

# **Foreign Direct Investment, Political Risk and the Limited Access Order**

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# **Foreign Direct Investment, Political Risk and the Limited Access Order**

## **Abstract**

The common explanations for political risk in foreign investment focus on the opportunism of host-country governments. However, when governments are too weak to regulate and effectively control them, domestic business elites may also cause political risk. In the literature on political risk, the host state is mostly modelled as a single, cohesive actor and elites outside of the government are not taken into account. By contrast, this paper conceptualises political risk as a lack of government assertiveness vis-à-vis domestic business elites, drawing on the limited access order (LAO) concept developed by Douglass North and his co-authors. It presents the case of Swedish Tele2's investment in Russia. The mobile telecommunications provider was highly successful in Russia until it became a threat to the business interests of three Russian oligarchs. Regulatory agencies in Russia lacked the necessary authority to provide a level playing field in the telecommunications industry. They did not intervene when Tele2's access to vital licenses was blocked by competitors, effectively squeezing the Swedes out of the Russian market. This paper concludes that in LAOs foreign investors are initially welcome, but political risk is high when the market competition with domestic elites becomes intense.

JEL codes: F2, K2, L5, L96, P2

Keywords: foreign direct investment, political risk, bargaining, political constraints, limited access order, telecommunications.

# **1 Introduction**

The investment environment for multinational companies has undergone a sweeping change in recent decades. Recipient countries of foreign direct investment (FDI) have adjusted their attitudes and policies to be more welcoming for foreign capital to the effect that new, previously isolated markets have become accessible. Hundreds of new international investment agreements as well as arbitration courts and political risk insurances provide protection against some of the investors' worst nightmares. Direct expropriations, the main political risk outcome of the 1960s and 1970s, nowadays happen only rarely (Hajzler 2012).

Yet, with the changing climate in international investment, new kinds of political risk have emerged. The variety of risks has become larger and includes actions of powerful entities that are not part of the government (Jakobsen 2010). As result of the opening of previously restricted markets, foreigners are more frequently crossing the paths of potent domestic competitors. Reacting to foreign competition, influential local businessmen have found new ways to protect their domains in ways that threaten the security of investors' property rights (Wells Jr 1998a; Henisz and Zelner 2003: 159).

Prevailing theories need to be adjusted in order to explain such novel forms of political risk caused by competing businessmen. The two most common explanations of political risk to date are the obsolescing bargain mechanism (OBM) and the lack of political constraints on government executives. Neither of them accounts for the risk posed by domestic business elites, either directly or via their influence over state agencies. On the one hand, the OBM describes how bargaining power shifts from a foreign investor to the host-country (HC) government once an investment has been made and cannot be reversed. On the other hand, political

constraints on HC governments are seen as a determinant of political risk because they make opportunistic policy changes less likely.

Both approaches are well-suited to explain opportunistic behaviour of HC governments. Initially, studies on political risk examined the consequences of government opportunism clearly felt by investors in many developing countries at the time. Since then, however, it became apparent that this is but one aspect of political risk. A disadvantage of the OBM and the political constraints argument is that they view the host state as a single and cohesive actor. They do not consider actors who are not part of the government and may cause political risk if the government does not have exclusive control over the means of coercion and the bureaucracy.

In an earlier issue of *New Political Economy*, Bakir (2015) made an important effort to overcome the single-actor view on HC states in FDI theory. Connecting bargaining theory to the emerging state capacity discussion, Bakir showed how weak state capacity impedes entry bargaining, losing Turkey a USD1.5 billion investment of Hyundai in 2005. While the approach of this paper is related to Bakir's, my focus is not on entry bargaining, but on political risk during later stages of the investment cycle.

I provide an explanation for political risk based on the LAO approach developed by North, Wallis and Weingast (North *et al.* 2009a, 2009b). Compared to the OBM and the political constraints argument, the LAO concept has a distinct advantage: It regards not only the government as a political actor and potential threat to foreigners' property rights, but also considers elites from different backgrounds, such as business, the military or even the clergy. As such, the LAO concept can help to explain why and when political risk arises if the economic rents of powerful

elites are threatened. This study is the first to apply the approach to explain political risk in FDI.

The changes in the political risk landscape of foreign investment require not only an update of theoretical explanations, but also a renewed empirical approach. The high number of direct expropriations during the 1960s and 1970s facilitated the creation of datasets for econometrical studies on political risk. Nowadays, instead of direct expropriations, investor discrimination mostly takes place indirectly and over time, making it difficult to count or compare individual cases.

This paper presents an in-depth case study on an investment project carried out by the Swedish mobile operator Tele2 in Russia. After commencing operations in Russia in 2003, Tele2 was highly successful and grew rapidly thanks to its high efficiency and an innovative marketing strategy. In conjunction with sluggish overall market growth since 2010, this resulted in a loss of customers to Tele2 by well-connected domestic competitors. To protect their business interests, they managed to exclude the Swedes from receiving new radio spectrum licenses. Because the lack of licenses meant the end of the ambitious plans Tele2 had in Russia, the Swedish owners finally yielded and sold their Russian subsidiary to a local state bank. Subsequently, the seemingly insurmountable regulatory hurdles that Tele2 had struggled with for years melted away within a few months.

Interpreting this case through the lens of the LAO framework, the study offers an explanation for the type of political risk Tele2 faced in Russia. The paper is organised as follows: Section 2 revisits existing explanations for political risk based on bargaining theory and the political constraints argument. In the third section, the shortcomings of these approaches are laid out and the LAO concept is introduced, followed by a new model for political risk and propositions which are based on the

LAO approach. This model is then tested in Section 4, using the case study on Tele2's investment undertaking in Russia. The conclusion discusses the generalisability of the findings from the case study as well as the model's integration with existing explanations.

## **2 Review of related research**

The first studies on political risk<sup>1</sup> for FDI were written in the wake of hundreds of expropriations which took place within a few years' time in the 1960s and 1970s. These events naturally set the agenda for scholars, who, in the following years, focused on the risk sources, culprits (usually governments) and risk outcomes (direct expropriations) prevalent in this period. Most of these expropriations of foreign investors took place in countries which had recently become independent and/or had undergone an ideological shift towards socialism (Kobrin 1980: 75). This triggered a discussion among researchers about the importance of political instability of governments and regime change as a source of political risk (Robock 1971; Weston and Sorge 1972; Green 1974). The focus of political risk research on governments, in turn, facilitated the development of political risk theories which treated the HC state as a single actor without considering influential elites who were not part of the government.

The high rate of expropriations in this era also shaped the methods of empirical studies investigating the outcomes of political risk. Spectacular expropriations happened frequently and could be measured directly. The incidents were compiled into datasets and evaluated statistically, enabling empirical work on sectoral and regional distribution (Kobrin 1980; Hajzler 2012), change over time (Kobrin 1984; Minor 1994) and institutional determinants of expropriation (Li 2009) (Figure 1).

[Insert figure 1]

International investment and political risk have undergone significant changes since newly socialist and post-colonial governments openly confiscated the property of foreign investors. Direct expropriations have become rare since the beginning of the 1980s (Minor 1994; Dolzer 2002). In addition, FDI policies in most developing countries have been liberalised and barriers such as restrictive screening procedures in HCs have largely disappeared (Wells Jr 1998b: 105). To the contrary, many countries turned to setting up investment agencies to attract multinational companies (Wells Jr and Wint 2000; Cass 2007). Moreover, several public and private organisations such as the Overseas Private Investment Corporation (OPIC) or the Multilateral Investment Guarantee Agency (MIGA) are offering political risk insurance. Finally, since the mid-1980s more than 3000 International Investment Agreements have been concluded, forming a dense network of contracts which enables investors to defend their interests in investor-state dispute tribunals in Washington DC, Stockholm or elsewhere (Elkins *et al.* 2006; UNCTAD 2013).

Concomitantly, however, new kinds of political risk have gained importance. Because many formal investment barriers have been abolished in developing countries, domestic businessmen previously protected by these barriers have taken to defending their interests by indirect, less obvious means (Wells Jr 1998a). Without formal restrictions marking clear no-go areas for foreigners, the new risks arising from opposing domestic actors become apparent only after an investment has been made.

Although political risk has more recently been characterised as a multidimensional phenomenon (Jakobsen 2010, 2012), two main theoretical approaches account for the vast majority of existing studies on political risk. On the one hand, bargaining theories and especially the OBM are common in the international business literature. On the other hand, the political constraints argument, closely related to theories of property rights and development, can be found in virtually all economic studies on political risk.

### ***Bargaining and political risk***

Bargaining theories are used to explain how disputes between HC governments and foreign investors arise and what their outcomes will be. They help to understand political risk which is caused by opportunistic behaviour of HC governments and changes in relative bargaining power between investors and HCs. It is assumed that investors and HCs can potentially realise gains between them if they cooperate. However, conflicting interests are said to frequently exist and the allocation of the investment's benefits is the outcome of a bargaining process (Kobrin 1987). The best-known bargaining model in political risk theory is Vernon's (1971) concept of the OBM. It characterises a situation in which a foreign investor initially has an advantage in bargaining power over the HC, being able to choose among different investment destinations. Yet, once the investment commitment has been made the investor's assets can be used by the HC to hold him hostage, giving the HC the upper hand in subsequent rounds of negotiation. Thus, the relative bargaining position of the investor weakens over time and HC governments can benefit by forcing a renegotiation of terms or, in the worst case, expropriating the investor's assets.

When the conditions for foreign investment had become more welcoming after the 1970s, bargaining theory lost some of its impact in the political risk literature. Dunning (1991) characterised the changes in HC-investor relations as a shift ‘from confrontation to co-operation’, questioning if the fundamental conflict of interests assumed by bargaining theory still exists.

Recent contributions to bargaining theory have begun to account for the more complex setting of actors and interests that foreign investors are presently confronted with. Levy and Prakash (2003) argue that the bargaining process should be seen as a multiparty negotiation instead of the traditional dyadic setting of one investor and one HC. Levy and Prakash’s multiparty bargaining allows for conflicting interests between a multiplicity of state actors and authorities, resulting in a less determined outcome of the bargaining process (Levy and Prakash 2003: 143). In a similar vein, Bakir (2015) extends bargaining theory with a state capacity approach, explaining the occurrence of conflicts within developing countries’ governments during entry bargaining.

### ***Property rights and political constraints***

While bargaining theories are common in international business research on political risk, most economists emphasise the importance of HC institutions, especially political constraints, on government executives. The main argument behind this view was originally developed in the literature on property rights, which holds that political constraints are connected not only to FDI inflows but to economic development in general. Property rights theorists maintain that private investment is essential for development and will take place only if investors believe they will not be expropriated by the government (Knack and Keefer 1995). A government, the argument goes, can only make credible guarantees not to

expropriate if it is institutionally constrained (North and Weingast 1989). Consequently, investment and development are less likely in autocracies than in democracies, as autocratic political elites do not face effective constraints<sup>2</sup> (Olson 1993).

Political economists argue that constraints on the government are the main reason why foreign investors prefer democracies over autocracies (Jensen 2003; Li and Resnick 2003). Although multinationals have at times benefitted from partnering with an autocratic government when they received special privileges (O'Donnell 1978), Li and Resnick (2003) find that on average lacking security of property rights outweighs these benefits. Similarly, Jensen (2003) sees institutional constraints on political leaders as the key competitive advantage in the competition of HCs for FDI.

### ***Two separate approaches?***

Although the OBM and the political constraints argument have different origins, their line of reasoning is closely related: If a government is able to credibly commit itself to not changing the terms of an investment agreement *ex post*, a large part of the political risk caused by the shifting of bargaining power can be mitigated.<sup>3</sup> Jakobsen (2006) finds that the OBM is in fact moderated by constraints on the HC government. The crucial similarity of OBM and the political constraints argument from the perspective of this study, then, is that neither of them questions the HC government's ability to assert itself against other domestic elites. The government remains as the sole and decisive actor determining the political risk foreign investors face. By contrast, the LAO concept used in this study models the HC state as a coalition of several influential groups, each of which has its own interests and leeway thus forming a more complex political risk landscape for the investor.

### **3 Theoretical void and the Limited Access Order**

Viewing HC states as single actors with consistent preferences is less problematic for countries with a monopoly on violence under centralised political control. However, many developing countries today do not meet this criterion. If power is dispersed and in the hands of competing groups of elites instead of a central government the single-actor perspective is an incomplete representation of HC decision making.

Bargaining theorists are well aware of this problem. Poynter (1982: 10) states that ‘Nations are not monolithic, or even bipartisan; they are composed of different groups, each of which is intent on maximising its special interests.’ Encarnation and Wells Jr (1985: 51) critically point out that bargaining theory views states like firms in neoclassical economic theory. Similar reservations can be found throughout the literature (Stopford *et al.* 1991: 136; Levy and Prakash 2003: 143). Most recently, Bakir (2015) has characterised viewing the state as a monolithic entity as the primary weakness of bargaining theory.

Similar concerns have been voiced in economics and political science. If the central government is only one influential elite group among others, political constraints on the government change the balance of power inside a HC but do not automatically lead to a more secure investment environment. Przeworski and Limongi (1993: 53) argue that ‘It is by no means clear that the villain is necessarily “the ruler.”’ Haggard and Tiede (2011) point out that governments in many developing countries lack the capacity to enforce basic formal rules in society. Constraining these governments further undermines control on violence, order and ultimately economic development instead of facilitating it.

The recent surge in studies on state capacity also shows an increasing interest in what enables governments to ensure rule of law and effectively regulate the economy (Besley and Persson 2010; Acemoglu *et al.* 2015; Savoia and Sen 2015). When state capacity is weak, elites who are not part of the government may compete to make the decisions behind the scenes: ‘The “state” thus becomes literally a bone of contention between opposed interests, both of whom want control over it in order to decide what precisely its role shall be and in whose interest the market shall be managed.’ (Stopford *et al.* 1991: 57) The problem of powerful interests outside of the government has become more important since the 1990s because economic development, privatisations and the opening of markets led to the rise of stronger local businesses in many developing countries (Wells Jr 1998a: 19).

So far, these competing elites have not been in the focus of political risk theory. Scholars both from international business and economics have recognised this problem, but to solve it, an update of the existing theories is needed. In this paper, I argue that the LAO concept of North and his co-authors can provide this missing theoretical link.

### ***Limited and Open Access Orders (LAOs)***

North, Wallis and Weingast characterise the LAO as one of two types of social orders existing in today’s world. At the outset of their theory of social orders, North and his co-authors ask how societies can control violence (North *et al.* 2007, 2009a, 2009b, 2012). The LAO and its counterpart, the OAO, represent two fundamentally different ways of how this is achieved.

In OAOs, a category that includes most of the developed democracies, the executive holds the monopoly on violence and is constrained by institutional checks and balances. Its citizens enjoy open – albeit not free – access to political and economic

competition. Open access and impersonal competition in the economy enables ‘creative destruction’ which in turn makes it difficult for businesses to use economic power to influence politics (North *et al.* 2009a: 24). Electoral competition and open access in politics prevent the abuse of political power for manipulating the economy in anyone’s favour. Thus, economic competition and political competition sustain each other, an interdependence which North *et al.* call the ‘double balance’.

The LAO, the category developing countries fall into, rather resembles a cease-fire between opposing violence specialists. In this type of social order, economy and polity are inextricably interrelated. The violence specialists, the so-called dominant coalition, are incentivised to keep their guns down by the economic rents of order and peace. They enjoy rents through economic privileges which in turn help them to sustain their political power. The LAO also features its own double balance in which limited access to politics and limited access to the economy are mutually reinforcing. This setting is in balance as long as the distribution of economic rents corresponds to the distribution of political power, thus giving no one an incentive to fight.

However, the decisive economic drawback of LAO societies is that members of the dominant coalition can and will try to prevent the erosion of their rents through competition. An innovative challenger outside of elite businesses will not have the backing of functioning market institutions such as secure property rights or effective regulation. Political risk is high for entrepreneurs threatening the elite’s rent income, which impedes welfare-increasing competition and makes development through ‘creative destruction’ impossible.

Most LAOs today feature elections, courts and laws that guarantee competition. These ‘institutional forms’ (North *et al.* 2007: 25) and the mechanisms of their implementation may be similar or, in the case of institutional transplants, identical to the OAO institutions they are modelled after. However, their de facto functioning often differs quite substantially. ‘The logic of the limited access order takes any institutional form or mechanism and bends it to the purpose of rent-creation to sustain the existing dominant coalition’ (North *et al.* 2007: 29). One example of this was the Russian Law on Bankruptcy which was introduced in 1998 and reflected the state of the art of Western market economies (Lambert-Mogiliansky *et al.* 2007). In the context of the Russian LAO, however, it did not lead to efficient restructuring of insolvent companies. Instead, in combination with dependent courts it served as a tool for politically connected elites in the expropriation and redistribution of assets (Volkov 2004).

### ***FDI in LAOs***

The effect of FDI on the political stability of LAOs is ambiguous. Where foreign investment opens up new markets, creates employment and brings new technologies to the LAO, it creates new opportunities to extract additional rents for the domestic elites (North *et al.* 2007: 40). FDI also increases the legitimacy of political elites of authoritarian regimes in the eyes of the citizens as well as in the international community. FDI is widely believed to accelerate economic catch-up and to lead to knowledge spillovers in the host economy (Javorcik 2004). These rent-creating aspects of foreign investment have a stabilising effect on the LAO and create an interest among elites in attracting and retaining foreign investors.

However, foreign investment is also a challenge for LAOs. It increases the complexity of inter-elite relations and it deepens international dependencies. When

financially potent foreign companies operate in the LAO economy, their strategies and decisions have an impact on rent distribution among the elites. If the foreign business is successful in the LAO market, domestic competitors may see their economic rents dwindle. Because economic rents in an LAO resemble entitlements connected to political influence, rent-erosion through FDI incites domestic competitors to utilise non-market tactics to defend their rents.

While the former (rent-creating) effect of FDI cushions political risk for the foreign investor, the latter (rent-eroding) effect aggravates it. Which effect outweighs mainly depends on the stage of the investment project, its success and on overall market conditions, especially market growth. During setup and expansion of the investment, the influx of capital to the LAO increases available rents. Especially for 'greenfield' investment projects, the rent-eroding effects follow with a certain delay. First, setting up the business takes time. Second, investors commonly choose expanding markets for investment. Competition then intensifies with increasing saturation of the market. In a stagnating market environment, the foreign investor becomes a threat to elite rents. For foreign investors who commonly rely on market-oriented decision making their impact on the rent distribution among domestic elites is hard to recognise or to take into account.

LAOs face the same rent-creation/rent-erosion trade off when they open up markets for international trade or allow for more domestic competition. However, there are two reasons why FDI is more threatening to elite rents. First, in contrast to foreign investors, domestic newcomers usually lack the financial means to quickly become a meaningful market player. Second, FDI is much harder to control for the elite coalition once the business has been set up. If competition from domestic entrepreneurs threatens elite interests, putting the entrepreneur behind bars is a

‘solution’ which rarely draws domestic or international attention.<sup>4</sup> Contrary to this, it is very costly to force an uncomfortable foreign investor out, as either an acceptable compensation has to be offered or the reputation among future investors and international relations will suffer.

The larger a business grows, the stronger its impact on the economic rents of powerful elites becomes. For foreign investors, the only protection against the political risk this creates is a politically powerful partner or patron.<sup>5</sup> In the words of Russian billionaire Vladimir Evtushenkov, who controls the mobile communications operator MTS:

In our society, and probably also in others, the size of a business has to correspond to the political influence of its owners. If the size of a business corresponds to the political influence, the owners can be sure about their business, because they have the resources and energy to defend it. If the size of a business significantly exceeds the political influence of the owners, it is very hard for them to hold on to it.

(Evtushenkov 2012)

Although international reputation and diplomatic support sometimes gives foreign investors support that domestic entrepreneurs do not have, Evtushenkov’s statement also applies for FDI. When foreign investors (and their partners) are not part of the inner circles of power in an LAO, political risk increases with success and business growth.

In summary, the LAO concept allows to derive the following propositions about political risk from competing domestic businesses: (1) In the early stages of the investment, the inflow of capital leads to rent-creation and cushions political risk.

(2) Growth and success in the LAO market puts pressure on domestic competitors, who consequently use their political influence against the investor, increasing political risk. (3) Overall market growth moderates the rent-eroding effect of the foreign investor's expansion.

#### **4 Empirical method and case study**

In this paper, a case study on a large FDI undertaking of Swedish mobile operator Tele2 in Russia is used to examine the propositions about political risk derived from the application of the LAO concept. The methodical approach used is similar to that of Bakir (2015) who employs a project-level case study to develop his state capacity extension of bargaining theory.

In the case study, I use process tracing to verify the propositions made above (George and Bennett 2005: 205; Gerring 2006: 172). The study is based on archival media research (using the Russian media database Integrum) as well as financial reports and committee protocols of the Russian Ministry of Communications and Mass Media *MinKomSvyaz'*, all of which are compiled into a case chronology for the years 2003-14. Six in-depth interviews of 60-120 minutes each with foreign businessmen, independent experts and the managing partner of a Russian telecommunications firm were conducted in Moscow between October 2012 and April 2014. Matching of interviews and chronology allowed for triangulation of the collected data to improve their validity.

The case study is situated in the Russian Federation and extends from the early 2000s to 2013. During this time, political power in Russia has arguably become more centralised in the hands of the Kremlin. Personalisation of the government has become stronger as Putin appears to be irreplaceable in the current political

system. Effectively, there are no political constraints in place. The Duma (the parliament) is dominated by Edinaya Rossiya, the Kremlin's party of power, and it enacts the laws which the Kremlin deems necessary. The courts have repeatedly been used to expropriate businesses or to harass opposition figures. Putin's 'power vertical' policy of centralisation may have enhanced the Kremlin's possibilities for ad-hoc action in a top-down manner in some cases. However, personalisation of power has also further weakened Russian institutions, making 'manual control', that is micromanagement by the Kremlin with direct involvement of Putin, the primary mode of governance in many cases (Monaghan 2012). State organs and officials are not effectively controlled by rules and susceptible to corruption and state capture (Ledeneva 2013: 89). This lack of reliable rule-based governance is *the* decisive limit on the Kremlin's capabilities of control.

The Russian economy clearly shows the differential consequences of 'manual control': While specific industries are increasingly centralised or micro-managed by the Kremlin, other sectors are marked by significant discretion for non-political elites. Oil and gas companies are the financial backbone of the Russian state and have been consolidated in state companies and under the control of Kremlin insiders (Vivoda 2009: 522). Politically sensitive businesses such as media outlets are carefully managed by the Kremlin as well. Oligarchs as well as foreign investors have felt the Kremlin's attention in oil and gas as well as in media.<sup>6</sup> Yet, powerful business elites dominate industries in which the Kremlin is not directly involved. Corporate raids, the fraudulent and sometimes violent hostile takeovers of companies often seen as a phenomenon of 1990s Russia, have not disappeared (Rochlitz 2014). The oligarchs in today's Russia may be smart enough not to pick a direct fight with the Kremlin. But in the Kremlin's shadow, the battle for assets is

as fierce as ever, including forms of state capture and discrimination against foreign investors. One example for this is the telecommunications branch.

### ***Russian mobile communications market***

The Russian mobile market was set up with the help of foreign capital, management and equipment between 1992 and 1993. Over a span of 20 years, the sector has evolved and grown to account for about 1.5 per cent of Russia's GDP in 2014. It is still catching up to the developed Western countries which were ahead at least four years technologically during the 2000s.<sup>7</sup> Yet, while foreign assistance was crucial to Russian providers in the 1990s, they no longer need outside help for importing equipment, building networks and running their operations. The most important scarce resource in the business has since become the licenses to use a certain radio spectrum. The role these licenses play is similar to that of drilling rights in the oil industry (Filonov 2014).

A radio communications license gives the holder the right to exclusively use a part of the radio spectrum. The license defines the frequency band, a geographical region and the communications standards that are allowed to be used. Communications standards are constantly improved and released by an international association of mobile communications providers and suppliers. With every new generation of standards, the possible data transfer speeds have multiplied. As mobile internet has become increasingly important to customers, providers have to offer at least 3G (3<sup>rd</sup> generation) internet speed to be able to compete in the current mass market.

In most developed countries, spectrum licenses are sold in auctions to the highest bidder. In Russia, however, they are given out in tenders, also called 'beauty contests'. The contending companies are awarded points along the lines of pre-

defined criteria and the licenses are assigned to the companies with the highest score for a symbolic fee. The criteria, which practically determine the outcome of the contests are formally defined by the state commission for radio frequencies (GKRCh) which is based at the *MinKomSvyaz'*.

The market is dominated by the so-called *Big Three*, an oligopoly of the providers VimpelCom, Megafon and MTS. Each of these companies is controlled by a Russian billionaire, Fridman, Usmanov and Evtushenkov respectively. In 2012, the combined net profit of these provider giants in Russia totalled USD4 billion.

### ***Big Three***

Although none of the three oligarchs dominating the mobile business in Russia can be considered a true Kremlin insider or a close friend of Putin, all of them have benefitted from political connections at some point in their careers. Uzbekistan-born Alisher Usmanov (Megafon) has been a businessman since the late it was under Putin's presidency that he rose to become Russia's richest man (his wealth was estimated to total USD18.6 billion by Forbes in 2014). He has been working as General Director for Gazprom-Investment Holding since 2001, consolidating and managing assets of the state company Gazprom. When Putin first became president, the leadership at Gazprom was exchanged and Usmanov was the only person both the old and the new leadership trusted, putting him in a unique position (Igumenov and Malkova 2012). During this time, he directly reported to then-Chairman of Gazprom's board of directors, Dmitry Medvedev, who would move on to become Prime Minister under Putin. Usmanov's own company, USM Holdings Ltd., registered on the British Virgin Islands, controls assets in many different branches, ranging from metallurgy, to sports clubs, to media. With his track record at Gazprom-Investment, he has built up the reputation that he can be trusted with

politically delicate business operations. This is also indicated by his investments in several well-known media companies (print, TV and online), which began just as Gazprom Media was also consolidating media outlets, leading analysts to conclude that he was acting on behalf of the same Kremlin strategy as the state company (Noskovich *et al.* 2006).

Mikhail Fridman (VimpelCom) is one of the few Russian oligarchs who made a fortune in the 1990s under former President Boris El'tsin and have managed to extend their wealth under Vladimir Putin. His closest business partner and co-owner of the Alfa Group business empire, Petr Aven, is crucial to this success. He was Foreign Economic Relations Minister under El'tsin and supported Putin when the latter was Head of the Committee for Foreign Liaison in St. Petersburg in 1992 (Dawisha 2014: 119). Petr Aven's first deputy in 1992, Mikhail Fradkov, was appointed Prime Minister by Putin in 2004. Furthermore, two employees of Fridman's Alfa Group went on to assume key positions in the Kremlin in the 2000s: Aleksandr Abramov became the president's assistant (Kremlin.ru 2013a) and Vladislav Surkov Deputy Prime Minister (Kremlin.ru 2013b). Fridman was a co-owner of the British-Russian oil joint venture TNK-BP until it was bought by the Russian state company Rosneft in 2013 (Malkova and Igumenov 2012). During the conflicted relationship with BP, the British company made Fridman responsible for the state harassment BP and TNK-BP CEO Robert Dudley were exposed to in Russia (Webb 2008). Fridman was Russia's second richest man in 2014 (estimated wealth USD17.6 billion), controlling VimpelCom Ltd. through an opaque chain of offshore firms.<sup>8</sup>

The career of MTS owner Vladimir Evtushenkov is linked to his friendship with former Moscow mayor Yuri Luzhkov. Previously working in the city

administration under Luzhkov, Evtushenkov set up the investment holding AFK Sistema in July 1993 and acquired companies in the communications sector which were privatised by the City of Moscow. Besides MTS, AFK Sistema today also controls several Russian technology companies. Luzhkov, who is also married to the sister of Evtushenkov's wife, was ousted by Medvedev in 2010. Since then, Evtushenkov had to adjust to a smaller role. His largest asset, the oil company Bashneft which he bought in 2008, was expropriated in late 2014, when Evtushenkov was investigated for money laundering connected to the acquisition. A court decided that privatisation of the company should be reversed and that it should be handed over to the federal state. In December 2014, after Evtushenkov had ceded control over Bashneft, Putin personally declared the case closed during a press conference (Dzyadko *et al.* 2014). The loss of Bashneft reduced Evtushenkov's wealth from USD9 billion to about USD2.8 billion. He did not attempt to pursue any compensation from the government (RBK news 2016).

### ***The case of Tele2***

Tele2 is an international mobile communications operator which focuses on emerging markets and is controlled by the Swedish investment company Kinnevik. When Tele2 was beginning operations in Russia, Kinnevik's then Principal Owner and Chairman, Jan Stenbeck, demonstrated not only an interest in investing, but also in Russian charity work. From December 2001 to May 2002, he set up an organisation in Russia named 'Art – Beacon of Life', funded an orchestra for young musicians and sponsored a commemorative concert for Raisa Gorbacheva, the deceased wife of former Soviet leader Mikhail Gorbachev (Intermedia 2002). Charities and donations are often seen as a way to ensure good relations with authorities (Doh *et al.* 2003; Frye 2006; Markus 2012).

Kinnevik's investments in Russia are not limited to telecommunications, but also include e-commerce (Avito.ru), agriculture and television (CTC Media). Since 2011, Kinnevik's co-owner at CTC Media is Yuri Koval'chuk, who controls the Bank Rossiya and is a close friend of Putin (Kiseleva and Miklashevskaya 2011). Cristina Stenbeck also knows Putin personally, since both were discussing the future of the Russian economy on the investor's forum 'Russia Calling!' in 2013 (Kremlin.ru 2013c). As a foreign investor she is experienced in the Russian environment and has established excellent contacts. However, in the case of Tele2 this did not translate into active protection of her business interests by the Kremlin.

In 2003, when Tele2 started servicing the Russian market, analysts did not expect Tele2 to stand a chance, as the market was already dominated by the *Big Three* (Gorlin 2002). In the following years, Tele2 expanded its operations to more and more regions by buying smaller regional providers and acquiring additional regional licenses in licensing competitions. The acquisitions and network expansion brought a sizeable inflow of capital and new employment opportunities to many Russian regions. In the stage of expansion, the investment was beneficial for the local governments as well as the Russian suppliers involved. In LAO terms, it increased their rents. For competing businesses, Tele2 was yet too small to be a substantial threat to their profits. The Swedes won licenses for 17 Russian regions in a large 'beauty contest' in 2007, allowing them to double their territory (Filonov 2014). In line with the first proposition, during Tele2's expansion in the Russian market political risk from competing elites was small.

However, Tele2 was determined to become a large national operator in Russia. The company was operating much more efficiently than the *Big Three*, having roughly the same profit margins while charging significantly lower prices. It was a lean

organisation with a Swedish top management that emphasised transparency and openness, contrasting with the strictly hierarchical and opaque internal structure of the *Big Three*.<sup>9</sup> While MTS, VimpelCom and Megafon are all part of large holdings and are used to cross-subsidise inefficient sister companies,<sup>10</sup> Tele2 was outsourcing strictly to the cheapest subcontractors. Tele2 attracted talented and ambitious employees while careers in the *Big Three* were often based on connections (for example Evtushenkov appointed his 26-year-old daughter as Vice President of MTS in 2003). Creative low-cost marketing stunts allowed Tele2 to save on television campaigns and still make the news (Grishin 2009). Tele2 passed the mark of 10 million customers in 2008. It was on its way to becoming a large national provider but still no threat to the *Big Three*. The reason was that in the years 2004-8, the market grew by an annual average of 25 per cent, giving all competitors ample opportunity for increasing revenue (Federal State Statistics Service 2009). In line with the third proposition, as long as the market was growing rapidly, Tele2 could expand without a significant increase in political risk (Figure 2).

[Insert figure 2]

When the overall growth of the Russian mobile communications market began to falter after 2008, the *Big Three* started feeling the competitive pressure from Tele2. From 2008 to 2012, the value of the Russian telecommunications market only grew from RUB1.2 to RUB1.5 trillion (Federal State Statistics Service 2010, 2014), while Tele2 more than doubled its customer base from 10 to 22 million

subscriptions. The *Big Three* struggled to gain customers and VimpelCom as well as MTS even lost subscriptions (Provotorov 2013). In some regional markets, Tele2's market share increased to over 50 per cent. Whenever Tele2 entered a region, prices and margins in the market significantly dropped (Lavitskii 2010). Tele2's conquest of the Russian market had gained momentum and – in combination with sluggish market growth – was hurting the *Big Three's* profits. Consistent with the second proposition, at this point the *Big Three* began using their political influence to corner the foreign competition.

In 2013, Tele2 was already boasting 23 million subscriptions while only being present in 41 of 83 Russian regions<sup>11</sup> and still growing fast. The Russian subsidiary of Tele2 was responsible for more than half of the customers of the Tele2 group and generated more revenue than any other country in the Tele2 portfolio, including the Swedish home market (Tele2 AB 2013: 80). Tele2 Russia had developed into a key strategic asset to its Swedish owners.

Because of Tele2's efficiency, its access to capital and its willingness to increase the market share in Russia, the only way to slow down the Swedes was through limiting its access to licenses. Technological progress required all providers to update their networks to the 3<sup>rd</sup> or 4<sup>th</sup> generation standard in the late 2000s, but to do that they needed new licenses. Tele2 had the necessary know-how to upgrade to the 4<sup>th</sup> generation standard Long Term Evolution (LTE) because it was already operating a network in Sweden since 2009, long before LTE even showed up on the agenda of *MinKomSvyaz'*.

### ***Konsortsium 4G***

Assigning spectrum licenses in a fair way requires strong, independent and well-organised regulators, as the financial stakes of the market players are extremely

high. However, during the introduction of LTE in Russia, the *MinKomSvyaz'* as well as the Federal Antimonopoly Service of Russia (*FAS*) looked weak vis-à-vis the *Big Three*. The case of Tele2 shows that the influence of business elites in LAOs cannot be compared with the lobbying common in developed countries. The *Big Three* violated decisions of the regulating authorities to exclude Tele2 from receiving licenses.

In its resolution from the 28<sup>th</sup> of December 2010, the radio frequencies commission at the *MinKomSvyaz'* determined that a joint consortium of all parties interested in LTE should be formed to discuss possible ways of frequency allocation and to carry out necessary experiments to avoid undesired consequences of the introduction of LTE. The commission decided that this *Konsortsium 4G* should *initially* be created by the *Big Three* together with the state landline company Rostelekom. The latter had been trying to get involved in the mobile business and, as a state company, enjoyed strong political support. The decision explicitly stated that this consortium should be 'without limitations to the composition of its members' (Minkomsvyaz' Rossii 2010). The results of the consortium were to be presented after six months' time (on 1<sup>st</sup> of July 2011).

In the following months, Tele2 repeatedly tried to become a member of this consortium, offering the experience it had gathered from running an LTE network in Sweden (Balashova 2011). However, it was denied access. The consortium dodged the commission's decision by stating that it could not invite new members until it was formally registered as a legal entity (RIA Novosti 2011). Formal registration of the consortium was delayed until the original four members had submitted all recommendations regarding the LTE introduction back to the *MinKomSvyaz'*.

While the ministry had devised the *Konsortsium 4G* as an open access organisation, the initial members managed to keep access limited with a very simple scheme: delaying its formal registration. Unsurprisingly, the consortium eventually recommended that a total number of four national licenses should be allocated by the *MinKomSvyaz'*. It also suggested specific criteria for the 'beauty contest' which would determine who receives a license (Boyko 2011). With these criteria, it was clear beforehand that only the members of the *Konsortsium 4G* would receive an LTE license.

To keep the total number of licenses at four, the lower frequency spectrum was to be split in a wasteful way. Each winner of the 'beauty contest' was intended to receive a license with a bandwidth of 7.5 MHz (out of 30 MHz in total in the 791-821 MHz spectrum). At the same time, the LTE standard only allows using spectrum bandwidths of 5 *or* 10 MHz – using 7.5 MHz for LTE is technically impossible. This means that the four winners would be using only 5 MHz out of their 7.5 MHz licenses and 2.5 MHz are practically wasted to limit the access to the mobile market (unless the winners would combine their spectrum).

The *MinKomSvyaz'* verbally protested the exclusion of Tele2 from the consortium. Deputy Minister of Communications and Mass Media Naum Marder asserted that 'When we made this decision [about the consortium], we wanted it to be an open consortium. ... But you just did not let them in, and in my opinion you clearly violated the commission's decision' (Gerashchenko 2011). Despite Marder's statement, the *MinKomSvyaz'* did not refuse or significantly alter the suggestions made by the *Konsortsium 4G*, but instead the radio frequencies commission adopted them and proceeded with the allocation of licenses (Balashova 2012).

Tele2 then brought the case to the attention of the antimonopoly agency *FAS*. An equally wavering reaction followed. *FAS* first criticised the ministry for limiting competition among potential LTE providers and demanded that suggestions made by other providers such as Tele2 should also be discussed. However, the suggestions handed in by Tele2 were not put on the agenda by the *MinKomSvyaz'* (Andreev 2011). *FAS* then declared it would not take part in the further development of specifications and norms of the LTE spectrum allocation. *FAS* Director Dmitry Rutenberg voiced his frustration, explaining that participation made no sense because 'with the decision of the commission for radio frequencies, there can't be any other outcome except that the four members of the consortium each get an LTE license' (Odnako 2011). Rutenberg indicated that *FAS* might initiate antimonopoly procedures against the LTE assignment at a later point in time.

However, *FAS*'s initial resistance melted away in December 2011, when the agency quietly resumed its cooperation in the introduction of LTE (Afanas'eva 2011). The following 'beauty contest' held by the *MinKomSvyaz'* in July 2012 led exactly to the result Rutenberg had predicted: The *Big Three* and Rostelekom each received a license, while the fourth-largest operator Tele2 ended up empty-handed (RIA Novosti 2012).

### ***Technical neutrality***

Not having won any of the new LTE licenses, Tele2 looked for other possibilities to offer its customers fast internet. It planned to use the LTE standard on the same frequencies which it used for its existing 2<sup>nd</sup> generation network. For this, it needed a certain regulation called *technical neutrality* to be adopted in Russia. *Technical neutrality* means that a mobile communications provider can use any standard of communications on the frequencies it already owns. This would enable Tele2 to

offer the new LTE standard without acquiring new licenses. At the time, this regulation was already an international standard adopted in most large telecommunications markets.

*MinKomSvyaz'* had delayed the introduction of *technical neutrality* in Russia for years, stating that it was not proven that there would not be any unwanted interference with voice transmission if LTE was used in the same frequency band as 2<sup>nd</sup> generation networks. The *Konsortsium 4G* eventually was mandated to conduct the necessary experiments to decide whether interference would be a problem. For obvious reasons, the consortium with its four original members slowed down the introduction (Fomicheva 2011).

To put pressure on the regulators, Tele2 itself set up a small test zone for LTE on its existing 2<sup>nd</sup> generation frequencies in the cities Omsk and Pskov. Authorised by the *MinKomSvyaz'*, it carried out experiments with the help of the state-owned Radio Research and Development Institute in 2012. As expected, the experiments showed no unwanted interference or other problems that would be caused by the introduction of *technical neutrality*. When Tele2 presented these results to the ministry in late 2012, the ministry was still not ready to make a decision and insisted on additional testing to be carried out by the *Konsortsium 4G*. The consortium announced that many questions had not been answered in the tests conducted by Tele2 and that it could not estimate how long the additional experiments would take (Ser'gina and Tsukanov 2012).

### ***Tele2 under Russian control***

Eventually, the owners of Tele2 decided that the regulatory risks were too high. Without LTE, there was no chance to continue competing for a market share in Russia. The company would begin losing customers and decrease in value soon, as

fast mobile internet had become a *sine qua non* condition in mobile communications markets worldwide. On 27 March 2013, Tele2 went public with a deal that sold the Russian subsidiary for USD2.4 billion (including USD1.15 billion of Tele2 debt) to the Russian state bank VTB (Filonov 2014).

Under the ‘roof’ of VTB, the now Russian Tele2 had the strong political backing it needed to push for the introduction of technical neutrality in Russia. In September 2013, VTB President Andrei Kostin wrote a letter directly to Vladimir Putin, asking him to support Tele2 in this matter. The arguments made in the letter did not contain anything new. Within weeks, the president forwarded the letter to Prime Minister Medvedev with a hand-written instruction on it: ‘review and support’ (Ser’gina 2013). Already in December 2013, technical neutrality was introduced in Russia. Tele2’s new Russian president Provotorov announced on the same day that his company would be offering LTE for its customers very soon (Krasnikov 2013).

## **5 Conclusion**

This article argues that theories of political risk have focused too much on central governments while neglecting powerful entities outside of the state executive. It discusses the limitations of this approach both for the literature on bargaining theory as well as explanations based on the lack of political constraints. The LAO concept is then introduced to extend political risk theory for explaining risk originating from non-governmental actors. The propositions derived from the LAO concept are that non-governmental political risk is low when the investment is made, increases with market success and is cushioned by overall market growth.

The Tele2 case is presented to analyse how political risk can arise without central government involvement. While the OBM as well as the political constraints

argument cannot sufficiently explain why Tele2 was forced to sell its Russian subsidiary, the LAO approach offers an explanation. The case study shows how the rents of competing business elites were eroded by the Swedish newcomer. Initially, market growth beyond 25 per cent gave every company in the market sufficient room for expansion. When overall market growth subsided and competition intensified, the competitors used their influence over the regulatory authorities to deny the Swedes access to vital licenses. Thus, the case study corroborates the propositions developed using the LAO concept. However, the LAO explanation does not replace the existing theories on political risk. The Tele2 case also points towards possible links between the existing theory on political risk and the LAO approach.<sup>12</sup>

Political constraints in the form of independent veto players such as courts restrain not only the government, but also other powerful actors, especially when domestic competitors try to capture state organs to move against foreign investors. This is documented by a huge telecommunications licensing scandal which took place in India in 2008. Local businesses had colluded with the telecommunications ministry to secure 122 licenses in 2008, excluding British Vodafone (as well as Indian competitors) from the competition. The Indian Prime Minister protested but was unable to effectively control the decisions of the Communications Minister Raja. However, in 2011, Raja was arrested and, despite the considerable complexity of reversing the ministry's decisions, in 2012 the Indian Supreme Court eventually decided to annul all 122 licenses and ordered that they should instead be auctioned off (The Economist 2012). While in this case, as in the case of Tele2, the head of the central government is not responsible for political risk, the Supreme Court acted as a constraint on other actors as well.

Similarly, there are two insights to be gained for the OBM model from the LAO approach. First, when the OBM is extended to not only characterise the state-investor relationship, but more generally a domestic elites-investor relationship, it can explain risks which arise from relations with local business partners. Partnering up with a powerful domestic business is a strategy often adopted where greenfield investment is perceived to be too risky. However, only over the last few years in Russia are there multiple examples where this leads to battles for control over the domestic company or the joint venture. In accordance with the OBM, foreign investment is welcomed initially, but once the investment has been made, the local business partner has an interest to deprive the investor of his control rights, using influence on courts or state agencies to do so. BP's struggle with Mikhail Fridman over TNK-BP is one example of this. Another prominent case is the experience of Norwegian Telenor, which until 2015 held about 30 per cent of VimpelCom's shares, and was engaged in a battle for control with Fridman's Alfa Group for years. At one point, Fridman managed to have Telenor's shares arrested through a Moscow court. Only when Norway's Prime Minister Stoltenberg turned the case into an issue of diplomacy did the Kremlin intervene and stop the expropriation, again displaying 'manually controlled' industrial policy (Sincan 2016).

In a second contribution to the OBM, the LAO approach also offers an interpretation for bargains which obsolesce not because of opportunism, but because of the lack of central control by the HC's government. The officials negotiating with the investor may not be able to *ex post* enforce the investment conditions against the interests of powerful elites who were not at the table during negotiations, even if they wish to do so. A case from Mexico exemplifies this: The Mexican government introduced a new Federal Telecommunications Law in 1995

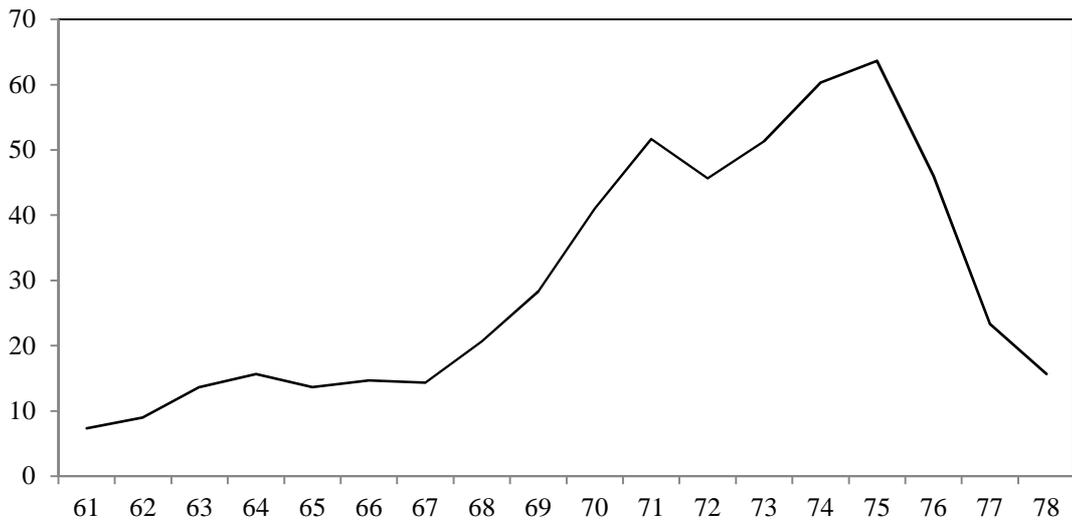
that guaranteed foreign investors fair competition with Carlos Slim's Telmex, a privatised former state giant which was managing the landline network. However, after US telecommunications firms had invested billions of dollars in Mexico, it became clear that the regulators were not able to contain Telmex's anticompetitive practices. In violation of the new law which had attracted the investment in the first place, Slim's company charged prohibitive interconnection rates in order to retain its monopoly position. Eventually, the Telmex agreed to a settlement with the investors in December 2000 in order to end several national and international lawsuits against it (Eyth 2002: 240). Again, political risk was not caused by the central government, but by an influential businessman, and it was political constraints that eventually protected the investors.

As the examples from India and Mexico show, political risk created by elites outside of the government is neither a post-communist nor a specifically Russian problem. This aspect of the Tele2 case study is generalisable for many different regions. However, there is an important distinction regarding the business sector in which the investment takes place. The telecommunications branch in Russia is dominated by powerful businessmen and not of primary importance to the Kremlin. This stands in contrast to other branches in Russia. Especially in oil and gas, the Kremlin has become the dominating actor.<sup>13</sup> It is here that the traditional explanations of the OBM and the political constraints argument are the most convincing. This is demonstrated by Vivoda (2009), who uses bargaining theory to explain the experiences of foreign investors with resource nationalism in oil-producing countries including Russia in the 2000s. In summary, the OBM and the political constraints argument have not become obsolete. They perform better in

explaining strategic sectors and need to be adjusted in branches which are not 'manually controlled' by the central government.

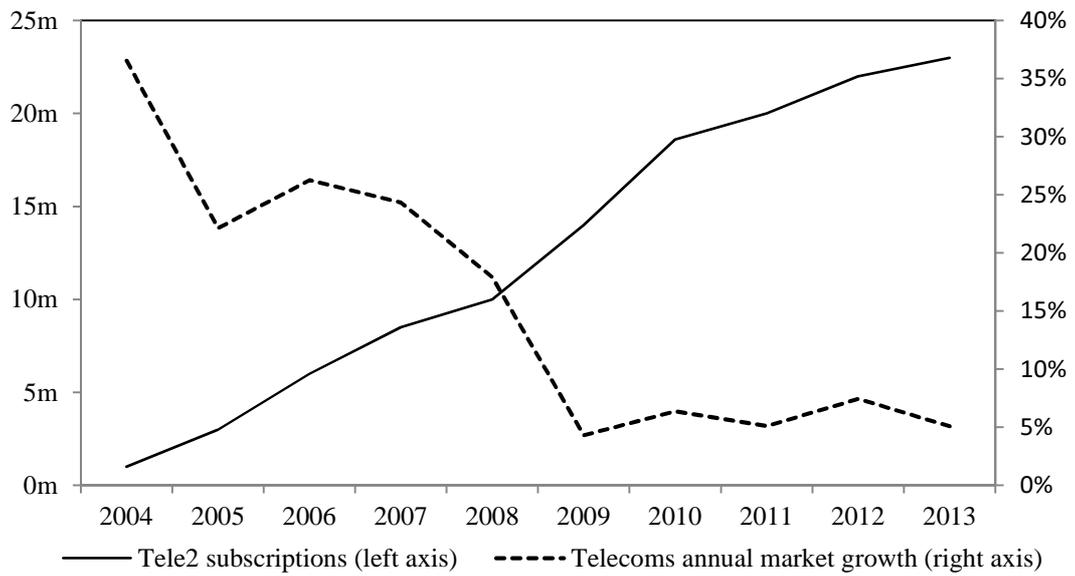
In addition to the theoretical extensions, there are implications to be drawn from this article for business practitioners as well as policy makers. Investors cannot rely on the ability of governments to regulate and create a level playing field when powerful domestic businesses are present. This is true especially when markets that are dominated by domestic oligarchs open up for foreign investment. This will most likely concern investors who are looking to take advantage of investment opportunities in countries such as Myanmar, Indonesia or the Philippines in the near future. To minimise political risks in these countries, investors as well as local governments have to take into account the long-term effects a foreign company will have on the distribution of economic rents.

**Figure 1: Annual number of expropriations 1960-1979**



Source: three-year moving average, based on data from Kobrin (1984) and Hajzler (2012)

**Figure 2: Tele2 Russia subscriptions and market growth**



Source: Tele2 Rossiya (2015) and Federal State Statistics Service (2009, 2010, 2014)

## Notes

<sup>1</sup> A large number of definitions for the term political risk have been provided in the literature over the last decades (for detailed discussions see Fitzpatrick (1983); Jakobsen (2012: 32)). In this paper, I rely on a definition introduced by Kennedy (1991): ‘political risk can be defined as the probability that events in the nonmarket [...] environment of business will cause financial, strategic, or personal losses to the firm’.

<sup>2</sup> A common way to capture the constraints on a government executive is to focus on veto players, ‘actors whose agreement is required for a change of the status quo’ (Tsebelis 2002: 17). Because veto players make abrupt policy changes less likely, they can function as a protection against expropriative government actions. Henisz (2000) develops a structural measure for political constraints (POLCON), counting effective veto points for 157 countries. He finds that a higher number of veto points increases growth rates and investment in highly regulated industries such as telecommunications (Henisz and Zelner 2001).

<sup>3</sup> With incomplete contracts, the time inconsistency problem described by the OBM may also apply to situations when independent enforcement of contracts is available (Hart and Moore 1988).

<sup>4</sup> Criminal expropriations of entrepreneurs are a central feature of Russia’s post-soviet economy (Firestone 2010; Rochlitz 2014).

<sup>5</sup> This may also be connected to risks, as the case of Telenor’s VimpelCom investment exemplifies.

<sup>6</sup> In oil and gas, the oligarchs Khodorkovskii and Evtushenkov were expropriated. Foreign investors Shell (Sakhalin 2 project) as well as BP (Kovykta project) were pressured to renegotiate or sell. In media, former Russian moguls Gusinskii and Berezovskii had to flee to London to escape prosecution. Most recently, a new media law forced publishing groups such as Axel Springer to sell their Russian business.

<sup>7</sup> While 3<sup>rd</sup> generation networks were already operating in most developed countries by 2003, in Russia 3<sup>rd</sup> generation licenses were only allocated in 2007.

<sup>8</sup> Fridman is a shareholder of ‘Crown Finance Foundation’ (Liechtenstein), which controls ‘CTF Holdings’ (Gibraltar), which controls ‘Alfa Group’ (Russia), which controls ‘Altimo’ (British Virgin Islands), which controls ‘VimpelCom’ (Bermuda).

<sup>9</sup> When former Rostelekom president Provotorov was later appointed to lead Tele2, he was impressed that the management’s desks were on the same floor with everybody else, only separated by glass walls (RIA Novosti 2013).

<sup>10</sup> For example, the company Sitronics could not survive without cross-subsidisation by MTS (interview with managing partner of Russian telecommunications firm, Moscow 2014).

<sup>11</sup> While in Swedish hands, Tele2 was never present in Russia’s largest and most profitable market Moscow, as the company could never acquire a license for the city.

<sup>12</sup> I am grateful to an anonymous referee for pointing this out.

<sup>13</sup> I am grateful to an anonymous referee for pointing this out.

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