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The Low Quality of National Governance and Unevenness in the Economic Competitiveness of Regions: The Case of Russia

Irina Busygina
Professor, Department of Political Science, National Research University – Higher School of Economics St. Petersburg, Russia
ibusygina@hse.ru

Mikhail Filippov
Binghamton University (SUNY)
filippov@binghamton.edu

Abstract

Strong institutions and good governance are instrumental for success in the global economy. While the quality of national governance has positive effect on a country's economic performance, it is not a necessary condition. Poor governance can be offset with the country's comparative advantages; however, such advantages are likely to be geographically concentrated. We argue that in present-day Russia weak institutions and low quality of national governance make most regions unable to compete in the global economy.

Keywords

Russia – political institutions – quality of governance – economic competitiveness – regional inequality

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Introduction[1]

There is a well-respected school of thought suggesting that the demands of global economic competition promote conditions for better domestic governance and lock politicians into policies necessary to improve economic and social outcomes.[2] According to La Porta, Lopez-de-Silanes and Shleifer, globalization 'encourages competition among countries for foreign direct investment, for capital, and for business in general, which must as well put some pressure toward the adoption of good legal rules and regulations.'[3] The *New York Times* columnist, Thomas Friedman, paints a vivid picture in explanation for why this is the case in his story of the Electronic Herd of global investors putting a Golden Straitjacket on sovereign nations:

> When your country recognizes … the rules of the free market in today's global economy, and decides to abide by them, it puts on what I call the Golden Strait Jacket. […] Those countries that put on the Golden Straitjacket and keep it on are rewarded by the herd with investment capital. Those that don't put it on are disciplined by the herd – either by the herd avoiding or withdrawing its money from that country. […] In the end, it always responds to good governance and good economic management.[4]

Regarding Russia, Friedman says that the problems of economic development are directly related to the gap between the expectations of the global investors and the prevailing governance practices.

The good governance as a condition for a national economic success emphasizes the importance of national state in global economy for ensuring the efficiency of markets. The argument is that for an economic success a national

1 The study was implemented within the framework of the Basic Research Program at the National Research University – Higher School of Economics, St. Petersburg in 2018.

2 See, in particular, Mark R. Brawley, *The Politics of Globalization: Gaining Perspective, Assessing Consequences* (Toronto: University of Toronto Press, 2008); Dani Rodrik, *The Globalization Paradox: Why Global Markets, States, and Democracy Can't Coexist* (Oxford: Oxford University Press, 2011); Kenneth N. Waltz, Globalization and Governance, *PS: Political Science and Politics* 32, no. 4, (1999): 693–700. Klaus Segbers, ed., *Explaining Post-soviet Patchworks: Actors and Sectors in Russia Between Accommodation and Resistance to Globalization*. (Abingdon: Routledge, 2017).

3 See Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, "The Economic Consequences of Legal Origins", *Journal of Economic Literature* 46, no. 2 (2008): 327.

4 See Thomas L. Friedman, *The Lexus and the Olive Tree* (New York: Farrar, Straus, Giroux, 1999): 86–88.

state must provide a rule of law, to implement policies limiting corruption, enforcing property rights, and to credibly commit (not to expropriate). In a global economy, those are necessary conditions for private investors to support national economic development. Otherwise, international as well as domestic investors will move elsewhere.

However, global markets do not always punish the regimes with low quality governance. Corruption does not seem to deter FDI in absolute terms.[5] Some countries with low quality of governance, including Russia, attracted significant volume of foreign investments. Bessonova and Gonchar describe as 'a confusing anomaly' the fact that 'in the 2000s, Russia managed to attract large-scale FDI despite having weak institutions.'[6] Moreover, in the Russian case, until the annexation of Crimea and the drop in oil prices in 2014, most observers expected steady pace of economic improvements. The low quality of governance in the 2000s did not prevent a significant improvement both in economic growth and in attracting foreign investments. High and increasing level of corruption since Putin came to power in 1999 did not prevent Russia from achieving significant economic growth and receiving *relatively* large foreign direct investments. In fact, where in 2000 the Russian GDP per capita (current US$) was twice less than in Brazil, a similar large and democratizing federal country, $1,772 against $3,739, in 2013 GDP the order was reversed, $16,007 against $12,217.[7] According to the World Bank, at the beginning of 2014, Russia's economy was the fifth largest worldwide in terms of the GDP adjusted for purchasing power parity (PPP).

Between 2000 and 2014, the stock of foreign direct investments in Russia increased from 32 to 576 billion dollars (in Brazil from 122 to 725 billion dollars).[8] In 2013 FDI inflows to the Russian Federation jumped to US$94 billion making it the world's third largest recipient of FDI for the first time ever.[9] Even after removing data for FDI that originated in Cyprus, Bermuda, and Caribbean

5 See Habib Mohsin, and Leon Zurawicki, "Corruption and Foreign Direct Investment," *Journal of International Business Studies* 33, no. 2 (2002): 291–307.

6 See Evguenia Bessonova, and Ksenia Gonchar, "Bypassing weak institutions in a large latecomer economy," *Journal of Institutional Economics* 11, no. 4 (2015): 847–874.

7 http://databank.worldbank.org/data/reports.aspx?Code=NY.GDP.PCAP.CD&id=1ff4a498&report_name=Popular-Indicators&populartype=series&ispopular=y (accessed 8 April 2018).

8 UNCTAD World Investment Report 2015. http://unctad.org/en/PublicationsLibrary/wir2015_en.pdf (accessed 8 April 2018).

9 The rise was mainly attributed to the large acquisition by BP (United Kingdom) of 18.5% of Rosneft (Russia Federation) as part of Rosneft's US$57 billion acquisition of TNK-BP. See UNCTAD, Global Investment Trend Monitor, 28 January 2014:7.

countries (e.g. likely the so called 'round-tripping' or de-facto domestic reinvesting), the ratio of Russia's FDI inflows for 2007–13 is estimated to be about 2.4 percent, of GDP, comparable to that for Brazil.[10] In 2014, FDI flows to the Russian Federation fell by 70 per cent as regional conflict and sanctions deterred investors.

And all along, as Anderson pointed out, by almost any numerical measure, Russia enjoyed 'the dubious distinction of being the most corrupt economic and political system among the major economic powers.'[11] Corruption is often named as the greatest impediment to conducting business in Russia: for example, according to the economic leadership survey by the 2012 World Economic Forum.[12] The Transparency International's Corruption Perceptions Index for 2014 places Russia in the 136rd place (out of 174 countries), near Iran and Nigeria, while Brazil is ranked 69th next to South Africa and Italy.[13] Russia moved to the 135th place in the 2017 annual index (out of 180 countries).

Similarly, in terms of the market-enhancing conditions associated with the quality of governance, a number of successful Asian economies (e.g. China and Vietnam) performed rather poorly.[14] More generally, scholars point out that those political institutions as such have been explaining less and less of variation in cross-national economic success since the late 1980s.[15] All this poses a conundrum for the scholars of governance and development alike and flies in the face of well-established theories. Whenever there is poor governance but markets seem to fail to sanction it, explanations in the literature are usually along the lines of suggesting that economic development and investments in

10 Around a third of FDI in Russia may have been round-tripping re-investment, see Karlygash Dairabayeva, Michael Ferrantino, Alberto Portugal-Perez, and Gabriela Schmidt, "Export Competitiveness and FDI Performance Across the Regions of the Russian Federation", *Policy Research Working Paper,* no. 7821 (Washington, D.C.: World Bank Group. 2016).

11 See Anderson, Liam, Political Corruption in Russia: Past, Present and Future, in: Charles Funderburk, ed., *Political Corruption in Comparative Perspective: Sources Status and Prospects* (Farham: Ashgate, 2012): 71.

12 See Paul M. Healy and Karthik Ramanna, "When the Crowd Fights Corruption", *Harvard Business Review*, no. 91 (January-February 2013): 122–129.

13 https://www.transparency.org/cpi2014/results (accessed 8 April 2018).

14 See Mushtaq Khan, *Governance, Economic Growth and Development since the 1960s: Background Paper for the World Economic and Social Survey 2006* (New York: UNDESA, 2006); Isthiaq Jamil, Steinar Askvik, and Tek Nath Dhakal, *In Search of Better Governance in South Asia and Beyond* (New York: Springer, 2013).

15 See Andrew Hussey, Michael Jetter, and Dianne McWilliam, "Explaining Inequality between Countries: The Declining Role of Political Institutions", *GESifo Working Paper Series*, no. 6320 (2017) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2924451## (accessed 8 April 2018).

such cases are somehow second-rate and is in some ways deficient.[16] The most general argument is that economic growth without good governance is non-sustainable – that these political regimes accumulate serious economic and social problems – structural imbalances, dependence on exports of natural resources, lack of innovations, growing inequality, overcrowded cities, pollution etc. We are building on this logic, but focus on the severity of the problem of regional inequality in regimes with low quality of governance.

We argue that when the quality of national governance is low, investments and economic opportunities are likely to be associated with significant regional discrepancy. Low quality of governance reduces national competitiveness while globalization increases the importance of being economically competitive – in combination these two lead to increasing significance of local comparative advantages. We illustrate the argument focusing on the Russian experience where over-centralization combined with low quality of national governance leads to highly unequal distribution of regional economic competitiveness.

The overall competitiveness of firms located in different nations, regions and localities depends on a combination of territorially specific factors and quality of governance provided as a nation-wide public good. Firms located where the quality of governance is low (e.g., where corruption is high) either must have special territorial advantages or cannot compete in the global economy. Thus, where quality of governance is low and only the well-endowed localities can succeed in passing the threshold of competitiveness. In the Russian case, a combination of the low quality of national governance and the lack of real federalism that would allow the quality of regional level governance to attract investment, most of the regions are unable to compete in the global economy. Most regions cannot expect nor do they receive any significant domestic and foreign investments so necessary for their economic revival. Successful in attracting investments are the major capital cities of Moscow and St. Petersburg, locales with abundant valuable natural resources, and border regions serving.

The next sections expand and develop our main argument. Section two then moves to the case of Russia and discusses what amounts to the value for

16 See for example, Vinod Thomas, Mansoor Dilami, Ashok Dhareshwar, Daniel Kaufmann, Nalin Kishor, Ramon Lopez, and Yan Wang, *The Quality of Growth* (Washington, DC: The World Bank and. Oxford University Press, 2000); Montfort Mlachila, Rene Tapsoba, and Sampawende J.A. Tapsoba, "A Quality of Growth Index for Developing Countries: A Proposal", *Social Indicators Research* 134, no. 2 (2017): 675–710; Simplice Asongu and Ndemaze Asongu, "Comparative Determinants of Quality of Growth in Developing Countries", *International Journal of Happiness and Development* 4, no. 1 (2018): 65–89.

Russia of the key independent variable in cross-national comparisons, the governance, and specifically the role of the federal government as the key condition for good governance in Russia. Section three moves the analysis to the sub-national level and examines three cases of the relatively successful regions – the cities of Moscow and Saint Petersburg, and Russian resource rich regions. Section 4 addresses the political implications of territorial asymmetries. Section five concludes.

1 The Argument

The concept of competitiveness originated at the firm level and extended to applications at the national and regional levels.[17] In *The Competitive Advantage of Nations* Michael E. Porter defines the competitiveness of a location as the productivity that companies located there can achieve. Porter focuses on four necessary local determinants of competitiveness: appropriate strategies by economic agents; access to input factors (e.g., trained work force, natural resources); access to strong consumer demand; and presence of supporting industries and infrastructure. However, he posits, favorable combinations of economic conditions are strongly mediated by the choices made by national governments. Government policies define important contextual variables, which influence the competitiveness of firms – among them are 'national economic structures, values, cultures, institutions, and histories.'[18]

We rely on Porter's logic here and assume that competitiveness of firms in a global economy depends on the quality of national governance together with a combination of locally specific factors. We focus on competitive advantages and disadvantages due to the location given that quality of national governance and other nation-wide factors remain constant in the short run. The nation-wide factors promoting national competitiveness include favorable exchange rates, low interest rates, nationwide investment in education, technological advancements, the availability of natural resources, low transportation cost etc.

Next, we add Sutton's argument that in the global economy there is a critical minimum level of technological capability, and any firm with capability

17 See Karl Aigingerand, and Matthias Firgo, "Regional Competitiveness: Connecting an Old Concept with New Goals," *Handbook of Regions and Competiveness: Contemporary Theories and Perspectives on Economic Development*, (Cheltenham Edward Elgar: 2017): 155–191.

18 See Michael E. Porter, *The Competitive Advantage of Nations* (New York: Free Press, 1998): 19.

below this critical level will have zero sales (revenue) in equilibrium.[19] This result leads to the notion of a 'window' of capability for a firm to be viable. Globalization causes the bottom of the 'capability window' to move up, raising the threshold for participation in the economic competition.[20] Sutton, in particular, focuses on those firms and countries that were left behind by global markets during the 1990s and now face the challenge of 'getting into the window' of global competition. For Sutton the focus is on the conditions favorable for technological transfers, e.g. technological investments.

Modern globalization increasingly makes even newest technologies available on the global market. Thus, firms of all nations have potential access to the same technological opportunities. What differs is the quality of national governance. We thus propose to extend the notion of the necessary minimum 'capability window' by adding (1) good governance and (2) localized competitive advantage at sub-national level. In other words, we assume that a combination of technology, quality of governance and territorial competitive advantage influences the 'window' of capability in the global competition at the level of a locality. Then, it follows that if the level of technology does not improve, in nations and regions where quality of governance is low firms either must have other special advantages or cannot compete in open global economy.

Our argument resonates with Roberto Camagni, who states: 'unlike the case of countries, cities and regions compete in the international market … on the basis of an absolute advantage principle, and not of a comparative advantage principle. This means that there is no efficient, automatic mechanism to grant each territory some role in the international division of labor, whatever its relative performance. Therefore, weak and lagging territories – in terms of competitiveness of the economic fabric, internal/external accessibility, quality of the human and environmental factors, internal synergy and learning capability – risk exclusion and decline to a larger extent than in the past.'[21] Thus regions risk long-term decline and exclusion as they cannot 'compete' with others in global economy.

Additionally, we stipulate that production factors to an extent can act as substitutes for each other, so that the low quality of national institutions could

19 See John Sutton, *Competing in Capabilities: The Globalization Process* (Oxford: Oxford University Press, 2012).

20 See Sutton, *Competing in Capabilities*, 13.

21 See Roberto Camagni, "On the Concept of Territorial Competitiveness: Sound or Misleading?" *Urban Studies* 39, no. 13 (2002): 2407. See also Robert Huggins and Piers Thompson, eds., *Handbook of Regions and Competitiveness: Contemporary Theories and Perspectives on Economic Development* (Cheltenham: Edward Elgar, 2017).

be compensated by low transportation cost or by abundance of natural resources in particular localities. This assumption allows for the possibility that favorably located firms can successfully compete in a global economy, even absent improvements in technology or good national governance. However, it also implies that in nations with low quality of governance most regions would find themselves excluded from opportunities to compete in a global economy despite average quality technological base. Below we show that most Russian regions are indeed 'excluded' from the opportunities of globalization.

2 The National State as Key to Improve Business Climate in Russia

Mainstream economic theory is cautious of government intervention in markets, but it does support public policies aimed to correct market failures and reduce transaction cost of economic interactions. The development of globalization stimulates new debates about the changing role of the national states in economic development and good governance.[22] On one hand, 'the state itself is in its death throes, we are constantly told. For this is the era of "civil society" and "postmodernity," of "global society" and the transnational market. [...] Wherever we look across the social sciences, the state is being weakened, hollowed out, carved up, toppled or buried.'[23] Others agree that the role of the national state is changing to accommodate new societal and international demands, but argue there is no reason to expect its domestic dominance to diminish any time soon.[24]

Despite the increasing globalization, the national state remains the fundamental element of contemporary governance.[25] Moreover, recent studies suggest that the national state becomes strategically important for a success in

22 While the concept of government usually refers to the formal governing processes at the nation state level, governance is commonly regarded as patterns that emerge from the governing activities of state and non-state actors operating at subnational, national and international levels. For a review of the concept and the indicators of governance, see Daniel Kaufmann and Aart Kraay, "Governance Indicators: Where are We, Where Should We Be Going?", *The World Bank Research Observer* 23, no. 1, (2008): 1–30.

23 See Linda Weiss, *The Myth of the Powerless State* (Ithaca, NY: Cornell University Press, 1998): 2.

24 See Saskia Sassen, "The State and Globalization," *Interventions: International Journal of Postcolonial Studies* 5, no. 2 (2003): 241.

25 See Graeme, Gill, *The Nature and Development of the Modern State* (London: Palgrave Macmillan, 2016).

the global economy. Based on experiences of Brazil and other Latin American countries, Carlos Bresser-Pereira concluded that: 'given the competition that characterizes globalization, nation-states have become less autonomous, but, as a trade-off, their role has become more strategic.'[26] Under the forces of globalization, 'the role of government is progressively shifting toward providing an appropriate enabling environment for private (corporate) enterprise.'[27] In general, as Dani Rodrik argues, the key role of national governments is to minimize transaction costs within national boundaries thus making national economies competitive in global economy.[28] In order to minimize the transaction cost, the state must be able to provide good governance, be limited and insulated from the political pressures of special interest groups.[29]

Domestic governance is improved when there are fewer incentives for politicians to engage in venal, greedy, corrupt, and rent-seeking methods of governing. A necessary condition of good governance is the existence of effective mechanisms of political accountability.[30] The possibility of consequences (rewards and sanctions) is a constitutive element of accountability relations. It is important to distinguish between formal political accountability mechanisms and real opportunities to impose the consequences on politicians and bureaucrats.[31] Regular and fair elections allow citizens to discipline politicians but it is not sufficient condition for an effective political accountability.[32] In fact,

26 See Luis Carlos Bresser-Pereira, *Globalization and Competition: Why Some Emergent Countries Succeed while Others Fall Behind* (New York: Cambridge University Press, 2010): 2.

27 See Ali Farazmand, ed., *Sound Governance: Policy and Administrative Innovations* (Westport, CT: Praeger, 2004). See also Ali, Farazmand, "Governance Reforms: The Good, the Bad, and the Ugly; and the Sound." *Public Organization Review* 17, no. 4 (2017): 595–617.

28 See Dani Rodrik, *The Globalization Paradox*. (Oxford: Oxford University Press, 2011).

29 See Pranab Bardhan, "State and Development: The Need for a Reappraisal of the Current Literature," *Journal of Economic Literature* 54, no. 3 (2016): 862–92.

30 See Alicia Adserà, Carles Boix, and Mark Payne, "Are You Being Served? Political Accountability and Quality of Government", *Journal of Law, Economics, and Organization* 19, no. 2 (2003): 448.

31 See Mark Bovens, "Two Concepts of Accountability: Accountability as a Virtue and as a Mechanism", *West European Politics* 33, no. 5 (2010): 946–967; Johan P. Olsen, "Democratic Accountability and the Terms of Political Order," *European Political Science Review* 9, no. 4 (2017): 519–537.

32 See Luigi Manzetti and Carole Wilson, "Why Do Corrupt Governments Maintain Public Support?" *Comparative Political Studies* 40, no. 8 (2007): 949–970; Guillermo Cordero and Andre Blais, "Is a Corrupt Government Totally Unacceptable?", *West European Politics* 40, no. 4 (2017): 645–662.

'ensuring accountability to and for the public's interest is, perhaps, the most vexing problem within contemporary democracies.'[33]

States with effective economic policies are not only accountable but also have sufficient political and administrative capacity.[34] In other words, in effective states politicians and bureaucrats are both *motivated* and *capable* to provide effective governance. The literature increasingly recognize the importance of state capacity as a fundamental ingredient for effective governance and national competiveness.[35] For example, Francis Fukuyama views 'quality of governance' as a government's ability to make and enforce rules.[36] Tobin Im and Youngmi Choi present government capacity as an important component of national competitiveness.[37] Andrei Melville and Mikhail Mironyuk review state capacity of post-Soviet nations in terms of major characteristics that enable the state to act effectively.[38] Among the most important indicators of the state's capacity are effective abilities to collect taxes (weaker states mostly rely on rents from exports of natural resources) and to protect private property.

In general, state capacity has two sources: from above (where authoritarian regimes have a relative advantage because of their hierarchical structure and repressive resources), and from below (where democracies are more effective due to a combination of electoral and societal accountability, media freedom, as well as institutional checks and balances which create 'horizontal' or intrastate accountability). As far as state capacity is concerned, states in the middle (like Russia), with weak democratic institutions, find themselves the most vulnerable.[39] They do not have the tight and efficient top-down hierarchy due to

33 See Joy M. Moncrieffe, "Accountability: Idea, Ideals, Constraints," *Democratization* 8, no. 3 (2001), 26.

34 See Brian Smith, *Good Governance and Development* (Palgrave Macmillan, 2007).

35 For a review, see Antonio Savoia and Kunal Sen. "Measurement, Evolution, Determinants, and Consequences of State Capacity: A Review of Recent Research," *Journal of Economic Surveys* 29, no. 3 (2015): 441–458.

36 See Francis Fukuyama, "What is Governance?", *Governance* 26, no. 3 (2013): 347–368.

37 See Tobin Im and Youngmi Choi, "Rethinking national competitiveness: A Critical Assessment of Governmental Capacity Measures," *Social Indicators Research* 135, no. 2 (2018): 515–532.

38 See Andrei Melville and Mikhail Mironyuk, "'Bad enough governance': State Capacity and Quality of Institutions in Post-Soviet Autocracies," *Post-Soviet Affairs* 32, no. 2 (2016): 132–151.

39 See Jessica Fortin, "Is There a Necessary Condition for Democracy? The Role of State Capacity in Postcommunist Countries," *Comparative Political Studies* 45, no. 7 (2012): 903–930; Michelle, D'Arcy and Marina Nistotskaya, "State First, Then Democracy," *Governance* 30, no. 2 (2017): 193–209.

the weakening of the authoritarian order, nor do the institutions of democratic control from function at a sufficient level, being still underdeveloped.[40] For the countries of post-Soviet Eurasia, bad governance is a common problem.[41]

Institutions (rules) aim to reduce transaction costs, or the costs of the market transactions and division of labor. The state and national institutions provide guarantees for property, contracts and obligations: in short, they create a favorable national business climate. There are an increasing number of indexes that present empirical estimates of the competitiveness of national and regional economies. In particular, there is annually published by World Economic Forum *Business Competitiveness Report*, which is based on Michael Porter's methodology. The Forum defines national competitiveness as the 'set of institutions, policies and factors that determine the level of productivity of an economy'.[42] In the 2017–2018 Report, the Russian Federation occupies 38th position globally – this is an improvement of 5 positions from the previous ranking. However, the report outlines that the Russian economy remains highly dependent on mineral exports and its prospects remain uncertain. The report also states that in Russia institutions and rules are weak (83th global rank), in particular, in the financial markets (107th), property rights (106th) and judicial independence (90th). Corruption remains one of the most problematic factors for doing business in Russia.

In Russia political incumbents both lack accountability and do not have a continuing means of sustaining state capacity. As the central state in Russia is not willing or capable to provide good governance, perhaps there are some regional and local authorities who could govern more effectively? However, in the Russian case, political and economic over-centralization denies regional and local leadership legal and financial means necessary to provide better governance locally.[43] Thus, regional and local authorities even if they wanted

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40 See Hanna Bäck and Axel Hadenius, "Democracy and State Capacity: Exploring a J-Shaped Relationship," *Governance* 21, no. 1 (2008), 1–24; Mark Robinson, "Hybrid States: Globalisation and the Politics of State Capacity", *Political Studies* 56, no. 3 (2008): 566–583; Maria Franco Chuaire, Carlos Scartascini, and Mariano Tommasi, "State Capacity and the Quality of Policies: Revisiting the Relationship between Openness and Government Size," *Economics & Politics* 29, no. 2 (2017): 133–156.

41 For some explanations, see Vladimir Gel'man, "Political Foundations of Bad Governance in Post-Soviet Eurasia: Toward a Research Agenda," *East European Politics* 33. no. 4 (2017): 496–516.

42 See Klaus Schwab and Xavier Sala i Martin, *Global Competitiveness Report 2017–2018* (World Economic Forum, 2017), 11.

43 See Cameron Ross, "Federalism and Inter-Governmental Relations in Russia," *Journal of Communist Studies and Transition Politics* 26, no. 2 (2010): 165–187; David, White, "State

could not significantly compensate the insufficient quality of the state at the national level.[44] Of course, the regions of Russia are very different in terms of their potential attractiveness to investors – and the Perm or Sverdlovsk region is difficult to compare with Ingushetia or Buryatia. In fact, empirical studies show that, moving from the average to the top governance quality across Russian regions could more than double the regional FDI stock.[45] However, poor quality of national governance in a way 'equates' investment opportunities of Perm and Buryatia. If investors could invest *only* in Russia (and not in the whole world), then they would certainly prefer Perm to Buryatia, but the broadest opportunities of globalization together with bad national governance create a situation when both Perm and Buryatia do not hold up to the thresholds which would make them attractive enough to investors.

3 Regions Adapting to Global Competition: Two Capital Cities and Regions Rich in Natural Resources

The poor quality of governance prevents most Russian regions from actively participating in the global economy. However, as we argue above, low quality of governance at the national level could be compensated by unique comparative advantages. Russia's comparative advantages are limited oil, natural gas, metals and wood which are geographically concentrated. Such comparative advantages provide only few Russian regions and cities with opportunities to participate actively in global economic competition. Thus, the combination of globalization and low quality of the national governance contributes to increasing territorial differences within Russian economy.

A recent World Bank study demonstrates that the degree of foreign orientation is an important determinant of regional socioeconomic development. Regions with the highest degree of participation in globalization (e.g. regions with either relatively high per capita mineral exports, relatively high per capita

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Capacity and Regime Resilience in Putin's Russia." *International Political Science Review* 39, no. 1 (2018): 130–143.

44 See Luis Moreno and Anastassia Obydenkova, "Federalization in Russia and Spain: the Puzzle of Reversible and Irreversible Outcomes", *Regional & Federal Studies* 23, no. 2 (2013): 151–168; Gulnaz Sharafutdinova, "Gestalt Switch in Russian Federalism: The Decline in Regional Power under Putin", *Comparative Politics* 45, no. 3 (2013): 357–376; Willam M. Reisinger and Bryon J. Moraski, *The Regional Roots of Russia's Political Regime* (Ann Arbor, MI: University of Michigan Press, 2017).

45 See Olga Kuzmina, Natalya Volchkova, and Tatiana Zueva, "Foreign Direct Investment and Governance Quality in Russia," *Comparative Economic Studies* 42, no. 4 (2014): 874–891.

FDI, or both) – have the highest standard of living while the regions with the lowest foreign orientation have the lowest degree of economic prosperity.[46]

Scholars have identified the most important determining factors for the FDI inflows into Russian regions – such as GDP per capita in the recipient region, distance from the investor to Moscow, the economic situation in the region, the innovative capacity of the region and the FDI inflow in the previous period. The problem is that those factors are highly concentrated and thus, 'FDI inflows into Russia are concentrated only in few regions.'[47]

The distribution of FDI across Russia's regions is significantly more concentrated than the distribution of GDP or population. Before the 2014 crisis, around half of FDI flows went to Moscow city, Moscow oblast and St. Petersburg. Seven regions attracted no FDI at all. After 2014, the volume of FDI declined significantly yet the pattern of the allocation remains the same. In 2016, according to the EY – a consulting company, there were 205 projects that received direct investments from foreign investors in Russia. As for the geography of the FDI projects, the overwhelming majority of them fell to the Central Region of Russia. One fourth of the projects involving foreign direct investment went Moscow or the Moscow region, there were 49 projects in total. Fifteen projects started in St. Petersburg and the Leningrad region.[48] In the next sections, we briefly examine two types of territorial communities with territorial advantages – the capital cities of Moscow and St. Petersburg as well as the regions rich in natural resources.

The Capital Cities and Their Agglomerations

From early modern times until the present, Russia had two capital cities: Moscow and St. Petersburg. The two capital cities traditionally sucked lion share of financial resources of over centralized Russia. After the Soviet collapse Moscow as the capital city continued to play an exceptional economic, social, cultural and political role in Russia.[49] As John O'Loughlin and Vladimir Kolossov stressed, this is almost paradoxical that democratization, federalization and

46 See Karlygash Dairabayeva, Michael Ferrantino, Alberto Portugal-Perez, and Gabriela Schmidt, "Export competitiveness and FDI performance across the regions of the Russian Federation" (English), *Policy Research Working Paper,* no. 7821 (Washington, D.C.: World Bank Group. 2016).

47 See Oleg Mariyev, Igor Drapkin, Kristina Chukavina, and Heiko Rachinger, "Determinants of FDI Inflows: The Case of Russian Regions," *Ekonomika Regiona* 1, no. 4 (2016): 1244–1252.

48 http://www.ey.com/Publication/vwLUAssets/EY-attractiveness-survey-russia-2017-rus/$File/EY-attractiveness-survey-russia-2017-rus.pdf (accessed 8 April, 2018).

49 See James H. Bater, "Moscow's Changing Fortunes under Three Regimes," in: Josef Gugler, ed., *World Cities Beyond the West: Globalization, Development and Inequality* (Cambridge:

market reforms did not lead to reduction of the role of Moscow within Russian space.[50] In fact, it has effectively 'monopolized' the functions of a mediator between the country and the world economy and thus has become by far the most important national node of financial flows.

Since the early 1990s gross regional product of Moscow's agglomeration has been growing faster than the national gross domestic product and in 2017 it was more than 26 percent of Russia's total.[51] In 2010 93 percent of the total investments in the Russian commercial real estate were made in Moscow and Moscow region. Another 3 percent of the real estate investments were made in St. Petersburg, and only 4 percent – in the rest of Russia.[52]

In 2010 more than 3000 companies with foreign capital with around half a million employees were registered in Moscow.[53] According to Mercer's 2013 cost-of-living survey, Moscow was ranked as the most expensive city in Europe and the second most expensive in the world. It ranked as the 9th most expensive city in 2014 and 50th – in 2015 (St. Petersburg – correspondingly 35th and 152th) as a result of Russia's rubble losing significant value against the US dollar, lower oil prices, and a lack of confidence in the currency following Western sanctions over the crisis in Ukraine.[54]

One of the explanations for the special status of Moscow is that, in Russia geographic proximity to 'central' politicians and officials contributes to success of foreign direct investments. According to Natalia Zubarevich, in the modern Russian political regime the status of capital city is one of the most important institutional factors of economic success. Effectively Moscow acquires a special 'Capital City Rent' – a territorial version of bureaucratic rent due to the high level of rent-seeking and corruption opportunities in Russia. This rent emerges due to over-concentration in Moscow of headquarters of the largest companies that play leading role in Russia's economy.[55] For example,

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Cambridge University Press, 2004), 191–211; Irina Busygina, "Der Platz and die Rolle Moskaus in der Russlaendischen Foederation," *Osteuropa* 49, nos. 11–12 (1999): 1144–1156.

50 See John O'Loughlin and Vladimir Kolossov, "Moscow: Post-Soviet Developments and Challenges," *Eurasian Geography and Economics* 43, no. 3 (2002): 161–169.

51 https://riamo.ru/article/222915/dolya-moskovskoj-aglomeratsii-v-vvp-rossii-sostavlyaet-26-3-.xl (accessed 8 April 2018).

52 http://www.arendator.ru/articles/2/art/45503/pg/3/html (accessed 8 April 2018).

53 http://www.investmarket.ru/NewsAM/NewsAMShow.asp?ID=536055.htnl (accessed 8 April 2018).

54 https://www.mercer.com/newsroom/cost-of-living-survey.html (accessed 8 April 2018).

55 See Natalia Zubarevich, "Four Russias: Human Potential and Social Differentiation of Russian Regions and Cities", in: Maria Lipman and Nikolay Petrov, eds. *Russia 2025* (London: Palgrave Macmillan, 2013), 67–85.

the growing state involvement in the credit sector has stimulated concentration of banks in Moscow and now practically in every region largest commercial banks are branches of Moscow banks.[56] All in all, as long as the system of power and business in the country is super-centralized, Moscow will receive 'fantastic bonuses', and the talk is already not about Moscow's competitive advantages vis-à-vis other Russian regions, but about its 'hyper-break from becoming poorer country'.[57]

The post-Soviet decades have witnessed the unprecedented growth of the city of Moscow due to mass migration inflows, and apparently official statistics does not always reflect the situation.[58] Moscow mayor Sergey Sobyanin claimed that the official records underestimate the number of residents in Moscow: 'first, the real boundaries of the Capital City have long been beyond the Moscow Ring Road, second, many residents of the surrounding territories, work in the City. So, in fact there are not 12, but 25 million people who live in Moscow agglomeration'.[59] In fact, one of the most important sources of wealth of the metropolitan agglomeration is income from labor migrants. In 2016 labor migrants paid 6.8 billion rubles in income taxes to the Moscow budget, which is 2.3 times higher than the revenues from the oil companies registered in the capital.[60]

Saint Petersburg agglomeration, Russia's 'second capital' is smaller than Moscow, however, as Anokhin et al. show, this is Sankt Petersburg that serves a testing ground for studying global urban trends in Russia as well as the trends characteristic for the development of European cities.[61] Indeed, Saint Petersburg, more precisely Saint Petersburg coastal region that includes the city of Saint Petersburg and the Leningrad region, holds a unique position in Russia's spatial system as it combines territorial advantages of large agglomeration, transport and resource region, and border seaport region, located on international trade routes.[62]

56 See Svetlana Ageeva and Anna Mishura, "Regional disparities in the development of banking institutions," *Regional Research of Russia* 6, no. 4 (2016): 304–313.

57 http://polit.ru/article/2018/03/06/moscow/(accessed 8 April 2018).

58 See Vadim Rossman, "In Search of the Fourth Rome: Visions of a New Russian Capital City," *Slavic Review* 72, no. 3 (2013): 505–527.

59 http://riarealty.ru/urban/20160701/407656507.html.

60 https://lenta.ru/news/2016/08/06/migrants_pay/ (accessed 8 April 2018).

61 See A. Anokhin, S.S. Lachininskii, D.V. Zhitin, A.V. Shendrik, N.M. Mezhevich, and A.I. Krasnov, "Post-Soviet Urban Environment: The Experience of St. Petersburg", *Regional Research of Russia* 7, no. 3 (2017): 249–258.

62 See Sergei Kuznetsov, and Sergei Lachininsky, "Modern Understanding of Geo-economic Position and the Saint Petersburg Agglomeration", *Baltic Region* 1, no. 19 (2014): 81–82.

During the times of nation-wide economic crisis Saint Petersburg and Leningrad region belonged to the regions that have managed not only to maintain positive economic growth, but to increase the investment inflow as well.[63] In 2014 the city of Saint Petersburg has even overtaken Moscow in a global rating of financial competitiveness known as the Global Financial Centers Index (GFCI), compiled by the London-based consultancy Z/Yen Group. This jump was first of all due to the city's role as a center for foreign investment. In addition, St. Petersburg adopted a new strategy in 2014 that facilitates a substantial increase in foreign investment.[64]

Regions Rich in Natural Resources

The geographic distribution of foreign direct investments in Russia shows that besides Moscow only a few locations have managed to become integrated into the global economy. Topmost among these locations are regions with natural resources. In fact, practically almost all empirical studies point out the primary significance of natural resource endowment as a location determinant of FDI in Russia. For example, Ksenia Gonchar and Philip Marek analyzed records of nearly ten thousand Russian enterprises with a foreign shareholder in the period 1999–2009, across 83 regions. The empirical results indicate that though both resource endowments and other market advantages matter for the distribution of FDIs across Russian regions, the significance of oil and gas endowment grows overtime.[65] Similar, Kayam, Yabrukov, and Hisarciklilar demonstrated that FDI allocation in the Russian regions chiefly depends on natural resources and the size of market.[66]

For instance, the unique energy-rich Sakhalin region at the Russian Far East is seen as a new gateway for the growing world demand for natural resources,

63 These regions rank high in the 2015 investment attractiveness rating worked out by National Rating Agency (NRA). In NRA's opinion, regions most attractive for FDI include not only large megapolises (such as Moscow and St Petersburg) or oil producing territories (Tyumen and Sakhalin Oblasts), but also a number of other sub-federal entities, such as the Republics of Tatarstsan and Bashkortostan, Krasnodar Krai, Belgorod, Leningrad, Moscow, Kaliningrad, Kaluga, Lipetsk and Samara Oblasts (http://www.ra-national.ru/en/node/58679 accessed 16 April 2018).

64 https://www.rbth.com/economics/2014/12/02/st_petersburg_rated_most_financially_competitive_city_in_the_countr_40075 (Accessed 17 April 2018).

65 See Ksenia Gonchar and Philipp Marek, "The Regional Distribution of Foreign Investment in Russia." *Economics of Transition* 22, no. 4 (2014): 605–634.

66 See Saime Suna Kayam, Alexandr Yabrukov, and Mahtap Hisarciklilar, "What Causes the Regional Disparity of FDI in Russia? A Spatial Analysis," *Transition Studies Review* 20, no. 1 (2013): 63–78.

and one of its most valuable Russia's geographic assets – first of all in terms of its trade, energy production and forest and ocean resources. Sakhalin island has an estimated 45 billion barrels of oil equivalent (BOE), making it one of Russia's most important oil and gas producing regions and a prime target for foreign investment. Vast resources drive Sakhalin's largest energy extraction projects: Sakhalin-1 and Sakhalin-2, both operated by international consortiums.[67] The experts of the Higher School of economics argue, that if Sakhalin would be sovereign country, it would join the group of high income countries.[68]

4 Asymmetric Political Demands in Russia

Today, according to the level and depth of regional differences, Russia is ahead of not only developed countries, but also of developing countries. Word Bank experts emphasize that If Russian regions were separate countries the highest-income regions would be considered high-upper-middle income or high-income countries. For example, the per capita income of the Far Eastern region of Sakhalin (almost $16,000 in real PPP terms) would qualify it for the World Bank's high-income group if it were a separate country. The per capita income in the Sakhalin region is among the highest in the country and it is 10 times higher than in Kalmyk region (the region with the third lowest per capita income). In fact, the lowest per capita income regions are comparable to many countries in Sub-Saharan Africa.[69]

Overall, the 'big six' regions – cities of Moscow and Saint Petersburg, Moscow oblast, Tyumen Oblast, and Khanty-Mansi and Yamal-Nenets autonomous districts, consistently occupy the leading economic positions. These regions account for almost half of the domestic GDP, they are the main donors to the federal budget, and form the largest part of consumer demand. Most of the country's largest corporations operate in these regions.[70] Alexander Novikov points at the interesting peculiarity of this six-region group: while two capital

67 https://www.aljazeera.com/indepth/opinion/2011/08/201182111112465596.html (Accessed 17 April 2018).

68 https://www.rbc.ru/economics/17/09/2016/57dc1c649a7947834a1d1f01 (Accessed 17 April 2018).

69 See Karlygash Dairabayeva, Michael Ferrantino, Alberto Portugal-Perez, and Gabriela Schmidt, "Export Competitiveness and FDI Performance Across the Regions of the Russian Federation", *Policy Research Working Paper*, no. 7821 (Washington, D.C.: World Bank Group. 2016).

70 See Alexander Novikov, "Regional Disparities in the Socio-Economic Development of Russia", *Naukovedenie,* no. 1 (2013).

cities together with Moscow oblast host largest corporations, the other three regions are rich in natural resources (oil and gas) and, therefore, provide financial resources that are then redistributed in both capitals. Novikov argues that the link between two types of regions – metropolitan and resource-oriented leads to the unique 'concentration of territorial advantages.' The obvious problem is that the population of most other regions could not enjoy the level of economic prosperity concentrated in the leading group.[71]

Already in 1997, stressing the growing significance of the economic differences across Russian regions, Philip Hanson has exclaimed 'How Many Russias?'[72] Since then, economic and political differences have significantly accumulated. By the 2010s, the disparities between the regions have reached the point when researchers stressed existence and significance of three or four economically and politically distinctive parts of Russia. First, there was 'Russia-1' of the large cities. It included twelve cities with the population over one million people and two smaller cities (Perm and Krasnoyarsk) with a total of around 20 percent of the country's population. Second, there was 'Russia-2' of industrial cities. Third – peripheral 'Russia-3' of small towns and village settlements, and finally, 'Russia-4' of ethnic republics of Northern Caucasus and Southern Siberia. With regards to their interests, priorities and values they represent four different 'worlds'.[73] Political observers supported the concerns of the political geographers: well-known publicist Kirill Rogov talked about distinctive 'parts of Russia' as oriented towards distinctive socio-economic models and political demands.

The inequality of economic opportunities and expectations of population in the distinctive parts of Russia have already determined inconsistent political demands and political actions across the nation.[74] In 2011 comparatively well-off regions and large cities were consistently over-represented in protest activism over other, with the largest share of the protests in Moscow and St. Petersburg. Economically underperforming regions and small cites were noticeably under-represented in protests.[75] In particular, the population of small cities expected from Kremlin more budget subsidies, while the population

71 See Novikov, "Regional Disparities", 4.

72 See Philip Hanson, "How Many Russias? Russia's Regions and their Adjustment to Economic Change," *International Spectator* 32, no. 1 (1997): 39–52.

73 See Zubarevich, "Four Russias".

74 See Irina Busygina and Mikhail Filippov. "The Calculus of Non-Protest in Russia: Redistributive Expectations from Political Reforms," *Europe-Asia Studies* 67, no. 2 (2015): 209–223.

75 See Tomila Lankina and Alisa Voznaya, "New data on protest trends in Russia's regions," *Europe-Asia Studies* 67, no. 2 (2015): 327–342.

of large cities was more likely to demand an accountable, transparent, less corrupt, build on the rule of law governance.[76]

5 Conclusion

There are many reasons why one should expect domestic and foreign investors to direct their capital to the Russian regions: large potential markets, abundance of primary resources, relatively low labor costs, available telecommunication networks, and educated population. In practice we see that, most investments that arrive go to the capital cities and few selected regions.

Above we argue that an important factor explaining existing and growing regional economic disparities is low quality of national governance, where the process of globalization serves as an intermediate mechanism working to raise the disparities. Globalization and the quality of national governance boost each other's effect: the former magnifies the advantages of good governance as well as the losses from poor governance. Territorial comparative advantages can mitigate the negative impact of globalization, but only in specific localities of poorly governed nations. In the Russian case, low quality of national governance makes most regions (despite very significant differences between them) unable to compete in the global economy, depriving them of an opportunity to attract domestic and foreign investments. The combined force of globalization and low quality of governance in Russia sharpens regional inequalities and – as a consequence – the level of economic asymmetries and the resulting political polarization. If globalization is indeed going to sharpen interregional inequalities then – as a consequence – the level of political polarization in Russia will further increase.

The literature linking globalization and growing inequality stresses 'very different effects on participants and non-participants'.[77] The excluded, the non-participants, stand to lose from globalization, and this effect contributes to the increase of inequality both at national and sub-national level. In the Russian case, it means that if Russia as a nation is losing from globalization, and if the contributing factor is its low quality of governance, then the source of poor

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76 Interview of the President of Centre for Strategic Research, Mikhail Dmitriev, *RIA Novosti*, 14 March 2012 http://ria.ru/interview/20120314/593787664.html (accessed 8 April 2018).

77 See Peter H. Lindert and Jeffrey G. Williamson, "Does Globalization Make the World More Unequal?" in: Michael D. Bordo, Alan M. Taylor, and Jeffrey G. Williamson, eds. *Globalization in Historical Perspective* (Chicago: University of Chicago Press, 2003): 227–276.

governance could also be blamed for the growing inequality of economic opportunities across the Russian regions.

We suggest that in order to create political conditions stimulating more equal economic opportunities among the Russian regions, fundamental causes behind Russia's poor governance must be addressed. This may mean initiating a genuinely competitive political process at the national level and modernizing the state, bureaucracy in order to strengthen institutional compliance and reduce corruption.