of the interview material. In this respect I followed Mayring (2000). I used summarizing qualitative content analysis while applying the deductive approach. The reason to opt for this procedure was the already existing plethora of literature providing rich variables and concepts which could be used as points of departure.

5. Consequences for Western Business

5.1. Political corruption

Corruption exists in many forms and is committed at various levels in Russia. Due to the hidden nature of such transactions it is very difficult to identify the structure of this phenomenon. Western firms encounter it mostly in the state administration where public officials demand things which they should not demand (Interview 5, Interview 19 & Interview 30). Corruption structures function in all state institutions (Interview 9). Each body has a certain sphere of specialization. Corruption is also visible in the some state regulatory bodies (at the senior official level) such as the finance police, tax inspectorate, customs service, fire department, work inspectorate or sanitary inspectorate (Interview 21).

As of the scale, the number of corruption transactions drops but the range of the money grows (Interview 8 & Interview 16). It also constitutes a kind of compensation: As salaries in public administration are quite high, it is a higher risk for an official to involve in corrupt practices. Companies are also using it for accelerating or delaying decisions or processes (Interview 2, Interview 5, Interview 8 & Interview 21).

The official combat against corruption makes the basic bribery more difficult. Such an old practice like an envelope containing money is not possible any more (Interview 9, Interview 15 and Interview 17). Supervision of corruption acts has become stricter, but the companies have also learnt to adapt and invent new instruments or other “solutions” which are not formally banned by law (Interview 9 & Interview 13). The rate for corruption payments depends on the

size of the contract and the type of service. The average rate of corruption demand is estimated at 30-40 percent of a transaction (Interview 9 & Interview 11).

The incidence of such acts depends on the size of a project and line of business. A foreign company can encounter such a demand when awarding a state contract or contract with or companies close to the government. The chance of solicitation of bribes is bigger, when the involved company is large one and when is applying for a federal state project (Interview 6 & Interview 15). Companies experienced that when interested in state procurement (Interview 4 & Interview 9) and dealing with public tenders (Interview 15, Interview 19, Interview 21, Interview 23 & Interview 24). Obtaining a certificate or in Russia is connected with corruption money (Interview 5, Interview 13, Interview 19 & Interview 21).

Bribing is still present in infrastructure projects especially in state ordered projects (Interview 15). It is also used in branches which work with projects in general. Each one needs a license from the state or from a licensed company (Interview 19).

5.2. Political favoritism

There are only very few companies, which conduct projects with partners who are politically well-connected and belong to one of client-patron networks in the country (Interview 10, Interview 22 & Interview 24). There are a very few cases, where an Austrian or German company has been threatened (Interview 15, Interview 21 & Interview 24). If a confronted company ignores a raider threat, the other party has so far refrained from further actions. An attempt of such an unfriendly takeover can happen in a sector where Russian oligarchs are operating (Interview 32). In the high risk group are enterprises which offer good standards in production or trade (Interview 21). There are various options in use. A company may receive an offer of selling shares to a local political businessperson. A company reaching a certain level of turnover or sales volume can also become a subject of raider attack (Interview 21 & Interview 17).

It can also happen that a Russian businessman gets dissatisfied with a new Western competitor and falsifies the ownership documents of the foreign rival's company. Then an inspection may be sent which starts to collect some informal information about a company of interest, also by insiders (Interview 4). As an alternative, a Western businessman can be forced to sign a document passing the ownership on the raider (Interview 15). Sometimes the raider does not stop short for using law enforcement agencies to fulfil their demands. The third option is to

provide some criminal claim to the court. The judge is bribed to issue an illegal sentence which makes the foreign company pay a certain fine. This money is used to pay the law enforcement agencies to take the company over by force physically or use some sort of goods raiders (Interview 4).

6. Coping Strategies of Western business

Western companies have developed some strategic options which help them minimize the potentially losses coming from the institutional environment. They try to adapt to the local model in order to be successful.

Foreign businesspeople understand that running a business could be risky in Russia, but brings also large profits. Companies reduce some risks by seeking contacts to informal networks. If a large company has established good rapports with high-ranking government representatives or the President himself in the best case and made an arrangement regardless of its form, they will have no problems in their business activities in Russia. This is a kind of political “Krysha” (“special protection”).

Companies without such a direct contact have to look for support through business partners with political clout. It helps to outsource the corruption problem or obtain state contracts. A company can also cooperate with a local domestic consulting company, which has regular connections with the regional authorities and know what their demands and requirements. The largest companies have their own departments with some well-informed and well-connected employees who are very familiar with the peculiarities of the Russian political landscape.

Another strategic option in order to minimize the risk of raider attacks is to keep local exposure at a low level. This can be reached through various measures. Instead of establishing a fully operating local subsidiary, the parent company only sets up a local representative branch which then outsources its activities to local firms or leaves the core processes with the parent company in the home country. Another approach in this strategy would refer to property. In order to prevent the exposure from expropriation, one has to avoid adding any property within the country. Instead, the firm rents its entire business infrastructure, from the building to the telephone.

The second set covers corruption. A first strategy is to avoid bribery at all. Some firms have given up doing business with public authorities and try to cooperate with independent “private” partners. They decided not to take part in public tenders or state procurement. Another option is to find a niche where foreign products are sought-after and the local competition is low

or they offer a high-tech product which cannot be provided by domestic companies or which is connected with know-how.

Another kind of corruption avoidance is the strict maintenance of control of the sensitive areas of the own company like finances or accounting to external specialized companies. These companies report directly with their headquarters in Europe and thus give the outer control on the regional manager.

Corruption, however, can also be outsourced. They can also shift responsibility for some business operations such as sales and distribution to the Russian partner or cooperate with independent local companies in these areas. In sectors where state permissions, licenses or certificate are obligatory a company can use a mediator to solve this problem for it. They engaged special company responsible for getting certificate for them.

7. Conclusions

Research on effects of corruption and political favoritism in transition countries is still limited. The available data on corruption is mostly about quantitative information. Informal networks and their impact on business are poorly analyzed. This paper addressed a previously limited area or research in international business: how informal institutions embedded in political system impact on business activities of Western enterprises. My theoretical framework was based on the concept of neopatrimonialism, which provides the tools to analyze individual institutions and their interdependence.

The empirical findings show the methods and schemes of corruption in wide range of sectors and in various sizes of companies. It also provides some insight into methods of operations related to existence of political favoritism.

Results of this research attempt to shed a light on some aspects and could serve as a starting point for further research. Empirical data were collected in Moscow, which represents a large metropolis with a high concentration of foreign investors. The business environment faced by foreign companies in other regions was no part of this study.

Several themes may emerge from these findings and consequently require additional work. Further exploration could provide important insight into the accessibility of local networks to Western business, corruption schemes in particular sectors or depending on companies' size or use of legal intermediaries in problem solving process.

Furthermore, practitioners interested in entering the Russian market could also benefit from these findings. They could be warned of the role of informal institutions and easier develop coping strategies or refrain from entering the market.

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Interviews:

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- Interview 3, am 25.03.2014
- Interview 4, am 26.03.2014
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- Interview 6, am. 27.03.2014
- Interview 7, am. 27.03.2014
- Interview 8, am 28.03.2014
- Interview 9, am 28.03.2014
- Interview 10, am 31.03.2014
- Interview 11, am 01.04.2014

Interview 12, am 01.04.2014
Interview 13, am 01.04.2014
Interview 14, am 02.04.2014
Interview 15, am 02.04.2014
Interview 16, am 02.04.2014
Interview 17, am 03.04.2014
Interview 18, am 03.04.2014
Interview 19, am 10.04.2014
Interview 20, am 22.04.2014
Interview 21, am 14.05.2014
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