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Corruption and International Business Community
Is Integration into International Business a means of Reducing Corruption? The case of Russia

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***Abstract*—**The article examines an opportunity of corruption restriction exercised by international business community in Russia. Integration of Russian economy into the international business does not reduce corruption inside the country. Foreign actors investing in Russia under the condition of obtaining their required rates of returns will be reluctant to harm their investments by involving into anti-corruption activities. Furthermore, many Russian firms' competitive advantage could be directly related to their corruption connections. In this case, foreign investments would only accentuate corrupt companies' success by supporting them financially

***Keywords*—**Corrution, FDI, Russian Federation

I. Introduction

CORRUPTION is often defined as the misuse of public office for private gain [4]. Recent research, as demonstrated by meta-analysis articles, confirms negative consequences of corruption for country's economic development. A genuine link between higher corruption and lower economic growth is confirmed by numerous studies [5]. Corruption restricts foreign direct investments [7], negatively affects human capital development and undermines the efficient use of economic resources [11]. Often, these negative effects of corruption are compared to these of taxes, differing primarily in that the payment does not end up as public revenues, depriving governments of providing public goods [25]. However, recent research suggests that on a firm's level corruption can be more damaging than taxation, because of high level of secrecy and uncertainty involved in corrupt transactions. [Shleifer, Vishny, 1993]. Hypothetical rights acquired in a corruption transaction cannot be enforced in courts. A firm can spend a lot of time searching for potential bribe-taking counterparty. Kaufmann and Wei [12] point out that more bribe payment is not associated with time savings on delays and lower burden on firms, as firms generally spend more time to negotiate corruption deals. Shleifer and Vishny [1993] state that the very system of heavy regulatory burden is created and promoted by corrupt-prone officials in order to extract more bribes.

Fismann and Svennson [2007] attempt to give an estimation of magnitude at which corruption affects economic growth on a firm level. Researching a complete data set on bribe payment of Ugandan firms, they estimate that a one percentage point increase in the bribery rate (defined by bribe payments divided by sales) is associated with a reduction in firm growth of more than three percentage points. As compared to taxation impact, corruption effect appears to be 2,5 times greater.

The relationship between corruption and growth is complex with many exceptions related to different regions (as such the literature continues to provide support to phenomena such as the so-called Asian paradox, a positive correlation between corruption and growth in a number of successful Asian economies, including China). Academic research and international community mostly support the point of view that corruption negatively affects economy. Key international policy actors such as the IMF, World Bank and the OECD, as well as an increasing number of anti-corruption agencies and campaigns continue their effort in reducing corruption.

International effort from policy forming bodies and NGOs is not sufficient in itself. Private business implication is as much important. Some researchers argue that companies as the main party of corrupt transactions should also renounce extortion demands. Firms should preserve the functioning legal environment in which they operate in order to be able to benefit from commonly established rules of the game. Rose-Ackerman [21] argues that firms created in the framework of legal systems have a moral obligation to refrain from corruption. Even if individual corrupt deal is efficient, actions that contribute to the acceptability of corruption in the marketplace undermine global economic efficiency for society on the whole.

In this connection, some liberal politicians as well as academic researchers in Russia express hopes that developing international openness of Russian business will serve to restrict corruption in Russia. [29] , [15].

The article examines an opportunity of corruption

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restriction exercised by international business community in Russia. My main hypothesis is that integration of Russian economy into the international business does not reduce corruption inside the country. Foreign actors investing in Russia under the condition of obtaining their required rates of returns will be reluctant to harm their investments by involving into anti-corruption activities. Furthermore, many Russian firms' competitive advantage could be directly related to their corruption connections. In this case, foreign investments would only accentuate corrupt companies' success by supporting them financially.

First, I examine the resent research related to corruption in Russian and analyze the nature of Russian corruption and its extent. Then, I focus on potential instruments of control over corruption which could be used by international business community in order to restrict the corruption in Russia. In particular, I focus on foreign direct investments (FDI) and listings of Russian companies' equity on foreign exchanges. I conclude with an analysis of potential efficiency of these instruments.

II. The reality of corruption in Russia

The founding country of the Soviet Union, Russia made spectacular progress in its economic development during the past 20 years. In 2009, the World Bank put Russia to the 6th rang of the world GDP by country. Thanks to a growth level approximating 6% on average over 1998 – 2009, in 2009 Russia with a GDP amounting to 2,7 bn of international dollars, was placed behind Germany and bypassed the United Kingdom in the world GDP rating [World Bank, 2010].

This spectacular economic progress was followed by a deep implanting of corruption. In 2009 Transparency International Index Russia was placed 146th out of 180 countries. It is difficult to judge on the corruption evolution across a certain time period based only on TI index, as data collection and analysis methodology change from year to year. However, other studies show a steady increase in corruption level in the country during the 2000th. Anderson and Gray [1], analyzing a panel of corruption and governance studies related to Russia, state that almost all of these studies conclude that corruption increased or accentuated. Thus, The Executive Opinion Survey, conducted by World Economic Forum, confirms the deterioration of the governance climate, especially in the domain of judiciary power. A local NGO, Indem Foundation, conducted two in-depth comparable studies of corruption in Russia in 2000 and 2005, interviewing more than 1000 Russian companies [Indem, 2001 and 2005]. According to these studies, the volume of informal payments to public officials by Russian businesses increased 10-fold from 2000 to 2005. Bribe volume in Russia passed from $33,5 bn in 2001 to $316 bn in 2005. If in 2000 for an average business bribe one could buy an apartment of circa 30 m2 in Moscow, in 2005 an apartment of 209 m2 could be bought for the average bribe. Authors state the relative harm of corruption to the Russian economy, which receives less public investments and public goods and deters foreign investments.

Corruption is the focal point of many Russian politicians, who regularly launch notorious fight campaigns against it. Mr. Medvedev announced that fight against corruption is one of his top priorities. Even Mr. Putin, answering a teleconference question, stated that the main failure of his presidency was the failure to curb corruption [2].

Legally, public authorities succeeded in creating a modern and elaborated toolbox to fight corruption. From the legal point of view, corruption, bribe taking as well as proposing bribes are criminal offences in Russia, with a maximum penalty of 15 years of incarceration. Penalty somewhat varies depending on the bribe amount, however, the threshold of large bribes is of 150 000 rubles, or circa 3 500 €, which is relatively small considering the country's salaries and incomes level. Other normative documents regulate counteraction and preventive measures against corruption. Since 2008 the law on corruption counteraction prescripts income declaration for state parliament deputies and high rank civil servants, including their family members. During 2010 many politicians and civil servants indeed published their and their family members' incomes for 2009. Most of the politicians showed relatively moderate incomes. However, their wives and other family members boasted of much higher revenues [3]. These publications were not followed by detailed inspections or audits; they went almost unnoticed by the press and the state television. Some on-line publications did not stir up large public discontent due to their restricted auditory.

Legal framework alone does not create a necessary basis for fight against corruption. The functioning of legal enforcement institutions can be restrained by resistance of political elite. According to many researchers [Indem, 2001 and 2005], corruption in Russia deeply affects its judicial system. Along with road control police local courts and police were named the most corrupt institutions in the country. Corrupt judiciary does not only favor those who pay over those who do not. It also renders almost impossible the execution of corrupt officials. In Russia, judiciary can also carry out direct orders of executive authorities, using legal persecution to reach some political goals. The best example of this situation would be the second trial over Mr. Khodorkovsky, a former CEO of Yukos, an oil company, now turned prisoner for his political ambitions.

Russian researchers also note the evolution of corruption character from the presidency of Mr. Yeltsin to the Mr. Putin's and following the nominal presidency of Mr. Medvedev. Researching corruption evolution during this time frame, [2] notes that corruption became more centralized and institutionalized. During Mr. Yeltsin's era corruption remained highly deregulated and eparpilated with multiple officials extorting arbitrary amounts of bribes. Today's corruption evolved towards centralized system with a well-balanced sharing of its fruits throughout the entire public administration hierarchies.

Nureev [2006] proposes an original classification of Russian capitalism based on historical observations starting

from the collapse of the Soviet Union. This classification brings interesting insights into the character of Russian corruption. Russian capitalism can be assessed with three main capitalist types: (i) competitional, where the state creates and supports the rules of the game and restrains from interference in private business, (ii) oligarchic, where economy is dominated by large firms and the ultimate relationship between state and business can be described as 'state capture' [Hellmann, Kaufmann, 2001] and (iii) state-corporative, where state exercises an important role in economic affairs, defines and implements its vision of national economy. The third type of capitalism ultimately leads to the 'business capture by the state'. Nureev classified the modern Russian economy as the third type. In this situation the internal fight against corruption is almost impossible. Supported by high natural resources rents, the system is quite stable and the local business community prefers system's visual stability to its efficiency. Business community with low level of organization [Yakovlev, 2005] chooses the strategy of individual survival over the increased efficiency for the society as a whole.

Is there any alternative to this development path, which could introduce new forces in curbing corruption on the local level? We propose to consider international integration and openness of Russian business as a possible counterweight to corruption in the country. At each stage we will analyze theoretical research on the subject and then apply its postulates to the case of Russia.

III. International Integration of Russian Business and Corruption

International openness can be assessed through multiple channels. I propose to analyze two of them: the foreign direct investments (FDI) and equity listings of Russian corporations on major international financial markets. Also, researchers often site exports and imports as indices of economic openness [Treisman, 2000, Judge, McNatt, Xu, 2010]. However, a large part of Russian exports is related to oil and gas industries. According to Rosstat, export of mineral products represented 70% of all Russian exports in 2008 [Rosstat, 2009]. As such, the specific nature of Russian exports, highly standardized and rare resources on a global scale of a foremost importance does not indicate the country's openness. Hardly any country or economic agent could refuse these kinds of products. As such, we did not include it in our analysis.

A. Foreign direct investments

Evidence from academic research supports the negative effects of corruption on FDI. According to [7], companies competing in global industries know that operations success in one market will critically influence the performance of other markets in their network. Thus, rampant corruption may lead to a delay in investment in the country in question or a move to an alternate location. They found that the level of FDI in a country is negatively correlated with its Corruption Perception Index, published by Transparency international.

One could expect that increase in corruption, as exposed above, would lead to decrease in FDI to Russia. A first look at the statistical data proves the opposite.

According to data, published by the Central Bank of the Russian Federation, which collects data on balance of payments accounts, FDI steadily increased since 2000 from $2,7 bn at a compound annual growth rate of 51% to reach $72,0 bn in 2008, the pre-crisis year. However, capital outflow also increased passing from $3,2 bn in 2000 to $ 55,6 bn. As such, net inflow in the country amounted to $34,8 bn for the period 2000 – 2008.

The global economic downturn negatively affected foreign direct investments in Russia. In 2009, inflow decreased by $ 38,3 bn as compared to 2008. The figures for January – October 2010 show a further decrease by $10,3 bn. Moreover, the crisis years changed the sign of net capital movement. In 2009 and the first ten months of 2010 the outflow of direct investments exceeded the inflows. On the overall, Russia lost $ 7,7 bn in 2009 and another $ 7,4 bn in the first ten months of 2010.

Taking out of consideration the crisis years of 2009 and the beginning of 2010, FDI flow in Russia seems to contradict the foundings of [7]. However, an analysis detailed by a country of origin shows that most FDI to the non-banking sector in 2008 and 2009 are originated from tax heaven countries, such as Bermuda, Virgin British Islands and Cyprus. For the period of 2008 and 2009, FDI from these three countries amount to 52% of total FDI inflows. Experts assume that these flows represent reinvestments of capital generated in Russia, which is then transferred to off-shore accounts through various tax saving schemes [OCDE, 2004]. As such, the increasing level of FDI in Russia, at least for the pre-crisis years, reflects at a large degree the internal movement of capital. Among other countries, which heavily invested in Russia in 2008 and 2009, are Germany (10% of total FDI in 2008 and 2009) and the Netherlands (18%). The Netherlands is a relatively small country with a liberal taxation system, so it can be assumed that the origins of capitals are most probably not Dutch. As such, it seems that out of industrialized world only Germany develops strong economic relations with Russia. Germany invested in some important Russian oil and gas infrastructure projects, in particular the Northern Stream, it also boasts of almost 2 million of Russian speaking population. USA the major industrial country, invested only $3,3 bn in Russian in 2007 and 2008, or only 3% of total FDI inflows to Russia.

Thus, the main conclusion here is that statistical data on FDI confirms Habib's and Zurawicki's thesis that FDI are negatively affected by corruption. Indeed, development of corruption in Russia can be the very reason of large inflow from tax heaven countries, as crony politicians and businessmen use bank accounts in lightly regulated countries for money-laundering.

Development path taken by Russia based in a major part on energy resources exports is not really affected by FDI. FDI inflows in Russia represent to a large extent the internal circle

of money transfers. As such, a potential decrease or a threat of it in FDI inflows to Russia will not serve as a major constraint to government action in reducing corruption.

B. Equity listings on international financial markets

Another way to invest in the country while gaining all the necessary protection of a powerful judiciary system is to buy shares of Russian companies listed on foreign exchanges. We propose to consider only foreign listings and exclude local stock exchange analysis for a number of reasons. Local stock exchanges are regulated by the country's authorities and their basic functioning can be influenced by local corruption practices. International investors reacting to some piece of news or a change in situation would be more reluctant to quit the local exchange altogether for reasons of licensing, access to the stock exchange, etc, whereas investors can easily switch from one stock to another inside a foreign stock exchange.

Theoretical research suggests that investors recognize corruption as an additional risk and thus require higher returns [Pantzalis, Park, Sutton, 2008]. Would international investors be reluctant to invest in Russian firms in case of a major corruption scandal? Would a clearly perceived increase in corruption level in Russia hamper investments?

IPO on foreign exchanges is a relatively new way of financing for Russian companies. The process started in 2006 and reached a significant scale by 2010 with a record pre-crisis year of 2007. The London Stock Exchange has been and remains the primary market for trading Russian shares internationally.

According to statistics from Uralsib, the Russian commercial and investment bank [cited by Lubomudrov, Molyneux, 2009], the total amount raised by Russian companies through 79 IPOs and SPOs to 2009 is $ 62.7 billion. Just over half of this ($ 32.9 billion) came in 2007, the biggest year so far for Russian IPOs. As an example, in 2007 Sberbank raised $3.304 billion and VTB raised $8.02 billion on the LSE, while in 2006 Rosneft raised $10.44 billion (constituting 3.82%, 22.6%, and 11.34% of the market capitalization of these companies). Russian shares are also listed on the Deutsche Borse, NASDAQ, First North, OMX, NYSE, and other exchanges [Kolleeny, Fedotov, 2009]. As of January 2010, there are 100 companies from Russia and the CIS region listed across the LSEG's markets.

In terms of performance Russian companies are outperforming main markets. A special index, FTSE Russian IOB Index, tracking 15 largest Russian companies listed on London Stock Exchange, was conceived by FTSE Group. Since its creation in December 2006, the index value increased by 5,4%. The total capitalization of Russian companies in the index reached $ 246 bn as of January 2011. For a comparable period of 5 year, London FTSE index increased by only 4% and French CAC 40 index decreased by 15%.

IPOs on foreign markets became a valuable financing solution for Russian companies, allowing them ultimately to raise large amounts of capital, which is not always possible on restricted local market.

As such, Russian case confirms the idea, expressed by Pantzalis, Park and Sutton, that higher returns are required for companies operating in corrupt environment in order to compensate investors for higher perceived risk due to corruption. As long as Russian companies outperform their foreign peers in terms of financial returns, investors will be willing to invest significant amounts of capital without any ethical consideration concerning corruption.

In some cases, foreign capitals may even act as contributors or "promoters" of corruption in a country. Under this assumption, foreign investors could support bribe-paying firms, whose competitive advantage is derived primarily from their connections to corrupt politicians. Naturally, investors would not be interested in the source of the firm's competitive advantage as long as required returns are gained from their investments.

Fan, Rui and Zhao [2008] research 23 cases of firms connected to politicians, which were involved in corruption scandals in China. One of the authors' conclusions suggests that bribe paying firms gain competitive advantages from rent seeking. A quick analysis of Russian firms traded on the foreign exchanges reveals that this hypothesis cannot be totally excluded from our considerations. Among Russian firms traded abroad the most important capitalization value relates to Rosnefty, a state owned company created following the largely illegitimate expropriation of Yukos assets. Puffer and McCarthy [2007] consider that the Yukos affair "raised additional doubts about institutions like private property and the court system, potentially resulting in serious damage to the country's economic future". Other firms include Basic Element, an aluminum holding, whose CEO, Mr. Deripaska, according to NY Times, is closely connected to Kremlin officials. Another fresh illustration concerns the recent partnership between BP and Rosnefty, in a situation where trials over assets transfers from Yukos to Rosnefty are not closed yet.

Investing in Russian companies, whose main comparative advantage might relate to their political connections, would accomplish investors' goals in terms of returns. However, this investment activity would support potentially inefficient firms. If bribes are means by which individual firms get ahead at the expense of those who do not pay, corruption reduces economic growth at the macro-level, gains for some firms are achieved through massive losses on the global society level.

In addition, Russian state in a context of absence of independent law enforcement institutions does not create any foreseeable threat to corruption prone companies and politicians. On the contrary, corruption accreted in the corps of Russian state to a degree that even loud corruption scandals do not lead to criminal investigations against allegedly guilty authorities.

A brief press analysis reveals a number of corruption scandals in Russia, which mostly involve subsidiaries of international companies, such as Siemens (sale of equipment for Russian hospitals), Diebolt (sale of ATM machines),

Daimler (bribery of public officials in order to get contracts for automobile purchases in 22 countries, among which Russia). Investigations against these companies were opened either through Foreign Corrupt Practices Act, a US law, in case of Daimler and Diebolt or through German legislation, in case of Siemens. In March 2010, Daimler was condemned by American judge to pay a fine of $185 m. However, no investigation was opened against its Russian counterparts in public sector at least no such mention is made public on the web site of Investigatory Committee of the Russian Federation, which is responsible for investigating all corruption offences in the country. An investigation was opened only against Siemens after the case was brought to the attention of the prime-minister [Sledstvennii komitet, 2010]. Diebolt's case is still under investigation by the SEC and Justice Department. However, again, no criminal investigation was opened against corrupt politicians in Russia.

In the context of permissiveness and ineffectual judiciary system, the level of equity investments in Russian economy will remain sustainable until above-average return margins are reached by Russian companies. Thus, equity investments could not serve as a checking mechanism effective in curbing corruption.

IV. Conclusion

Openness to international financial markets does not constitute an effective means for fight against corruption. Russia is not dependent on FDI in its development path, the major development lever being exports of natural resources. In fact, most of Russian FDI can be compared to internal movements of capital in the framework of tax optimization schemes.

Another possible instrument of foreign influence, the equity investments in Russian companies listed abroad, is not effective either in curbing corruption. Investors will continue to invest in Russia until their investments show above-average margins, which should take into account their perceived level of risk due to corruption. Even more, if the firm's main competitive advantage relates to its political connections, foreign investments can help support this inefficient firm for a long period. If bribes are means by which individual firms get ahead at the expense of those who do not pay, corruption reduces economic growth at the macro-level, gains for some firms are achieved through massive losses on the global society level.

Effective fight against corruption in Russia could be mainly conditioned by implication of its political elite. In fact, recent success story of effective fight against corruption, for example, the case of Georgia, were largely possible because of public authorities' direct involvement and their clear and consistent strategy in this matter.

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