

**Riitta Kosonen & Maija Sirkjärvi  
& Elmira Sharafutdinova**

# Post-Socialist Reconstructing: Firms, State and Local Governance in Kostomuksha, Russia

CEMAT Papers 3/2009



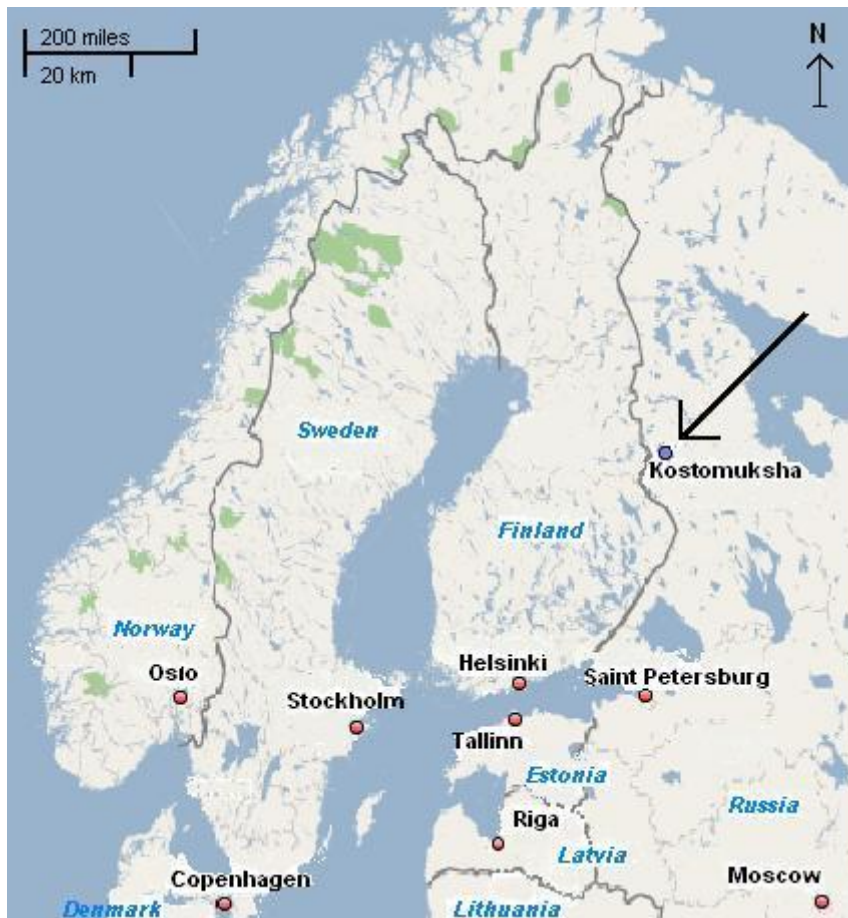
**Abstract:** *After nearly twenty years after the collapse of socialism the resulting fragmentation of the Russian business and regional economies has become visible. The winners stand tall compared to the losers. One relatively successfully restructured local economy is the town of Kostomuksha. Based on a regulation cum governance approach, we show that the mining town of Kostomuksha in Russia is an example of a local economy, where the local forms of governance have managed to create a local compromise and a common agenda among the local and foreign-owned firms, the public sector, and the labour force to promote and support the local economy. Hence, although the Kostomuksha economy first collapsed in the post-socialist turmoil of early 1990s, the local economic actors in the business community, the public sector and the labour force have later succeeded in constructing a governance mechanism that has been effective in regulating the local economic accumulation. Today, during a novel crisis, the coherence is threatened by external shocks. This paper analyses the building blocs and the formation of a coherent local restructuring mechanism which enabled mushroom growth in the otherwise economically retarded Karelian Republic. The formal and informal forms of governance as well as various market novelties, socialist legacies and hybrids, have played a key role in the formation of this effective local governance mechanism.*

## **Introduction**

Kostomuksha is a Russian mining town that is located near Finland; it is only 35-kilometres from the Finnish-Russian border (Map 1). Kostomuksha is an example of a local economy that developed within the framework of a socialist planned economy from nothing into a full-scale socioeconomic entity. After the collapse of socialism, it sunk again into economic and social problems, but managed to generate a new development mechanism. This process has largely revolved around the co-operation that has arisen between local enterprises, Finnish and other foreign investors and the local government. This development mechanism is a combination of formal and informal interaction and the ability to adopt the market economy paradigm without completely discarding the operational models of the socialist era.

Kostomuksha was quickly born at the end of the 20<sup>th</sup> century based on political decision making. In 1967, Gosplan, the governmental planning committee of the Soviet Union, and the Ministry of Iron Metallurgy decided to build an ore mining combine and town together in order to utilise the Kostomuksha iron ore deposit (Prohorova & Rautio 2008). All of the construction work was acquired from Finland within the framework of a bilateral clearing trade agreement between Finland and the Soviet Union. As the result of a seven-year negotiation that was initiated by the presidents of Finland and the Soviet Union in 1970, the Finnish Finn-Stroi group began the construction of the combine and its related town infrastructure. The construction was completed in 1984. Only a year later, the population in Kostomuksha had already reached 25,000 (Prohorova & Rautio 2008). Today it is approximately 30,000. During socialism, Kostomuksha developed into an entity operating around a single factory (a mono-industrial town). The factory was in practice the sole employer of the town for a long time. It also maintained the social infrastructure of the residents. In the 1980s, a few consumers' cooperatives were established in the town as well. After the collapse of socialism, the combine was privatised and renamed as Karelsky Okatysh in 1993, and the Russian mining company Severstal became its majority owner. After a major reorganisation, the operation of the factory was restored to a new upswing in 2004. With a market economy, Kostomuksha has witnessed the establishment of some small and medium-sized enterprises, especially in retail trade and other services. Foreign investors, especially from Finland, have begun investing in Kostomuksha. Today, approximately 15 Finnish enterprises from different areas of business operate in Kostomuksha. These include the forest sector, wood processing, electrical equipment and electronics, fish farming and engineering workshop industry. PKC Group, a Finnish wiring harness and electronic component manufacturer, is the second largest enterprise in Kostomuksha after Okatysh. In the 21<sup>st</sup> century, there have been large investments made into Kostomuksha from Sweden, Germany, Australia and Spain. Despite the slow diversification of the economy, Kostomuksha has continuously proven to be very dependent on the Karelsky Okatysh combine, which is still responsible for nearly 90 per cent of the town's total production. The combine's share of the total taxes of the town is approximately 70 per cent, and it still employs approximately 46 per cent of the town's workforce.

**Map 1: Kostomuksha**



Until 1990, Kostomuksha was closed to ordinary tourism and immigration. However, Finland has had a large role in Kostomuksha's development, starting from the town construction project. The majority of the Finnish constructors lived in Kostomuksha from Monday to Friday and returned to Finland for the weekend. At best, approximately 4,500 foreigners lived in the town. Even though the interaction between the local residents and foreigners was controlled and restricted during the socialist era, the workers, engineers and technicians formed personal relationships between each other. The locals noticed considerable differences between the work culture and work ethic of the Finnish and Soviet workers (Iljukha et al. 1997).

Kostomuksha was significantly different from other Soviet towns. The town infrastructure represented high Western quality, and plenty of Western food supplies

were imported to the town. Kostomuksha developed, during the socialist era, into an exceptionally wealthy town, which attracted trained professionals and residents with a settler mindset. This improved the mental and social capital of Kostomuksha considerably, which later on helped surviving the economic chaos resulting from the collapse of socialism (cf. studies related to local identification, social capital and regional identification Putnam 1993; Paasi 1986; Sweeney 1990; Saxenian 1994). Today, Russian papers describe Kostomuksha as Finnish-built, and the richest and most modern town in Karelia, with a European image and a cosy streetscape of carefully constructed houses (Ovsjannikova 2009).

Kostomuksha has become the economic miracle of the Republic of Karelia, which is suffering from the economic crisis. The Republic of Karelia is classified as a crisis zone in the regional classification of the Russian government (Economic monitoring 2007b). The regional GDP of Karelia comprises only a few per cent of the GDP of all of Russia. By the end of 2008, the Republic of Karelia had received only approximately 0.12% of the foreign investments into Russia (Rosstat 2009), and is considered one of the riskiest regions with one of the lowest investment potentials in Russia (Ollus et al. 2007). Kostomuksha is a bright spot for the Republic of Karelia. Even though Kostomuksha's share of the population in the Republic of Karelia is approximately 4% and its surface area only covers 2% of the total area of the Republic, its share of the economy of the Republic has been as high as 35% (Jurinov, see Väyrynen 2005). The share of investments has decreased in recent years, but the share of the small town is still approximately 17% of the economy of the entire Republic (Town of Kostomuksha 2009). The position of Kostomuksha is also strong regarding foreign investments. In addition to investments directed to the mining combine the town has attracted foreign investments from various fields of business. Investments have been directed, for example, to such spheres as light bulb production and furniture industry, while in the Republic of Karelia as a whole, the investments have basically been addressed to woodworking industry. Also the range of investor countries in this small northern town is impressive. It covers a number of countries in Europe and reaches all the way to Australia. Kostomuksha also has a significant role in the foreign trade of the Republic of Karelia. Just the share of ores and minerals, which consists mostly of the Karelski Okatysh operation, is approximately 13% of the exportation of the Republic

(Karelijastat 2009). The income level of the residents of Kostomuksha is also significantly greater than in the rest of the Republic of Karelia and all of Russia. In 2006, Kostomuksha received an award that was given to the best economic centres of the Russian Federation regional districts. In the Republic of Karelia, Kostomuksha has become a “pocket of development” (Bond & Tykkyläinen 1996).

Kostomuksha is a prime example of the successful reform of a local economy as well as fruitful international business cooperation in peripheral conditions. Recognising the mechanisms of the structural changes in Kostomuksha in turn offers the other regions of Russia a fine example of the possibilities and ways to rise from economic recession and to attract foreign investments. Recognising the present development mechanisms can also be utilised in the current recession being experienced by the town, which is ultimately being caused by the global economic crisis. When analysing the development mechanism, it is especially interesting to assess how the enterprises operating in Kostomuksha adapted to the collapse of socialism, what kind of challenges they faced in relation to their interest groups in business life, the public sector and labour market and how they solved all these problems. It is important for the analysis to take local and foreign enterprises into account.

The article is based on the research material collected by CEMAT, the Helsinki School of Economics Center for Markets in Transition. Personal semi-structured interviews are the main source of primary material. Eleven Russian (9) and Finnish (2) people who work in the management of nine different enterprises operating in Kostomuksha were interviewed for the study in Kostomuksha and Finland. Some of the interviewees had experience in working in the same enterprise at different times. The enterprises represented different lines of business in the industry and service sectors. The deputy manager of Kostomuksha’s economic development was also interviewed. Two other interviewees were also experienced in working within town administration or positions of trust. Additionally, two civil organisation representatives were interviewed so as to expand the point of view. All of the interviews were carried out anonymously so that the informants would also disclose the informal features of operation as freely as possible. The interviews were performed in the Finnish and Russian languages. They were recorded and transliterated, after which they were encoded using NVivo software.

The encoding helped organise the material into categories according to the theoretical framework and many subcategories arising from the material (such as hierarchy and productivity). As the research process went on, secondary sources such as economic monitoring reports of Northwest Russia (<http://www.hse.fi/ecomon>), official statistics of the Republic of Karelia, publications of Kostomuksha and local newspapers were analysed crosswise with the interview material. The accuracy, richness and criticism of the material were improved with triangulation. Additionally, triangulation developed the criticism of the sources and helped associating the analysis with the correct context (cf. Moisander & Valtonen 2006).

### **Regulation and governance theories—tools to analyse the local development mechanism**

The study uses regulation theory (Aglietta 1979; Lipietz 1988; Painter & Goodwin 1995; Kosonen 2002, 2005) as a theoretical tool to outline Kostomuksha as a socioeconomic and political operating environment for enterprises. Regulation theory describes the structure and development of economic systems. According to the theory, economic systems (i.e. accumulation systems) are conflicting social processes, which comprise production and consumption (accumulation) as well as the institutions that support them and alleviate conflicts. These include laws, regulations, agreements, social practices and values, for example. The general effect of these diverse institutions is called regulation. The actors of economic life utilise its possibilities with the help of, and under the control of, regulation. Regulation theory has been applied to studying both capitalism (Aglietta 1979) and socialism along with its collapse (Altvater 1993; Murray 1992; Smith 1998; Pickles 1995; Stryjakiewicz 2000; Kosonen 2002). Regulation theory has also been applied to studying national economies (Aglietta 1979) as well as local economies and regions (Tickell & Peck 1992, 1995; Kosonen 2002, 2005). As a result of studying different economic systems, regulation theory has started to also highlight the informal forms of accumulation (e.g. barter trade and grey economy) and institutions that support them (e.g. social networks and the black market relations). This is because informal actions often emerge quickly when the economy

collapses and formal government-controlled regulation becomes powerless. Regulation theory makes it possible to create a comprehensive image of the structure and operation of local economies, such as Kostomuksha (Tickell & Peck 1992, 1995). Regulation theory can also be used to determine the economic potential, consisting of production and consumption, which attracts the enterprises of local economies, as well as the formal and informal institutional practices that maintain and modify the business environment. The institutional practices that affect the economy can either be supportive or harmful to accumulation in nature. Thus, as a result of institutional practices, the production and consumption of local economy develop or degenerate (Painter & Goodwin 1995; Kosonen 2002, 2005).

Institutional practices can be reached with governance theory. Governance theory is applied in the present study in order to outline the interaction networks in the Kostomuksha economy and their prevailing practices. Thus, it is analysed as to how enterprises operating in Kostomuksha manage their relationships with the key actors of society, i.e. the public sector, other enterprises and internal actors (mostly labour and owners). Especially formal and informal cooperation and competition networks, along with their characteristic practices, are identified. From the point of view of governance, it is essential to assess as to how enterprises utilise the networks in solving the problems related to their societal relationships. The practices that have been developed in Kostomuksha are inspected in light of the town's enterprise history from when the town was founded up to modern day. At the same time, the study assesses the unravelling of socialist era interaction networks and practices, establishment of new ones after the market was freed as well as how old and new networks have become connected (cf. Smith & Swain 1998; Kosonen 2002).

When evaluating the administration mechanisms of enterprises, it is important to note the local embeddedness of governance (Granovetter 1985; Oinas 1998; Kosonen 2002) and what impact the governance practices of enterprises have on the economic, social and political coherence of the town. These factors affect how enterprises, and the whole local economy, can adapt and compete and how attractive a region is over a long time span. Through such administration practice analysis, the enterprises in Kostomuksha can be classified according to how they combine new and old thinking in

their operations, to what extent they are locally embedded and in what ways they affect local coherence. The enterprise classification is based on the typology that was developed from Vyborg in an equivalent manner (Kosonen 2002), which identified six types of enterprises.

**Figure 1. Typology for how enterprises adapted to the collapse of socialism**



*Source: Kosonen (2002, 2005)*

According to the typology, enterprises can be divided into six groups based on how they combine new market economy institutions and the institutional legacy from the socialist era. Institutional novelties include written contracts, tax payments and official salaries. The institutional legacy, on the other hand, covers those practices inherited from the socialist era. These include a paternalistic attitude towards labour, different formal and informal employee benefits, lobbying the authorities to decrease public expenses, for instance, strongly personified business relationships, and doing business—even barter trade—with acquaintances. Enterprises utilising institutional novelties are at the top of the figure and enterprises holding on to traditions are at the bottom, respectively. The form of the figure represents the local embeddedness of enterprises and their networking with local society. The enterprise types located in the thickest middle of the figure (such as *Constructors*) establish more economic, social and cultural networks than enterprises that are located in the thin parts of the figure (such as *Reactionaries*). The name of the

enterprise type reflects its impact on local coherence. For instance, the *Constructors* have a significant role as the maintainers of local coherence, but *Opportunists*, on the other hand, act in a way that disrupts that coherence.

*Opportunists* seek profit in the short-term. They seek quick market-economy profits and minimise social responsibilities, which makes their local networks weak. Naturally, these enterprises have a negative impact on the economy and business life of the region. *Neutrals* can be described as enterprises that operate closest in accordance with the formal Western business culture. They have embraced transparent market economy business practices, their decision making is based on economic efficiency, and they have no significant social obligations. However, Neutrals have to negotiate with the public sector often by using personal relationships that are typical of socialism. Generally, Neutrals do not have powerful social connections to the respective location, which makes it easier for them to realise large-scale dismissals, for example, if they are required by the economic situation at hand. On the other hand, Neutrals often have a good effect on the social coherence of the location because they usually work together with other local enterprises and the local government in order to improve the local operating environment. Furthermore, Neutrals avoid taking part in local politico-economic arguments. These typically include Russian and Western enterprises in a low-risk industry.

The institutional legacy of the socialist era is emphasised even more with the following enterprise types: *Constructors* choose a strategy that combines socialist and market-economic thinking. They strive to develop efficient business operations, but at the same time they often produce social commodities for more people than just the company employees. The enterprises actively participate in negotiations with the government, and they might take part in local politics so as to modify their operating environment. Additionally, Constructors actively join alliances between enterprises, and they negotiate with the workforce, thereby having a positive impact on the local coherence. *Disputing Constructors* are often involved in local arguments and in some cases even illegalities when they balance in a tense environment between institutional legacies and novelties. Usually, arguments arise between enterprises and the public sector and relate to enterprise ownership and relations with local authorities, for instance. Enterprises of

this type have a positive and negative impact on the local coherence: They might realise extensive social projects, but on the other hand, their arguments may slow general development and create an unsafe atmosphere. *Reactionaries* rely on old state regulations and refuse to renew and compete. They do not develop strategic cooperation, and it is difficult for them to establish local connections. These enterprises do not succeed, which is why they cause problems for the labour market and are unable to settle their payments. *Strugglers* are small one-man or family enterprises that often operate in the black market. This group was especially significant in Russia at the beginning of the 1990s. Since these enterprises often operate independently and in grey markets, they have weak local relationships. They do, however, have a positive impact on the regional coherence because they decrease social problems resulting from unemployment and an uneven distribution of income.

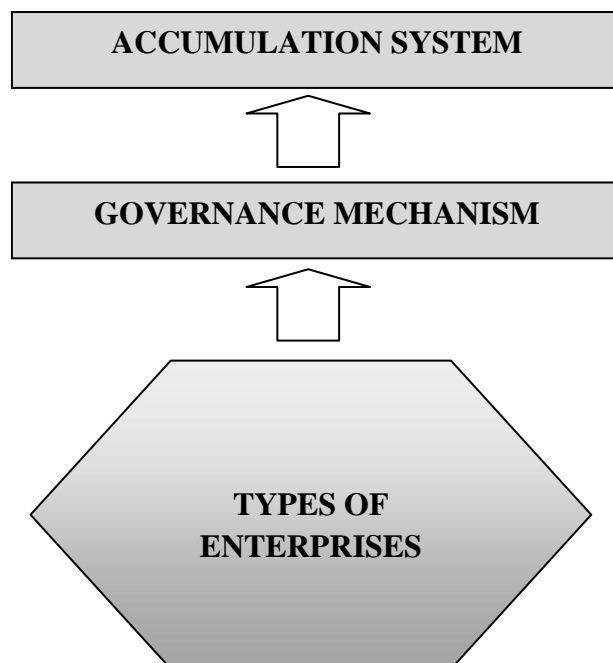
As the formal operating environment has developed due to the progress of the market economy in Russia, some of the aforementioned enterprise types have decreased noticeably. Especially the number of old Soviet-type *Reactionaries* has decreased considerably. Already at the beginning of the 21<sup>st</sup> century the majority of enterprises were *Neutral* (Rautio & Kosonen 2006; Kosonen 2005). This occurred because in a rapidly changing operating environment, the previously applied business practices, such as barter trade or tax evasion, became unnecessary, economically inefficient or difficult to realise. Enterprises with strategies and practices atypical to a developed market economy, such as the pursuit of short-term profit, still exist. Furthermore, as the Russian economy grows, the *Constructors* have gained new momentum. This is especially due to a growing labour shortage, which forces investors to compete for labour by offering ever-better salaries and social benefits, such as apartments maintained by the company. (Ibid.)

This research utilises the aforementioned enterprise typology when describing the adaptation of enterprises operating in Kostomuksha and analysing it in relation to the rapidly changing operating environment. The dynamics of enterprise adaptation and institutional development can be presented by using the typology because the existence and development of enterprise types is reliant upon changes in the operating

environment. Additionally, the typology makes it possible to describe the mechanisms of local economic development.

The general economic potential (accumulation system) of Kostomuksha can be analysed according to figure 2 with the regulation theory approach. Governance theory can be used to analyse the governance mechanisms in enterprise relationships, which affect the utilisation of the economic potential. This includes the relationships with the public sector, other enterprises and labour. Additionally, a comprehensive approach helps classify the enterprise types operating in Kostomuksha according to how they can utilise local potential over the long-term. Based on such an analysis, it is possible to identify the mechanisms that develop or degenerate the economy and the business environment in Kostomuksha. Figure 2 illustrates the levels that the study focuses on when analysing the local economy in Kostomuksha.

**Figure 2. The conceptual model of the study: the accumulation system of local economy and its governance.**



The present article focuses on the economy in Kostomuksha, its governance and prevailing enterprise types in the Soviet Union as well as the collapse of socialism. Subsequently, the reconstruction of Kostomuksha is analysed from the points of view of the accumulation and governance of economy, in which the enterprise types that are involved in the process are identified. The governance mechanism descriptions concentrate on the relationships between enterprises and the public sector, other enterprises and labour. Finally, the new economic challenges that Kostomuksha faces in the current global economy crisis are discussed and a summary is compiled.

### **Socialism and the post-socialist collapse in Kostomuksha**

Kostomuksha is a relatively young local economy because it was established by a centrally planned decision in 1967, built in the 1970s, and began its operations around a mining combine in 1984. Until 1991, Kostomuksha operated as a socialist, centrally controlled mining town that relied on a single factory and was relatively stable. After the collapse of socialism, the accumulation system in Kostomuksha could not survive because it was no longer supported by centrally controlled planning. The mining combine ended up in economic difficulties, in which no substitutive business or supportive institutions emerged quickly enough.

#### *Accumulation and regulation in the socialist Kostomuksha*

During socialism, Kostomuksha was completely dependent on the mining combine. The combine was, in practice, the sole employer of the town, and it was also responsible for the social infrastructure of the town. Kostomuksha was, in this relation, a typical Soviet town economy whose operation relied on a single production plant. The Kostomuksha mining combine produced 24 million tonnes of iron ore and 8.3 million tonnes of iron pellets on a yearly basis. It especially served domestic customers, because during the socialist era only approximately 5% of the industrial production of Kostomuksha was exported. The combine especially served the metallurgy factories in Cherepovets, Novolipetsk and Chelyabinsk. Additionally, the combine delivered 1.2 million tonnes of

iron pellets to Finland from 1983–1990. The Kostomuksha mining combine was, in practice, the sole employer of the town. It was also responsible for satisfying the social needs of the townspeople.

The mining combine also supported the business life of the town in ways other than the mining industry. For example, when a shortage for certain foodstuffs emerged in the town at the end of the 1980s, the combine started its own agricultural and food production.

In the 1980s, some small enterprises were established in Kostomuksha. These were mostly consumers' cooperatives that operated in wood processing, berry and mushroom picking, construction and transportation. After the economic reforms, the first private enterprises of Kostomuksha were born based on these cooperatives.

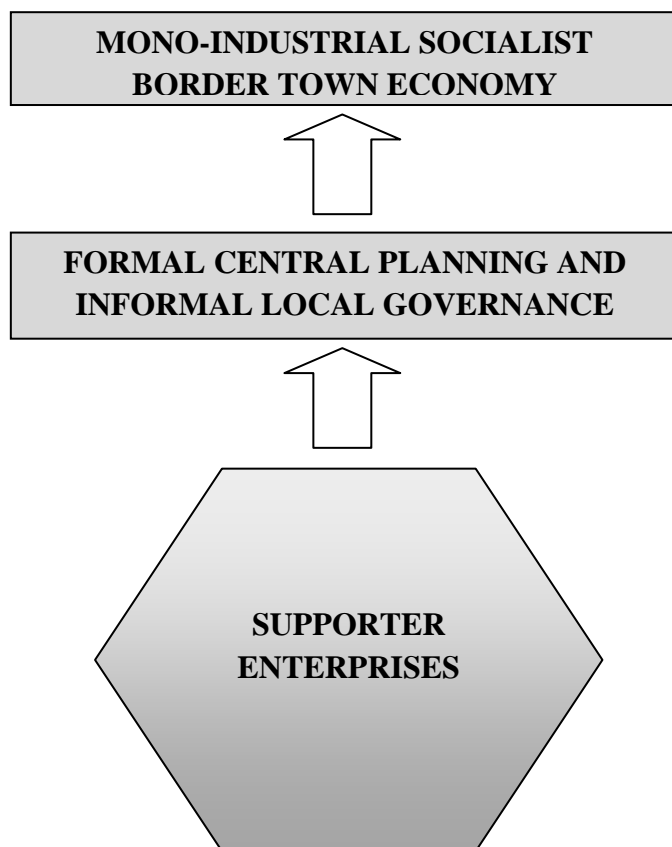
In practice, there was only one enterprise type operating in the socialist Kostomuksha: the *Supporter* enterprise. The most central *Supporter* was the mining combine, which maintained the social and cultural infrastructure of the entire town to the full extent of its abilities. The economic life in socialist Kostomuksha was stable, and Kostomuksha was a relatively static socioeconomic and political system. Clear governance mechanisms developed in the town, in which they emphasised the combine's dependence on the decisions by the Ministry of Ferrous Metallurgy of the Soviet Union. However, this arrangement was not flawless. The ministry's ability to react to the needs of the town was limited and, therefore, the town faced problems, especially regarding female unemployment and the lack of social infrastructure, such as schools, kindergartens and stores. This cast a shadow on the social situation of the town, which, as a border town, was otherwise better off than many other Soviet towns.

Informal institutions, based on locality, developed rather quickly to in turn accompany the formal centrally controlled governance mechanism. These institutions had a significant role in the construction of socialist Kostomuksha. Founding and constructing Kostomuksha was a special and international process, which provided the townspeople with much of their local identity. Kostomuksha was built by Finnish labour on the border between the Soviet Union and Finland. In addition to the modern combine, Finns constructed modern and Western social infrastructure in the town. Thousands of foreign

workers lived in Kostomuksha during the construction years, and residents with a settler mindset moved there from elsewhere in the Soviet Union. Since Kostomuksha was built from the ground up, and did not have any previous local history, an identity combining internationality with the embodiment of the Soviet pioneer spirit developed in the town. Thus, a strong myth emphasising local speciality was quickly born in Kostomuksha, in which it had a role in maintaining the socioeconomic and political integrity of the town.

Overall, a functional governance mechanism consisting of formal centrally controlled institutions and informal local institutions developed in the socialist Kostomuksha. It was effective enough to maintain and regulate the economy in Kostomuksha as a political system, in spite of the inherent problems of the centrally controlled system.

**Figure 3. The accumulation system in the socialist Kostomuksha**



### *The collapse of the socialist Kostomuksha*

The collapse of the Soviet Union and the centrally controlled economic system led to a recession, and the 1990s was a restless period in Kostomuksha. Investments were reduced and the mining combine suffered from a global decrease in demand, the increase of manufacturing costs and problems with quality. The combine's production decreased from 1992–1995 by 25% (Iljukha et al. 1997). The problems of the combine did not rise to the same level as in many other Soviet mining towns because the combine in Kostomuksha was able to keep its most important Soviet clients. Actually, little by little Severstal became the main shareholder of the combine through the privatising process. After privatising, the combine was renamed "Karelsky Okatysh". The combine's path, as a private enterprise, was rough. Economic problems led to two large-scale dismissal waves. Furthermore, the combine transferred a great deal of the social infrastructure to the local government as a result of long and difficult negotiations. However, the local government did not have the resources to receive and maintain the infrastructure, which made the socioeconomic situation of the town significantly more difficult. For instance, housing construction decreased considerably during the first half of the 1990s. The situation was made more difficult by increasing poverty and the resulting increased costs and decreased personal consumption.

In the 1990s, some new enterprises were established in the service sector and production. However, due to heavy taxation, a lack of industrial facilities, and undeveloped markets, much of the production plants underwent bankruptcy rather quickly. Enterprises in the service sector managed far better.

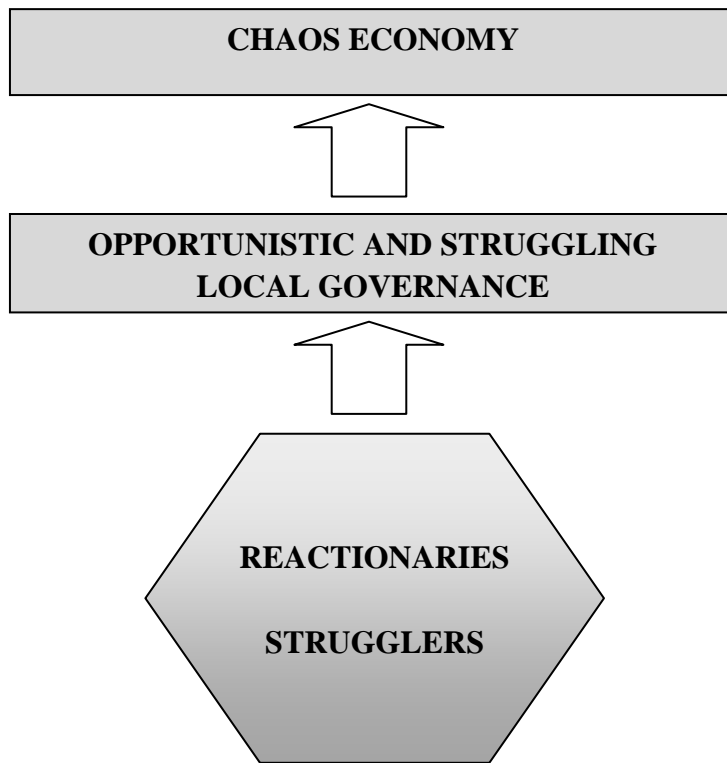
Foreign enterprises only started to flow into Kostomuksha in the 21<sup>st</sup> century. Finns, however, had already been in the town since the end of the 1980s, at first in the form of joint enterprises and after that generally in completely Finnish-owned enterprises. By 1993, there were six joint enterprises operating in the town. They operated especially in production, such as in the furniture, textiles, electronics and construction business. Some of these enterprises, however, also underwent bankruptcy rather quickly. Finns also acted in Kostomuksha as subcontractors and constructed a milk cattle farm, among others, for an agricultural enterprise owned by Karelsky Okatysh. The selection of

Finnish subcontractors was largely due to the townspeople's good previous experience with Finnish constructors.

The problems of the combine were partly institutional. Besides outdated technology and a lack of funding, other problems were caused by the low work ethic of the workers and the lack of skilled labour. A serious conflict arose between the combine and its trade union movement due to delayed salaries and the weakening of the position of employees. There was tension with the town administration as well due to the decisions taken to reduce social infrastructure. During the difficult years of the 1990s, the combine started to resemble a *Reactionary* enterprise, which had difficulties in adapting to a market economy and that started to lose its grip and position as the central actor of the socioeconomic society. A group of *Strugglers*, including many of new joint enterprises, operated in Kostomuksha alongside the *Reactionary* enterprises and fought for survival. Joint enterprises were shaken by the institutional conditions prevailing in Russia, which proved to be too difficult, time-consuming and costly. Especially, customs and taxation regulations were problematic.

The economic difficulties that were caused by the collapse of socialism also reflected on the governance mechanisms of the economy. After the collapse of socialism, the centrally controlled budget funding stopped and then local authorities found themselves more dependent on local taxpayers than ever before. Even at the beginning of the 1990s, the local government was heavily reliant upon the combine as a socioeconomic source of wealth in the town. The versatile promotion of entrepreneurship and programmes for creating new workplaces achieved only insignificant results. Only later on did people come to realise that the local government was in dire need of new funding sources. Overall, the governance mechanisms in Kostomuksha during the chaotic years of the 1990s were too weak to support, maintain and regulate the local economy as a socioeconomic and political system.

**Figure 4. The accumulation system of post-socialist chaos economy.**



#### **New growth in the Kostomuksha market economy**

With help from a new administration, Karelsky Okatysh got back on its feet, little by little. The new young executives of the company developed a modernisation programme based on which the company initiated operations around a new ore deposit and found new clients in the Czech Republic, Poland, Slovenia, Germany and Turkey. The reform and new ways of thinking started to produce results only gradually. In 2006, Karelsky Okatysh achieved a record level of production and also surpassed the previous production record achieved during socialism (Economic Monitoring 2007a). The recovery of the company was also supported by the loans granted by EBRD and ING Bank.

Some other smaller enterprises had been established in Kostomuksha during the 1980s. Many of these continued to operate even after the collapse of the Soviet Union, such as

a printing house, a food processing enterprise and a construction enterprise. Later, many of these became subsidiaries of Karelsky Okatysh, which, on its part, increased the role and significance of the mining company in the business life of Kostomuksha. Not all Karelsky Okatysh branch expansions were problem-free; for instance, the bankruptcies of a bakery and a furniture enterprise in Karelsky Okatysh's hands were seen as artificial takeovers that in turn sparked bitter discussion among the employees.

The offering of services started to improve gradually as new entrepreneurs became eager to establish more stores, cafes, restaurants and service stations (Novosti Kostamukshi 4.7.2002, see Prohorova & Rautio 2008). Their number multiplied at the turn of the millennium. In the 21<sup>st</sup> century, some service sector entrepreneurs expanded their operations into production. The consumers' cooperatives that were established in 1980s after the economic reform developed gradually into new enterprises, such as construction enterprises and restaurants. Many other previously state-owned enterprises also continued their operations and privatised, such as a timber enterprise. Furthermore, foreign-owned enterprises started to grow stronger. For instance, a Finnish-owned electronic assembly plant managed to increase the number of its employees from 18 to approximately 500 over the years. Other foreign investments, especially to the forest and mining business and service sectors, were received from Sweden, Germany, Australia and Spain.

The enterprise base in Kostomuksha grew relatively quickly soon after the devaluation in 1998. The growth was the most rapid in 2003 when the number of enterprises increased by over one thousand (2,503 enterprises). In 2005, the production of enterprises in Kostomuksha more than doubled compared to the previous year. As the economy kept recovering, and enterprise operations reviving, the unemployment in Kostomuksha gradually decreased to 1.6 per cent (Comment by Kostomuksha town administration on 01/01/2007). The slow revival of the Republic of Karelia that was struggling with economic troubles did indeed start from Kostomuksha. In 2007, the average salary in Kostomuksha surpassed 20,000 rubles, whereas the average salary in the capital, Petrozavodsk, was only slightly more than 15,000 rubles (Karelijastat 2009).

The relatively rapid economic growth realised in Kostomuksha in the 21<sup>st</sup> century began to be limited quite quickly, above all by the shortcomings in the infrastructure. The communications to the town are still inadequate, there are too few business premises, and the business life services do not meet the demand. The roads and postal services are also in poor condition and the logistics services are so modest that many enterprises organise the services themselves. Difficult customs practices impede purchases from abroad. Air communications to other towns in northwestern Russia, including the capital of the Republic, are nonexistent and, therefore, it takes two business days to process issues in the capital. Because of a difficult apartment shortage, the total population number in Kostomuksha (approximately 30,000) has not changed in the last 15 years, even though there are new workplaces available in the town. Already, the apartment shortage is impeding the recruitment of new workforce, and new investments have slowed. A labour shortage has also emerged in Kostomuksha.

There is a desperate need for business premises. Stores and workshops have been established in basements and kiosks as well as empty factories. Today, enterprises need to construct new business premises primarily by themselves as greenfield investments. There also exists a lack of business life services, such as funding, accommodation and restaurants. The funding sector began to grow in Russia only a few years before the economic crisis (Heininen et al. 2009), so that until recently business people have funded their operations either with their own or their acquaintances' and relatives' savings or unofficial funding markets.

Despite development, Kostomuksha is constantly very heavily dependent on the mining combine, which is responsible for nearly 90 per cent of the total production of the town. The combine's share of the total taxes of the town is approximately 70%, and it still employs approximately 46% of the town's labour. In addition to the mining industry, the chemical, forest, wood processing, agriculture and services industries are growing. The growth of these industries is relatively rapid in number despite the fact that production is still quite small in size.

The grey economy has remained at a relatively low level. Many enterprises operate in foreign trade, which renders their operations registered multiple times. Salaries are also

paid officially quite often. The official payment of salaries became more common in Russia at the beginning of the 21<sup>st</sup> century when the economy grew strongly, wherein people and enterprises started to believe more in economic progress, and consumers began to think and act with some long-term goals in mind. People became interested in securing their retirement days on top of short-span everyday living.

### **Reconstructing local governance in post-socialist Kostomuksha**

In the background of the rapid economic and social development of Kostomuksha is a versatile institutional governance mechanism, which combines old and new thinking, international, national and local impulses as well as formal and informal institutions in a fruitful way. Enterprises operating in Kostomuksha adopted new operating models and started to succeed in a market economy. However, the businesses did not blindly abandon all the old operating models but rather utilised them when integrating themselves deep into the society of Kostomuksha. The collapse of a centrally controlled planned economy made way to local governance practices and opened the door for international resources. The majority of mechanisms regulating the economy of the new Kostomuksha started to become transparent and formal, but alongside them there was still a group of informal institutions that were based on locality and, especially, contributed to the building of identity.

At the beginning of the 21<sup>st</sup> century, the town council of Kostomuksha was replaced with a more independent local government, which offered new possibilities to develop funding sources. One solution was to develop municipal multifunctional enterprises providing housing and municipal services. They succeeded quite well in maintaining the deteriorating infrastructure of the town. The local government followed the development of enterprises actively and attempted to relieve the problems caused by the radical economic change, where necessary. For instance, a loan granted by the Kostomuksha government saved the local wood processing company from bankruptcy at the end of the 1990s. The mining combine also received help during its economic troubles. The administration of Kostomuksha gave the combine time to settle its taxes and other municipal payments, decreased the taxation for Karelsky Okatysh and

reorganised its tax debts. The mining combine has participated in construction work in exchange for the help it received. In 2005, Karelsky Okatysh signed a contract with local and regional officials and agreed to pay additional taxes in the regional budget in exchange for the development of agreed upon infrastructural efforts. Throughout the years, Karelsky Okatysh has continued investing in certain social projects as well by supporting social centres and cultural and athletic activities in the town (Iljukha et al. 1997; RosInvest 2005). Karelsky Okatysh offers premises to various non-governmental organisations, such as the centre for mentally disabled children and the women's support centre. Additionally, it is helping to pay for the construction costs of the local swimming hall. The local government is also striving to develop the prerequisites for entrepreneurship and the well-being of residents by improving the local infrastructure, such as banking centres, marketplaces and car parks.

One of the local government's most important actions for developing business life was the new strategic plan for the socioeconomic development of the town until 2015, which was presented in 2004 (Prohorova & Rautio 2008). The town interacted closely with local residents and representatives of enterprises when preparing the programme. Based on this programme, promoting small entrepreneurship became one of the most central goals, even though it was previously quite neglected. The town aims in many ways to attract enterprises and facilitate their operation. The webpages promoting the business opportunities of the town have been improved, and information is now also available in English. Potential investors are served individually, starting from acquiring the land. Enterprises are also helped with their managing the difficult Russian bureaucracy jungle. They receive consultation, and in some cases they are granted temporary licences for starting their operations. In addition, the town administration organises seminars and discussions wherein enterprises and permit authorities can get to know each other and talk about their views and problems. Meetings with customs authorities are considered especially important.

The local government has also managed to grant enterprises various tax benefits and temporary exemptions from tax in exchange for investments. Such activity has in some cases led to problems between the authorities of different regional levels. However, the administration in Kostomuksha feels ready to bear the political responsibility in the

issue as long as its actions manage to attract enterprises to the area. This approach is extremely exceptional in Russia, where enterprises' experiences with the different levels of co-operation with authorities are generally negative (e.g. Heininen et al. 2008). Finnish and Swedish enterprises, for instance, have utilised tax benefits granted by the Kostomuksha administration. The tax benefits were related to a several-year struggle between regional and federal authorities regarding the establishment of a special zone and/or a border industry village in Kostomuksha. Background support for the negotiations was also received from Finland, where Kostomuksha's neighbouring municipalities from across the border, Kajaani and Kuhmo, received TACIS funding for project mapping. Eventually, the inconclusive negotiations were abandoned for good when Kostomuksha achieved its goals for attracting investments on its own without the status of a special economic zone. Instead, the town administration has continued close interaction in order to improve federal and regional legislation and to make it suit enterprises better. For instance, local authorities create bills for the parliament of the Republic to process.

Enterprises are also actively in contact with authorities, individually and in groups. The largest enterprises negotiate directly with customs, for instance, in order to develop co-operation. The negotiations between large enterprises and authorities make way for other enterprises that could not affect the authorities by themselves. Thus, they are useful for small and medium-sized enterprises in particular. Enterprises have also been gradually forming consortiums. Such activity is relatively new in Russia, where people have traditionally believed more in personal relationship operations, whose roots are in the *blat* system (Ledeneva 1998; Karhunen et al. 2008; Kosonen 2008). Consortiums of enterprises in Kostomuksha have been successful in opening communication channels with authorities at different regional levels. For instance, the female entrepreneurs of Kostomuksha have managed to discuss their problems with the President of the Republic. This is not possible in many regions (Logrén & Löfgren 2005).

Enterprise co-operation has also spawned new investments. For example, the local shopping centre was constructed after a few central enterprises combined their powers and produced the necessary funding for the project. Enterprise co-operation is supported by the enterprises' increased transparency and improved faith in the future. The

situation has improved considerably from the chaotic years of the 1990s when “nobody would buy a whole pack of cigarettes but only a few cigarettes at a time” and “no one wanted to invest in business life unless it provided a 200 per cent profit very quickly.” Before the start of the economic crisis in 2008, the business life in Kostomuksha had achieved a state where expectations became more realistic, commerce was conducted using the official means and channels, using receipts, and credit losses were rare. The largest problems between enterprises today are related to product quality issues. Solving these problems requires extensive training and investments in quality.

The town administration has started to invest in improving the road, rail and air communications. A railway connection to St. Petersburg has been achieved as a result of lobbying, and negotiations on opening an air connection are underway. New road connections are built and designed in order to improve connections to Europe. Finns participate in the development plans to increase their role as a frontier crossing point. At the beginning of 2009, an optical fibre cable connection between Kostomuksha and Kuhmo (Finland), built by TeliaSonera, was completed (Vaalisto 2009).

Even though the town has improved its interaction with enterprises and aims to facilitate their operation when possible, many small and medium-sized enterprises feel that the main focus of the town is continuously on large enterprises operating in the various industrial fields. According to the comments received, there is still a lack of faith in the small enterprises’ power to employ and increase tax revenues.

The town is trying to relieve the labour shortage in a number of ways. Local authorities are increasing the number of people being trained in critical lines of business. In co-operation with Karelsky Okatysh, the local branches of three universities have been opened so that the youth of Kostomuksha can have a chance to study at an institution of higher learning near their home. This is hoped to decrease the number of youths moving out of the town. Enterprises also participate in developing the prerequisites for business operations autonomously. They organise workplace transport for people in nearby villages so as to relieve the labour shortage. The best experts are even treated to business trips to St. Petersburg and back. Apartments are arranged when possible, albeit enterprises are not constructing residential areas for their employees, which is already

taking place in the Leningrad Oblast. The town has started a residential programme for 2004–2010, with the goal of producing approximately 3,000 square metres of apartments per year. Enterprises are continuously investing in the social and cultural life of the town by sponsoring athletic and cultural events and activities for the handicapped, for instance.

The problems that are related to the quality and skills of labour are solved in collaboration with the employees. In some enterprises, there is an operating trade union, which has been able to have some salary-related requests approved through disputes and striking. This has not always helped: Karelsky Okatysh, for instance, had to resort to large-scale dismissals at the end of the millennium in spite of the protests made by the trade union. To counter trade union pressure, the Russian personnel of some enterprises have suggested some completely opposite ways to improve work ethics or work quality. The suggestions have included paying only partial salary or setting 500-ruble penalties to shifts that have made mistakes. For now, such suggestions have struck foreign enterprises as odd, and they have offered their employees training in Finland instead, for instance.

Trust and willingness towards co-operation with authorities have been improved by the development of the legal system. Today, enterprises believe that they will receive relatively fair court proceedings as opposed to previous years when court proceedings were considered unjust. According to many Finnish enterprises operating in Russia, taking a dispute to court used to be “the same as shooting yourself in the back of your head.” The legal system did not work because of the Russian idea of the inherent dubiousness of doing business. This is why entrepreneurs were considered crooked from the start: “You are a criminal, even if you spend the rest of your life proving that you are not.” The development of the legal system has been important for increasing transparent business.

In spite of the increased harmony, the community that has developed in the 21<sup>st</sup> century Kostomuksha has in it some deeper processes that cause conflicts. A shopping centre project of a Russian entrepreneur operating in Kostomuksha clashed with the building authorities, and the construction was halted for several months due to a lack of clarity

with the permits. In the dispute, different authorities were pitted against each other, too, because the local government was considered to have given the construction site to the entrepreneur illegally and exceeded its authority by allowing the construction to go ahead without valid permits. A recent reorganisation of the enterprise in the wake of its bankruptcy has also attracted the interest of the judicial authorities (Fuks 2008). Such disputes can indeed bring to attention the hidden misuse of power or corruption that is still present in the Republic of Karelia as well as Kostomuksha. In December 2006, one of the leading entrepreneurs of the town fell victim to an attempted assassination, and in spring 2007 a representative of the town administration who had been spearheading a shopping centre project, among others, was a victim of homicide. Since both crimes are still unsolved, it is difficult to say in which way they represent the features of the business culture or the environment itself.

In spite of some conflicts, a group of versatile governance mechanisms originating from locality, national and international know-how and thinking in turn developed in Kostomuksha after all the chaotic years. Together, they were strong and effective enough to develop, maintain and regulate the local economy. A locally negotiated hybrid capitalism was developed in Kostomuksha. It utilises methods of discussion and participation between the actors of the economy. The main idea of the process is that local actors are unanimous, flexible and work together. The local government actively negotiates with the authorities of different regional levels in order to improve the prerequisites for economic life. At the same time, it works in a type of symbiosis with the most important enterprise, Karelsky Okatysh, and encourages foreign enterprises to make the business life in Kostomuksha more versatile. Apart from negotiations and pioneering work by major enterprises, the consensus is built by different alliances between enterprises. The trade unions have also joined the construction work quite well after the chaotic years of the 1990s. Finally, the process is affected by a strong local identity, which is based on the peculiar history of the town as Finnish-built and the citadel of residents with a settler mindset. During socialism, mostly young professionals moved into the town instead of “drunkards and bums as usual.” The population is fairly young and educated. People in Kostomuksha still retain a strong local identity, which is based on the shared experience about the settler spirit and survival under special circumstances. Kostomuksha’s nature as a border town and the Finnish construction

history bring their own twist to its identity. The building stock is different in a positive way from other towns that were built during socialism. In 2008, Kostomuksha was listed as one of the three cleanest and atmospherically pleasing towns in the Republic of Karelia.

### *Types of enterprise in Kostomuksha*

The strategies of the enterprises in Kostomuksha can be analysed in relation to the institutional environment with enterprise typology, according to how the enterprises have adapted to the change of the institutional environment after the collapse of the Soviet Union. With this classification, the enterprises can be divided into six groups. *Opportunists* represent enterprises that are the quickest to utilise the opportunities of the new system. However, these enterprises aim to gain profit only on a short-term basis, and others see their methods of operation as questionable. Next in the classification are *Neutrals*, *Disputing Constructors* and *Constructors*, each of whom combine their methods of operating from old and new systems differently. *Strugglers* are usually private entrepreneurs or small enterprises that operate mostly in a grey economy and merely try to make a living without attempting to integrate better with the formal institutional environment. The ones clinging the tightest onto the features of the old system are *Reactionaries*, who only aim at continuing their operations with minimal changes without trying to develop any new methods of operating.

The largest enterprise in Kostomuksha, Karelski Okatysh, has gone a long way from a Soviet enterprise that kept the whole town up to an actor of international market economy. At the same time, its relationship with the surrounding environment and public sector has gradually changed. The operation of the enterprise still has many features of a *Constructor* enterprise. During the Soviet era, Karelski Okatysh was responsible for the entire social and municipal infrastructure of the town until the beginning of the 1990s, which was the case in other one-enterprise towns as well. Through economic reforms, Karelski Okatysh has transferred the majority of these responsibilities to the town administration, but the enterprise still shares responsibilities for certain social commodities with the local government. Karelski Okatysh remains by

far the largest employer in Kostomuksha. The local government and the company form a type of symbiosis because of their interconnected interests, and they cooperate on many issues related to developing the town.

Due to its dominant position, the mining combine has many *Constructor* type features specifically in its relationship with the Kostomuksha local government and its public sector institutions. Since the company can use power in a completely different manner than smaller enterprises due to its dominant position, it is profitable for it to maintain close interaction with the local government. Karelski Okatysh has continued active interaction with the local government, but at the same time it has considerably developed its business into a direction of a modern enterprise that works on the conditions of market economy. It has also been boldly advocating its business-related goals whenever needed. At times, employee dismissals and the cutting of social responsibilities of the enterprise have provoked severe opposition by the townspeople, the trade union and the administration, but the company has still realised its large reform programmes to further its own goals.

Today, the majority of the enterprises in Kostomuksha can be described as *Neutrals*. Their actions are controlled by the logic of a market economy. Mostly, they do not have extra social responsibilities. They are relatively punctual taxpayers and are used to maintaining neutral relationships with other enterprises and the public sector. This group includes both foreign and locally owned small and medium-sized enterprises. Overall, the business environment has become more fixed, and even though this has affected the growth of the number of *Neutral* enterprises, Finnish influence can also be detected behind the development of business and administration practices. The experiences of the 1970s and 1980s make a foundation for many currently active collaboration relationships between Finland and Russia. Close business relationships with Finland and the greater availability of Finnish products have also led to competition for customers, which encouraged local enterprises to develop their work practices. Their relationships between enterprise partners became more neutral and less personal, and the collaboration became more efficient.

The significant number of *Neutral* enterprises can also be explained by the development of business services (especially the banking sector), stabilisation of the legislative business environment and increased competition. The relatively efficient relationships between enterprises and the public sector have affected the development of *Neutral* enterprises. It has become more possible for them to abide by Western business norms, as the bureaucracy has become more flexible, corruption is not dominant, the public sector operates quite flexibly and the enforcement of laws has developed, especially when it comes to courts of law.

At the same time, local entrepreneurs more often use formal and neutral ways when solving problems related to the business environment: they establish associations for entrepreneurs and develop mutual collaboration; they interact actively with the local government and also try to place advocates for the business world in representational bodies; they try to abide by the law and solve disputes with other enterprises or authorities with the help of professional attorneys. In spite of all this, many enterprises that are classifiable as *Neutrals* are still fairly paternalistic in their relationships with labour. Since the labour of smaller enterprises is unorganised, the employees have rather limited resources to defend their rights against illegal practices (such as penalties). On the other hand, some employees still exercise the Soviet mentality that it is a sort of “employee benefit” to sometimes use working hours for berry picking, for instance.

A fully neutral and legitimate market economy is not yet the reality in Kostomuksha. The disputed enterprise reorganisations of the 1990s can be interpreted so that the enterprises of the time still featured opportunistic spirit. Most of the enterprises that today are *Neutral* or *Disputing Constructors* were established in the post-socialist time, and they started their operations in the 1990s either as *Strugglers* or *Opportunists*. Usually, these were small private enterprises that aimed to gain profit on a short-term basis or merely tried to make a living day by day, especially by operating in the retail trade. However, the development of the business environment, increasing competition and narrowing margins decreased the prospects for quick profits. People began to seek long-term stability in business operations, after which *Struggler* and *Opportunist* type entrepreneurs began to specialise, invest in business development and improve the

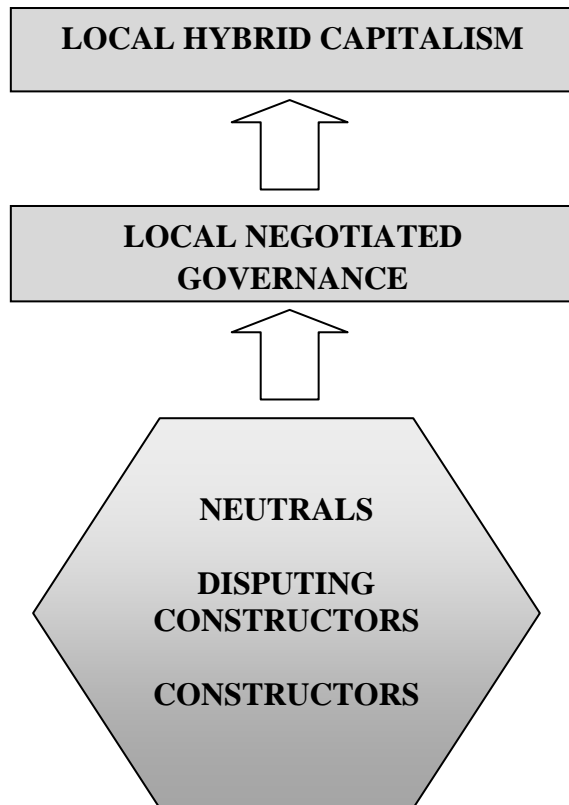
quality of their products and services. Many leading service and retail enterprises in Kostomuksha have gone through this type of development.

There are still enterprises in Kostomuksha that can be considered *Disputing Constructors*. Such enterprises are involved in local disputes that are often related to their business interests, such as ownership, dividing municipal property, and other relationships with other enterprises or the public sector. These disputes may lead to illegal actions, and apparently they have also previously led to acts of violence.

Firms who operate partly in the grey economy and avoid contact with authorities instead of utilising the interaction with the public sector, for example, can still be found in small enterprises particularly. *Reactionaries* were rare in Kostomuksha before the start of the new global economic crisis in 2008. The majority of the current enterprises in Kostomuksha, excluding the combine and its current and previous subsidiaries, were born only after the collapse of the Soviet Union. At the beginning of the 1990s, the combine had difficulties with adapting to a market economy and its operation. The combine collapsed for a moment but was revived after privatising, and it began to operate again gradually like a Constructor enterprise constructing local networks.

Foreign businesses are located in the typology as *Neutrals*, albeit they have to adapt to local conditions in order to achieve the best results. Often, this requires fairly close interaction with the authorities, great investments in following the intricacies of legislation and bureaucracy, great flexibility with labour and the observing of the meanings of personal relationships in all operations. The skill of social bargaining (Hirvensalo et al. 2000) still holds its value. Since the infrastructure of the society is still weak, it is sometimes useful for enterprises to invest in co-operation with the administration to improve the infrastructure. Many practice the sponsoring of social projects and PR operations. In addition, there may be transportation or accommodation services arranged for the employees as a part of the personnel policy: otherwise, the housing shortage would prevent the obtaining of good employees.

**Figure 5. The new accumulation system of Kostomuksha.**



### **‘Local participative hybrid capitalism’ in Kostomuksha faces new challenges**

The current global economic crisis has also hit hard in the Republic of Karelia, where it first harmed the wood processing industry and interrupted the operation of some enterprises completely. The demand for mining industry products has also decreased, but the immediate effects are not as severe as in the wood processing industry. At the beginning of 2009, the production of Karelsky Okatysh plummeted dramatically, and it is now equivalent to just approximately half of the level of production of the beginning of 2008. The company is now undergoing discussions regarding possible employee dismissals. The representatives of the company and the Government of the Republic have agreed to a shared crisis programme.

It is still early to assess how strongly the global financial crisis is affecting Kostomuksha. Since August 2008, the town administration has been preparing a crisis control programme to minimise the damages caused by the financial crisis, and the activity has also included meetings with the representatives of business life in the town. The town administration estimates that during 2009 the tax income of the town will drop approximately 15% from the level of 2008, and the enterprises in Kostomuksha will reduce the number of their employees by a total of 500 to 1,500 people. It is believed that only a part of this number will consist of actual dismissals and that retirement should take care of some reductions. Officially, unemployment in Kostomuksha was still very low in November 2008: only 1.1% or 190 persons in the whole town (Town of Kostomuksha 2009).

However, the situation became worse for Karelski Okatysh at the beginning of 2009. During the first quarter of 2009, the company's production dropped to less than half of the respective levels of the previous year. The production dropped due to a steep decline in demand. The combine introduced a shortened working week at the end of 2008 (Rosbalt 22.11.2008), but the latest information has it that massive dismissals are possible (Ovsjannikova 2009). An alternative to dismissals is cancelling the social support projects that the company is realising. The Swedish Swedwood Karelia has not yet declared any labour reductions. At the moment, the company is responding to the crisis by directing more of its production to Russian internal markets. The Finnish AEK Karhakos has already started to furlough and dismiss its employees, but the company has not yet announced the exact scale of these dismissals (Rautio 2008).

Kostomuksha has maintained its position as the pocket of development of the Republic of Karelia (Bond & Tykkyläinen 1996) and it is very important for the Republic. A town that relies on a few central enterprises and is very dependent on the variations in the global market prices of raw materials stands on a very unstable foundation in the new tumult of the economy. In addition to economic problems, the town is also facing a crisis in governance mechanisms, if the economic problems lead to a vicious circle wherein the fear of credit losses, the inefficiency of the funding sector and the weakening faith in the future increase the opportunism in authorities, entrepreneurs and consumers. This would result in a decreasing transparency in business. The lack of faith

would increase people's doing business based on personal relationships and possibly even barter trade, tempt businesses to pay their salaries unofficially, provoke authorities to make opportunistic deals with enterprises, and once again increase the authorities' distrust towards the field of business. Informal operating models are tightly embedded in the Russian society, and they emerge easily when problems arise. Again, after a long leap forward, the development of a market economy would take many steps backwards in Kostomuksha.

However, Kostomuksha is supported by many possibilities related to local and international resources. The short distance to the Finnish border is a resource for Kostomuksha today and in the future. The communications with Finland are good, and the infrastructure works well on the Finnish side. The global economy needs new solutions for overcoming logistics bottlenecks in the future. The importance of Kostomuksha might be increased in the future by the so-called Northlink logistics project. When realised, the project would connect the Finnish harbours in the Bothnian Bay and the Norwegian harbours in the Norwegian Sea with Central Europe, Russia and Asia. The project involves authorities, harbours and railway companies as well as ministries, customs and border authorities in Finland, Russia and several other regions. Barents collaboration authorities from Norway and Sweden are also involved in the planning of the project. However, the smooth progression of the project would require functional collaboration between borders. Indeed, the Russian border authorities and the unpredictability of border formalities have for now made it difficult for Kostomuksha as well as the whole of Russia to integrate with the global economy. The prolonged WTO negotiations are making integration even more difficult. In addition, the decisions made on the Russian federation level on timber tariffs and on expanding the border area, for instance, may make Kostomuksha's development more difficult, and it is not really possible to affect these decision making processes.

Kostomuksha also has some strengths of its own. Its population is relatively young and educated compared to other Russian towns. Additionally, the possibilities for education have been actively developed in order to keep the population from leaving the locality. The diversification of business life has also received a lot of attention, although small and medium-sized enterprises are still criticising the importance of large enterprises in

the town's development plans. Small and medium-sized enterprises could be the key to satisfying local markets better. Business based on the Russian markets, in the forest industry for example, should be developed to accompany the globally operating mining combine, which is sensitive to economic fluctuations. The last investments before the economic crisis in 2008 relied heavily on utilising the Russian markets. The local business life has prospects of development, especially in the funding, enterprise and consumer service industries.

## **Conclusion**

Due to the rapid socioeconomic development in 2004 and 2005, Kostomuksha held first place in the socioeconomic development comparison of the municipalities of the Republic of Karelia. The good position was the result of high regional GDP per resident, high tax income per resident, high salary levels, low unemployment and a relatively low crime rate, which decreased considerably in 2005. The salary development has been favourable after that too. In 2007, the average salary in Kostomuksha was 20,234 rubles, when in Petrozavodsk, the capital of the Republic, the average salary was only 15,314 rubles (Karelijastat 2009).

Since the 1990s, the town of Kostomuksha has been consciously developing development strategies and trying to realise the goals, as defined in them, with determination. Kostomuksha has achieved its essential goals rather well. It has managed to attract foreign investors to the town and diversify the business structure significantly from a one-enterprise town to an international "pocket of development" featuring several lines of business.

Kostomuksha has managed to create significant local coherence regarding the development goals of the town. Political decision-making utilises methods of discussion and participation, and the town administration interacts actively with the Republic and federal administrations. The development of Kostomuksha is, however, affected by a group of factors on which the town has very little direct say. These include the allocating of the tax income, the operations of the federal permit authorities and state-

level legislation and regulations, to name some. In spite of a number of problems with the Federation, a special governance mechanism has developed in Kostomuksha. It utilises resources from different regional levels and can be called local negotiated hybrid capitalism. Its essential elements are co-operation between the strong local government and large enterprises, and mutual flexibility. Networking between enterprises is also building a foundation for mutual benefit for the long-term. The local embeddedness of Kalresky Okatysh and the constructive market economy model assigned by many foreign businesses are in the centre of the governance mechanism. Finnish businesses have been pioneers in relieving problems related especially to customs clearance and other border formalities, in collaboration with the authorities. Employees and the trade union movement have been involved in the reconstruction of Kostomuksha fairly well after the chaotic years of the 1990s. The backbone and glue of the governance mechanisms is a strong local identity. It is based on the settler identity and the idea of an international border town, and adopted by townspeople regardless of their social class. Internationality began when the town was built with Finnish labour, and it has since then expanded to EU programmes that have given the development of the town a new lift. The building blocks of the local identity of Kostomuksha have survived the change of systems better than more traditional myths relying on the accomplishments of socialism, because most of them are still relevant. Still today, Kostomuksha is a northern pioneer town, which utilises natural resources and leads the economic and technological development in the Republic of Karelia.

Kostomuksha illustrates many previously theoretical discussions regarding the roles of institutions in the foundation and operation of local governments. The local negotiated hybrid capitalism in Kostomuksha is in many ways reminiscent of the idea from Amin and Thrift (1995) of the local institutional thickness, in which the local economy will eventually become a common agenda for the actors as a result of versatile interaction. The process may be strengthened by a strong identity based on local myths, which is noticeable in Kostomuksha as well. The meaning of historical factors, myths and symbols as constructors of a local identity (Paasi 1986) and as economic resources has been noted in many studies (e.g. Spilling 1991; Bruno & Tyebjee 1982; Adams 1992; Courlet 1989; Saxenian 1994). The hybrid market economy that has developed in Kostomuksha also reflects the previous studies on the collapse of socialism and the

meaning of different mutations and hybrids on the construction of a market economy (Burawoy 1996; Hardy 2004, 2007; van Zon 1998; Smart 1998; Kuczi & Makó 1997; Bénacek 1997).

In terms of regulation theory, Kostomuksha has managed to create economic, social and political coherence that has increased the competitive strength of the region and continuously attracted new foreign investors in the 21<sup>st</sup> century. The problems initiated by the current global economic crisis are again putting the coherence of Kostomuksha to the test.

## Bibliography

Adams, John (1992) Economic Change in the Fourteenth Century: The Case of Siena. *Journal of Economic Issues* 26, 125–135.

Aglietta, Michel (1979) *A Theory of Capitalist Regulation. The US Experience*. London: New Left Books.

Altvater, Elmar (1993) *The Future of the Market: An Essay on the Regulation of Money and Nature after the Collapse of 'Actually Existing Socialism'*. London: Verso.

Amin, Ash & Thrift, Nigel (1995) Globalisation, Institutional 'Thickness' and the Local Economy. In Healey, P., Cameron, S., Davoudi, S., Graham, S. & Madani-Pour, A. (eds) *Managing Cities: The New Urban Context*, pp. 91–108. Chichester: John Wiley & Sons.

Benáček, Vladimír (1997) Private Entrepreneurship and Small Businesses in the Transformation of the Czech Republic. In Grabher, G. & Stark, D. (eds) *Restructuring Networks in Post-Socialism. Legacies, Linkages, and Localities*, pp. 209–241. Oxford: Oxford University Press.

Bond, Derek & Tykkyläinen, Markku (1996) Northwestern Russia: A Case study in 'Pocket' Development. *European Business Review* 96(5), 54–60.

Bruno, Albert V. & Tyebjee, Tyzoon T. (1982) The Environment for Entrepreneurship. In Kent, C.A., Sexton, D.L. & Vesper, K.H. (eds) *Encyclopedia of Entrepreneurship*, pp. 288–317. Englewood Cliffs, New Jersey: Prentice-Hall.

Burawoy, Michael (1996) The State and Economic Involution: Russia Through a China Lens. *World Development* 24(6), 1105–1117.

Courlet, Claude (1989) Local Industrial Policies in Favor of Small and Medium Sized Firms: The French Case. In Albrechts, L., Moulaert, F., Roberts, P. & Swyngedow, E. (eds) *Regional Policies at the Crossroads. European Perspectives*, pp. 180–191. London: Jessica Kingsley Publishers.

Economic Monitoring (2007a) The Republic of Karelia in 2006. Biannual Review, May 2007. University of Joensuu, Karelian Science Centre. Available at:

<http://www.hse.fi/EN/cemat/projects/economicmonitoring/reports/>. Last checked 15.7.2009.

Economic monitoring (2007b) The Republic of Karelia in the first half of 2007. Biannual Review, December 2007. University of Joensuu, Karelian Science Centre. Available at: <http://www.hse.fi/EN/cemat/projects/economicmonitoring/reports/>. Last checked 11.8.2009.

Fuks, Aleksandr (2008) Tragedia v Kostomukše. Karelskaja gubernija 9.7.2008. Available at: <http://rep.ru/09Jul2008/rep/01.html>. Last checked 25.8.2009.

Granovetter, Mark (1985) Economic Action and Social Structure: The Problem of Embeddedness. *American Journal of Sociology* 91(3), 481–510.

Hardy, Jane (2004) Rebuilding Local Governance in Post-Communist Economies: The Case of Wrocław, Poland. *European Urban and Regional Studies* 11(4), 303–320.

Hardy, Jane (2007) The Transformation of Post-Communist Economies in a Globalised Economy: The Case of Poland. *Research in Political Economy* 24, 131–162.

Heininen, Polina, Mashkina, Olga, Karhunen, Päivi & Kosonen, Riitta (2008) *Leningradin lääni yritysten toimintaympäristönä – pk-sektorin näkökulma*. Helsinki School of Economics Publications B-88. Helsinki: Helsinki School of Economics.

Heininen, Polina, Mikkola, Olli-Matti, Karhunen, Päivi & Kosonen, Riitta (2009) *Yritysrahoitusmarkkinoiden kehitys Venäjällä. Pk-yritysten tilanne Pietarissa*. Helsinki School of Economics Publications B-102. Helsinki: Helsinki School of Economics.

Hirvensalo, Inkeri, Kosonen Riitta & Salmi, Asta (2000) Social Bargaining and Foreign Owned Companies in Russia. *Idäntutkimus* 7, 48–61.

Iljukha, O.P., Antoshchenko, A.V. & Dankov, M.Y. (1997) *Istoriija Kostomukshi*. Petrozavodsk: Mega-Press.

Karelijastat – Teritorialnyi organ Federalnoi Služby gosudarstvennoi statistiki po respublike Karelija (2009) Available at:

<http://krl.gks.ru/munstat/IndDoc/Forms/Items.aspx>. Last checked 17.8.2009.

Karhunen, Päivi, Kosonen, Riitta, Logrén, Johanna & Ovaska, Kristo (2008) *Suomalaisyriyten strategiat Venäjän muuttuvassa liiketoimintaympäristössä*. Helsinki School of Economics Publications, B-84. Helsinki: Helsinki School of Economics.

Kosonen, Riitta (2002) *Governance, The Local Regulation Process, and the Enterprise Adaptation in Post-Socialism: The Case of Vyborg*. HSE Dissertation series A-199. Helsinki: Helsinki School of Economics.

Kosonen, Riitta (2005) The use of regulation and governance theories in research on post-socialism: the adaptation of enterprises in Vyborg. *European Planning Studies* 13(1), 5–21.

Kosonen, Riitta (2008) Henkilösuhteet ja epävirallinen vaikuttaminen venäläisessä liiketoiminnassa. In Salmenniemi, Suvi & Rotkirch, Anna (eds) *Suhteiden Venäjä*, pp. 93–121. Helsinki: Gaudeamus.

Kuczi, Tibor & Makó, Csaba (1997) Towards Industrial Districts? Small-Firm Networking in Hungary. In Grabher, G. & Stark, D. (eds) *Restructuring Networks in Post-Socialism. Legacies, Linkages, and Localities*, pp. 176–189. Oxford: Oxford University Press.

Ledeneva, Alena V. (1998) *Russia's Economy of Favours. Blat, Networking and Informal Exchange*. Cambridge, New York: Cambridge University Press.

Lipietz, Alain (1988) Accumulation, Crises, and Ways Out. Some Methodological Reflections on the Concept of “Regulation”. *International Journal of Political Economy* 18(2), 10–43.

Logrén, J. & Löfgren, J. (2005) *Koukussa yrittäjyyteen: suomalaisten ja venäläisten naisyrittäjien motiiveja ja haasteita*. Helsinki School of Economics Publications B-64. Helsinki: Helsinki School of Economics.

Moisander, Johanna & Valtonen, Anu (2006) *Qualitative Marketing Research. A Cultural Approach*. London: Sage.

Murray, Robin (1992) Flexible Specialisation and Development Strategy: The Relevance for Eastern Europe. In Ernste, H. & Meier, V. (eds) *Regional Development and Contemporary Industrial Response: Extending Flexible Specialisation*, pp. 197–218. London: Belhaven Press.

Oinas, Päivi (1998) *The Embedded Firm? Prelude for a Revived Geography of Enterprise*. Helsinki School of Economics and Business Administration Publications A-143. Helsinki: Helsinki School of Economics and Business Administration.

Ollus, S-E, Simola, H. & Tekoniemi, M. (2007) *Venäjän aluepolitiikka 2000-luvulla – mitä uusi alueluokitus merkitsee?* BOFIT Online 2007 No. 9.

Ovsjannikova, Natalja (2009) V Kostomukše vybirajut iz dvuh zol. Balt Info 19.5.2009. Available at: <http://www.baltinfo.ru/stories/V-Kostomukshe-vybirayut-iz-dvukh-zol>. Last checked 19.8.2009.

Paasi, Anssi (1986) The Institutionalization of Regions: A Theoretical Framework for the Understanding of the Emergence of Regions and the Constitutions of Regional Identity. *Fennia* 164, 105–146.

Painter, Joe & Goodwin, Mark (1995) Local Governance and Concrete Research: Investigating the Uneven Development of Regulation. *Economy and Society* 24(3), 334–356.

Pickles, John (1995) Restructuring State Enterprises: Industrial Geography and Eastern European Transition. *Geographische Zeitschrift* 83(2), 114–131.

Prohorova, E. & Rautio, V. (2008) Clearing-kaupasta maailmantalouteen: suomalaisyritysten rooli Kostamuksen talouskehityksessä. Aleksanteri Papers 1:2008.

Putnam, Robert D. (1993) *Making Democracy Work: Civic Traditions in Modern Italy*. New Jersey: Princeton University Press.

Rautio, Sirkku (2008) Karhakos irtisanoo ja lomauttaa Kostamuksessa. Kainuun sanomat 2.12.2008. Available at:

[http://www.kainuunsanomat.fi/cs/Satellite?c=AMArticle\\_C&childpagename=KSA\\_news&site%2FAMLLayout&cid=1194608873213&p=1194613516391&pagename=KSAWrapper](http://www.kainuunsanomat.fi/cs/Satellite?c=AMArticle_C&childpagename=KSA_news&site%2FAMLLayout&cid=1194608873213&p=1194613516391&pagename=KSAWrapper). Last checked 19.8.2009.

Rautio, Vesa & Kosonen, Riitta (2006) A Soviet Enterprise's Journey from Domestic to Global Markets: The Adaptation Process of Mining Giant Norilsk Nickel. *The Journal of Comparative Economic Studies* 2, 33–58.

Rosbalt (2008) “Karelski okatyš” sokratit obemy proizvodstva na 50%. Rosbalt 2.1.2008. Available at: <http://www.rosbalt.ru/2008/11/22/543932.html>. Last checked 19.8.2009.

RosInvest (2005) Perspektivny raboty “Karelskogo Okatyša” satali temoi vstretši Glavi Respubliki Sergeja Katanandova s generalnim direktorom ZAO ”Severstal-resurs” Romanom Deniskinyim i generalnim direktorom OAO ”Karelskogo Okatyš” Valeriem Grinenko. RosInvest 29.6.2005. Available at: <http://www.rosinvest.com/news/105535>. Last checked 21.8.2009.

Rosstat: Russian Federal State Statistics Service (2009) Available at: <http://www.gks.ru/wps/portal/english>. Last checked 19.8.2009.

Saxenian, AnnaLee (1994) *Regional Advantage. Culture and Competition in Silicon Valley and Route 128*. Cambridge: Harvard University Press.

Smart, Alan (1998) Economic Transformation in China: Property Regimes and Social Relations. In Pickles, J. & Smith, A. (eds) *Theorising Transition. The Political Economy of Post-Communist Transformations*, pp. 428–449. London: Routledge.

Smith, Adrian (1998) *Reconstructing the Regional Economy. Industrial Transformation and Regional Development in Slovakia. Studies of Communism in Transition*. Cheltenham: Edward Elgar.

Smith, Adrian and Swain, Adam (1998) Regulating and Institutionalising Capitalism: The Microfoundations of Transformation in Eastern and Central Europe. In Pickles, J. and Smith, A. (eds) *Theorising Transition. The Political Economy of Post-Communist Transformations*, pp. 25–53. London: Routledge.

Spilling, Olav R. (1991) Entrepreneurship in a Cultural Perspective. *Entrepreneurship and Regional Development* 3, 33–48.

Stryjakiewicz, Tadeusz (2000) *Paths of Industrial Transformation in Poland and the Role of Knowledge-Based Industries*. Mimeo.

Sweeney, Gerry P. (1990) Indigenous Development Strategies in Peripheral Regions: The Example of Ireland. In Ewers, H.J & Allesch, J. (eds) *Innovation and Regional Development: Strategies, Instruments, and Policy Coordination*, pp. 265–285. Berlin: Walter de Gruyter.

Tickell, Adam & Peck, Jamie A. (1992) Accumulation, Regulation and the Geographies of Post-Fordism: Missing Links in Regulationist Research. *Progress in Human Geography* 16(2), 190–218.

Tickell, Adam & Peck, Jamie A. (1995) Social Regulation after Fordism: Regulation Theory, Neo-Liberalism and the Global-Local Nexus. *Economy and Society* 24(3), 337–386.

Town of Kostomuksha (2009) Official Kostomuksha City District Website. Available at:

[http://www.kostomuksha-city.ru/main.phtml?m=11&lang=ru&path\\_link=report\\_ser\\_2006.phtml](http://www.kostomuksha-city.ru/main.phtml?m=11&lang=ru&path_link=report_ser_2006.phtml). Last checked 19.8.2009.

Vaalist, Heidi (2009) Kostamus saa nopean valokuituyhteyden. Helsingin Sanomat 19.3.2009. Available at:

<http://m.digitoday.fi/?page=showSingleNews&newsID=20097385>. Last checked 17.8.2009.

van Zon, Hans (1998) The Mismanaged Integration of Zaporozhzhya with the World Economy: Implications for Regional Development in Peripheral Regions. *Regional Studies* 32(7), 607–618.

Väyrynen, Kaisa (2005) Työseminaari Kostamuksessa 25.-26.1.2005. Available at: [http://www.nk.chamber.fi/fi/document.cfm?doc=show&doc\\_id=108](http://www.nk.chamber.fi/fi/document.cfm?doc=show&doc_id=108). Last checked 19.8.2009.