

OCTOBER 2016



# THE KREMLIN PLAYBOOK

UNDERSTANDING RUSSIAN INFLUENCE  
IN CENTRAL AND EASTERN EUROPE

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A REPORT OF THE  
CSIS EUROPE PROGRAM AND THE CSD ECONOMICS PROGRAM

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Born as a think-tank, the Center for the Study of Democracy has evolved into policy development through dialogue and partnership. CSD's belief is that bringing a new culture of cooperation and trust in a milieu of inherited fragmentation and opacity is equally rewarding as the achievement of concrete social goals.

CSD has combined research excellence with policy advocacy for piloting social innovation and institutional reforms in a number of areas, most notably diagnosing and exposing corruption, tackling the hidden economy, reforming energy governance and energy security, monitoring organized crime risks, etc.

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# Preface

“. . . [Russia] uses overt and covert means of economic warfare, ranging from energy blockades and politically motivated investments to bribery and media manipulation in order to advance its interests and to challenge the transatlantic orientation of Central and Eastern Europe.”

—June 2009 Open Letter to the Obama administration from  
Central and Eastern European Leaders

“. . . [Vladimir Putin’s] got a playbook that has worked for him now two or three times. And he will continue to [use it].

—July 2014 Martin Dempsey, Chairman of the Joint Chiefs of Staff

“We are stronger because we are democracies. . . . We’re stronger because we embrace open economies.”

—President Barack Obama in 2014 in Tallinn, Estonia

When Central and Eastern Europe threw off the communist yoke and the Soviet Union collapsed, Europe and the United States transformed their Soviet policy of isolation and containment to one of political and economic integration with the Russian Federation. With its financial and political networks remaining largely intact, Russia’s integration with Europe was successful. In the past 10 years alone, the value of Russia’s global trade has nearly quadrupled from \$210 billion in 2003 to \$730 billion in 2014, and Russia’s trade with the European Union (EU) represented 44.5 percent of its total. Europe grew more reliant on Russian energy and financial resources, and this dependency has provided Moscow with key levers through which it is able to shape the policy debate in European capitals in favor of its interests.

In the aftermath of its economic devastation following the collapse of the Soviet Union, Russia pursued a form of oligarchic capitalism that has become an enduring trademark of Russia's economic and political model. The Kremlin has attempted to replicate or "export" this model, albeit on a smaller scale, in other postcommunist countries. The early and ongoing economic and democratic transition period in Central and Eastern Europe—with weak democratic institutions and nonexistent monitoring and control systems—proved to be fertile ground for fostering a highly corrupt network of transactions and interests between Russia utilizing its Council for Mutual Economic Assistance (COMECON) bloc and intelligence networks, which has served to further enrich a closely knit circle of Russian oligarchs whose interests the Kremlin has embedded in its political and economic agendas.

Over time, Russia's economic integration with Europe and the export of its economic model—specifically with the countries of Central and Eastern Europe—have gradually devolved from a positive source of growth into a negative and corrosive force. The 2008 global financial crisis intensified Russia's investment in European assets, which deepened its political influence. Unsurprisingly, nowhere else is more closely tied to Russian funding, commerce, and resources than Central Europe and this report's selected case study countries of Hungary, Slovakia, Bulgaria, Latvia, and Serbia. Former Central European leaders presciently warned President Barack Obama at the very beginning of his administration about these active Russian networks in their countries, but their warnings were ignored. Russia's illegal annexation of Crimea and military intervention in Eastern Ukraine in 2014 and Europe's attempt to maintain a coherent and collective policy response to Russia's violations of international law have highlighted the culmination of Russia's economic influence and its impact on governance, democratic standards, and ultimate policy orientation. The rise of nationalistic and anti-EU political sentiment across Europe has magnified and amplified the impact of Russian influence as fragile coalition governments with weakened economies are increasingly vulnerable to Russian-exercised influence. Central and Eastern European countries with less developed and deeply rooted institutions and civil society appear to be the most susceptible to malign Russian influence, although the permutations of this influence vary from country to country. Neither Western Europe nor the United States is immune from Russian influence either.

The weakening of democratic standards in the countries of Eastern and Central Europe has enabled elected leaders to implement policies that run contrary to core Western values and are increasingly authoritarian in nature. Despite being members of the European Union and the North Atlantic Treaty Organization (NATO) for over a decade, several countries in the region are experiencing an erosion of transparency, the rule of law, and good-governance practices. Freedom House's 2013 *Nations in Transit* report noted that only two out of 10 Central European countries (Latvia and the Czech Republic) have improved their democracy "score card" 10 years after EU and NATO accession. The other eight countries' ratings dropped in the areas of media freedom, electoral processes, judicial independence, and corruption, suggesting that communist-era networks of corruption and clientelism have persisted.

The erosion of democratic institutions and rampant corruption are the most evident in countries where Russian political, economic, and societal ties are the strongest and the rise of anti-European

and anti-American sentiment have been the most pronounced. While the circumstances surrounding developments in each state are unique and in many cases independent of one another, the evidence suggests that these trends may not be coincidental; Russian funding and support has seemingly contributed to the rise of political forces that seek to undermine the Euro-Atlantic orientation of these countries and foster greater support for Russian policies. Although it is difficult to prove a causal relationship between activities that occur in the shadows, this is the pattern that we observe and encourage our readers to draw their own conclusions.

European leaders are slowly awakening to the negative impact that the erosion of independent policy action and decaying democratic practices has had on European unity. The EU has instituted an annual review or “dialogue” that will take place in the European Council to ensure the “safeguard of the rule of law in the framework of EU treaties” from those EU members that breach the rule of law. The German Parliament held a hearing on the level of Russian economic activity in Bulgaria.<sup>1</sup> There are press reports that suggest the U.S. government will launch a multi-country Central and Eastern European anticorruption action plan to stem the decline in governance standards.<sup>2</sup> On a trip to Bulgaria in 2015, Secretary of State John Kerry remarked that fighting corruption is “about . . . shielding the country from those who exploit the situation to gain undue influence over your choices as a sovereign nation,” which represents a small but important recognition of the challenge.

Slowly awakening to the impact of Russian influence is a far cry from understanding the depth of the policy challenge and implementing policy responses, however. Although Russia’s military activism has received significant policy attention by the United States and NATO, transatlantic understanding of Europe’s susceptibility to and complicity with Russian influence—which constitutes an equally serious threat to European security—is completely lacking. A disunited, politically paralyzed, and antidemocratic Europe would erode the ability of NATO to defend and uphold transatlantic norms, values, and institutions, seriously undermining and ultimately questioning the future of the alliance. The stakes are enormous.

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1. Gerard Traufetter, “In the Kremlin’s Grip: Fears Grow Over Bulgaria’s Russian Dependence,” *Spiegel Online International*, May 12, 2014, <http://www.spiegel.de/international/europe/fears-grow-in-europe-that-russia-will-influence-bulgaria-a-968955.html>.

2. Sarah Sewall, “Remarks: New Frontiers in Understanding and Addressing Corruption,” U.S. Department of State, December 9, 2014, <http://www.state.gov/j/remarks/234870.htm>.



# Acknowledgments

It takes an analytical village to produce a report of this nature, and this study was no exception. The authors would like to profusely thank the transatlantic team of experts and thought leaders who contributed to this research over the course of our 16-month study. Due to the sensitivity of the content, several of our colleagues have asked to remain anonymous, although their contributions were no less valuable. We would specifically like to thank our regional experts, Kristian Takac from Slovakia, Andras Deak and Csaba Weiner from Hungary, and Reinis Aboltins from Latvia, whose hard work and research formed the backbone of the economic analysis. The credibility and relevance of this study derives solely from the in-depth local knowledge, expertise, and perspective that their work injected into our findings. The authors would also like to thank the participants at our workshops in Sofia, Bulgaria in September 2015 and Washington, DC in February 2016, as well as the many current and former senior-level officials from the region and the U.S. diplomats from whom we received crucial insights in private discussions and interviews throughout the study period, which helped shape our analyses. We would also like to thank Dr. Kiril Kolev from the Hendrix College International Relations Department for his assistance in helping us understand political party financing and media ownership trends in the region. We would like to thank the U.S. Departments of State and Energy for providing support for the acquisition of corporate database licenses to facilitate our economic footprint research.

The value of this report is that it is a true transatlantic analytical product that benefited enormously from two extremely talented and dedicated CSD and CSIS team members: James Mina and Martin Vladimirov, who have literally conducted hundreds of hours of research and writing. We are grateful to CSD Chairman Ognian Shentov and CSIS Europe Program Deputy Director Jeff Rathke for their ideas and encouragement, as well as Nirja Desai in the CSIS iDeas Lab for translating our analytical work into visual form. The comprehensive corporate data mining and tracking of economic indicators would not have been possible without the enormous effort in data analysis conducted by the CSD Economic Program team, including Dr. Todor Galev, Dr. Todor Yalamov, Nadejda Gantcheva, and Martin Tsanov, as well as Martin Sokolov and Nikol Chumova. Finally, we would like to thank the CSIS Europe Program's all-star cadre of interns for their dedication,

enthusiasm, and hard work, including Sriram Ramesh, Pierce Tattersall, Eric Adamson, and especially Andrew Thvedt, whose assistance preparing the final manuscript was indispensable.

The first step in resisting malign foreign influence is to understand its methodology, patterns, reach, and ultimate aims. And this important first step could not have been taken without the generous support and vision of the Smith Richardson Foundation.

# Executive Summary

## THE WARNING

In 2004, there was a deeply held transatlantic assumption that, with the historic expansion of NATO and the European Union, the countries of Central and Eastern Europe would continue their positive democratic and economic transformation as full members of these Euro-Atlantic institutions. Once this historic moment passed and policy attention dissipated, the United States became largely indifferent to ongoing developments in the region, assured in the knowledge that the European Union would encourage continued regional progress and act to discourage, or if necessary reprimand, regression. This assumption was incorrect; if anything, neither Washington nor Brussels fully recognized the region's transitional fragility and its policy responses to democratic backsliding have been negligible.

Four years later, the 2008 Global Recession shook the institutional foundations of nearly every country, but in particular the economic crisis violently shook the public confidence in democratic societies and market economies. In hindsight, Europe was shaken to its very core and, eight years later, remains unable to return to precrisis equilibrium. The devastating aftershocks of the Great Recession rippled across Central and Eastern Europe and were underestimated.

In 2009, a group of Central and Eastern European leaders wrote an open letter to U.S. president Barack Obama, warning the Obama administration that Russia was conducting "overt and covert means of economic warfare, ranging from energy blockades and politically motivated investments to bribery and media manipulation in order to advance its interests . . . [challenging] the transatlantic orientation of Central and Eastern Europe." Again, in hindsight, this too was a prescient message which built upon the region's incomplete democratic transition as well as its ongoing economic crisis.

## THE THREAT

Today, the failed assumptions and warnings have come to pass. The United States confronts a region in which Russian economic activity has increased; the region is more sympathetic to

Russian policy approaches; the region's democratic institutions have been diminished and illiberalism embraced. A disunited Europe and the weakening democratic institutions in EU and NATO member states seriously erodes the West's credibility and hinders the ability of the transatlantic alliance to globally promote liberal democratic values. Nowhere is Russia's policy better poised for success than the newest members of the European Union and NATO, as well as the states that aspire to join these institutions.

The Center for Strategic and International Studies (CSIS) and the Center for the Study of Democracy (CSD) in Sofia, Bulgaria, embarked on a 16-month study to understand the impact of Russian economic influence in Central and Eastern Europe in five case study countries of Bulgaria, Hungary, Latvia, Serbia, and Slovakia during 2004–2014 and its possible correlation to the region's general decline in governance standards. Our work has determined that **Russia has cultivated an opaque network of patronage across the region that it uses to influence and direct decision-making.** This web resembles a network-flow model, which we describe as an **"unvirtuous circle" of Russian influence.** The circuitous flow can either begin with Russian political or economic penetration and from there expand and evolve, in some instances leading to "state capture." Russia seeks to gain influence over (if not control of) critical state institutions, bodies, and the economy and uses this influence to shape national policies and decisions. **Corruption<sup>1</sup> is the lubricant on which this system operates, concentrating on the exploitation of state resources to further Russia's networks of influence.**

These Russian networks constitute a vital element of Russia's doctrine of New Generation Warfare, which "is primarily a strategy of influence, not of brute force," and its primary goal is "break[ing] the internal coherence of the enemy system—and not about its integral annihilation." Russia's strategy of influence seeks to alter the perception of—if not halt and eventually reverse—Central and Eastern Europe's Euro-Atlantic enlargement and orientation, which has the added benefits of breaking U.S. and Western dominance of the international and democratic liberal order, restoring Russia's historic sphere of influence, and returning to a bipolar organized world. Russian influence centers on weakening the internal cohesion of societies and strengthening the perception of the dysfunction of the Western democratic and economic system, which has stagnated since the global financial crisis and reels from the effects of globalization. This is achieved by influencing and eroding democratic governance from within its own institutions. Just as the West demonstrated the superiority of its economic and political model in the 1989–1991 era, which led to the dissolution of the Soviet Union, the Kremlin may be attempting to affect a reverse outcome by actively discrediting the Western liberal democratic system as well as offering the alternative model of its illiberal managed democracy and *siloviki*-style economic systems, which could undermine the cohesiveness and stability of NATO and the European Union. Once this outcome is achieved, a new European security architecture can be negotiated.

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1. For the purposes of this study, we define "corruption" as the alleged or reported exercise of one's power, position, or resources in order to exploit or exert undue influence over businesses, individuals, or state bodies and institutions, typically through nontransparent and questionable means. This may include actions that could be deliberate and/or unlawful, but may not necessarily be so. The examples we cite support our observations of how this unvirtuous circle works based on open-source facts and information, but these observations do not suggest or accuse any specific individuals of wrongdoing.

The United States can no longer be indifferent toward these negative developments in Europe. All members of NATO and the European Union must collectively recognize that **Russian influence is not just a domestic governance challenge, but a national security threat**, and efforts to counter it must be treated as such. Left unchecked this influence over time will compromise the integrity of Central and Eastern European democracies and dramatically impact U.S. foreign policy goals.

## THE FINDINGS

Malign Russian influence in Central and Eastern Europe primarily follows two tracks: one aimed at manipulating a country by dominating strategic sectors of its economy to abuse capitalism and exploit the weaknesses in its economic governance systems; and another that seeks to corrode democracy from within by deepening political divides and cultivating relationships with aspiring autocrats, political parties (notably nationalists, populists, and Euroskeptic groups), and Russian sympathizers. While there are specific patterns of conduct within each track, there is no clear-cut path that Russia appears to follow in any case. Rather, a tactical combination of actors and drivers may be used in pursuit of specific strategic outcomes—all of which depend on the unique conditions present within each country thus acquiring a Russian “tailor-made” strategy. Although these two tracks are not mutually exclusive, they represent the path through which Russian interests seem to have penetrated the domestic environment. Depending on the success of either or both tracks, economic and political influence tends to mutually reinforce the other, deepening Russia’s reach within the country.

The Russian economic footprint in the five case countries was determined by examining Russia’s corporate presence, direct investment, trade relationships (e.g., bilateral account balance), and private ownership and investments. Turnover, assets, and employment indicators for Russian-owned and controlled companies in each of the country case studies was used to estimate the share of Russian business in the overall economy, as these are the best proxies for the Russian economic footprint as share of GDP and can be easily compared. **Based on the economic data we collected, we observed that those countries in which Russia’s economic footprint was on average more than 12 percent of its GDP were generally more vulnerable to Russian economic influence and capture. For those countries with less than 12 percent of its GDP, these countries demonstrated greater susceptibility to Russian political influence.** Thus, we conclude that:

*Below the 12 percent GDP economic threshold:*

- Hungary and Slovakia are at greater risk of political influence, which appears to be connected to efforts to deepen or maintain Russia’s economic presence.

*Above the 12 percent GDP economic threshold:*

- In Bulgaria, where Russia’s economic presence averaged over 22 percent of the GDP between 2005 and 2014, there are clear signs of both political and economic capture, suggesting that the country is at high risk of Russian-influenced state capture.

*Above the 12 percent GDP economic threshold, but with varied results:*

- Russia's economic footprint in Serbia falls above the 12 percent threshold but Russian political influence appears to be more prominent, which amplifies Russia's economic influence over Belgrade's decisionmaking.
- Latvia is also above the 12 percent threshold and vulnerable to economic capture, but it has demonstrated greater resistance to Russian political influence in recent years.

There is qualitative evidence that suggests that Russia's economic influence in the region before the global financial crisis and the Georgian-Russian conflict was one of opportunity, roughly spanning from 2004 to 2007, as Russia explored its economic interests and utilized its networks in the five case study countries. However, the 2007–2008 period represented a notable shift concurrent with the Global Recession, which appears to be intentional, whereby Russian investment and its economic amplifiers (such as structural dependencies in key sectors) were designed to deepen Russia's influence in Central and Eastern Europe.

In 2007, President Putin's historic speech at the Munich Security Conference signaled the beginning of a new era of confrontation between Russia and the United States and Europe. A year later, the 2008 Russian-Georgian conflict was the physical manifestation of this new confrontation. Senior Russian officials publicly underscored the weakness of the European project and Europe's inability to economically sustain the regions of Central and Eastern Europe that were lagging behind in the aftermath of the 2008 global economic crisis, providing a growing body of evidence that a new policy agenda was geared toward undermining the West. Thus, Russian attempts to expand its economic influence in the region are viewed as a critical tool in support of this new policy approach.

Has Russian influence been deliberately cultivated, or is it simply a unique export of Russia's particular political and economic model? In her book *Putin's Kleptocracy*, Karen Dawisha describes Russia today as a "mafia state" ruled by "an interlocking network of associations and clan-based politics centered on Putin," which serves the purpose of "strengthening Putin's hold on power, silencing critics, and maximizing . . . economic benefits."<sup>2</sup> This network is hierarchical and far-reaching, consisting of politicians at all levels (including high-level ministers), intelligence and security officials, businessmen, prominent companies, state-owned enterprises, and organized criminal elements. According to Dawisha, state institutions—including the Russian Federal Security Bureau (FSB)—are responsible for maintaining these networks which have become so intertwined that "one cannot differentiate between the activities of the government and organized crime groups." Corruption is "the basis for upward mobility in Russia," and the reward of "access to illicit wealth" in exchange for loyalty is what allows this network to expand and grow.<sup>3</sup>

Russian influence spreads through the corrosive comingling of public and private interests. The power to award and reward—primarily through monetary means, but also through monopolistic power and influence—is essential to the transmission function, as it creates loyalty, enabling

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2. Karen Dawisha, *Putin's Kleptocracy: Who Owns Russia?* (New York: Simon & Schuster, 2015).

3. Brian Whitmore, "The Putin Syndicate," Radio Free Europe/Radio Liberty, June 9, 2015, <http://www.rferl.org/content/the-putin-syndicate/27062453.html>.

participants to capture new actors in the domestic environment through the distribution of ill-gained reward. **The promise and the protection of perpetual enrichment is the incentive that allows this system to operate**, and state resources provide an abundant source of wealth on which these drivers can draw. The “captured” individuals spread their antidemocratic and corruption contagion to others, widening and entrenching this circular system. Thus, Russian influence expands and sustains itself until its ultimate goal of state capture has been achieved. Russian influence has become so pervasive that it has challenged national stability in certain countries as well as their Western orientation and Euro-Atlantic solidarity.

What has allowed this unvirtuous cycle to persist and proliferate undetected is **Western susceptibility to, and at times complicity, with these practices and Russia’s exploitation of this susceptibility to ensure opaqueness and nontransparency**. Russian actors have used extensive business, security, intelligence, and political networks, contacts, and companies to create a level of complexity that is designed to obfuscate their activities and relationships throughout the region. Recent leaks such as the Panama Papers highlighted how Russian entities are linked to local actors in the region through a combination of companies and offshore accounts. Although many of these transactions are considered legitimate and legal, they are opaquely designed to exploit and benefit from the loopholes in democratic frameworks with a specific purpose to acquire influence, power, and strategic assets. Where such malfeasance can be identified, it is not obvious and requires deliberate and cross-border investigation. In some instances, the West may be willingly complicit in Russia’s acquisition of influence by allowing the Kremlin to systemically exploit these vulnerabilities.

## AN EXAMPLE OF THE UNVIRTUOUS CYCLE

Malign Russian influence can be likened to a virus that attacks democracies. After inconspicuously penetrating a country through what appears to be a harmless and most likely legal business transaction, the virus begins to spread purposefully through local networks, quietly taking hold of its democratic host. For years (if not decades), the virus of Russian influence is typically undetected or ignored because of its opaque design. Democratic institutions are able to function as normal. The virus initially thrives as it gradually works its way through the host apparatus clandestinely. This is the case in the 2004–2008 study time period as Russian influence slowly infected different strategic sectors of the economy (energy, financial, media, and infrastructure sectors) and regions. Over time, the host countries’ economies and institutions become compromised to such a point that the very institutions designed to combat corruption and monopolistic practices (e.g., anticorruption offices, interior ministries, prosecutor’s offices) are fully disabled, allowing Russian influence to rapidly spread to the point where the infected democracy is rendered incapable of resisting Russian influence, which allows for the Kremlin’s effective control over the government. If the host democracy resists, the government can be brought down by exposing the extent of the corruption and malfeasance, which may be a temporary political setback to the Kremlin but has the added benefit of further eroding public confidence, trust, and credibility in mainstream political parties and democratic systems, which enhances the popularity of extreme parties that are anti-European and anti-American. There is an undeniable elegance to these “win-win” tactics for the Kremlin; it is

the perfect strategy to erode the foundations of democracy from within, which powerfully discredits the Western model of governance while elevating the Kremlin's model.

Here is one example of how this process works: Russian-linked entities work to support select state actors who in turn work on their behalf. This support can include investing in rising politicians, cultivating relationships with prominent businessmen, or helping to ensure that its business affiliates become well positioned in government. From a position of authority and power, these local affiliates can work to expand a system of Russian patronage by ensuring that lucrative contracts and rewards are doled out to Russia's preferred partners, who then are beholden to the Kremlin's network and become instruments of its influence. Russia's networks can be so extensive that they penetrate government institutions and investigative bodies, disabling a democracy's ability to conduct oversight as well as ensure transparency and accountability, which erodes the rule of law and renders it vulnerable to exploitation and manipulation. Russia's networks can also be so deeply embedded in the local environment that they pose a systemic danger to the economy.

Russia's strategy is simple and straightforward: it exploits the inherent weaknesses within the Western capitalist democratic system. By penetrating and utilizing the system from within—for example, taking advantage of lax ownership disclosure requirements, not investigating corruption allegations, preventing the work of an independent press and judiciary, preventing transparency into political party financing and nongovernmental organization (NGO) registration, as well allowing media outlets to disseminate erroneous information that fosters public confusion and disillusionment—Russian influence can weaken European democratic institutions and thereby lay the groundwork for its corrupt influence to spread further with relative ease. Because it is designed to operate in a Western system, these channels have gone undetected for years (if not decades). Ultimately it is because of the lack of rigorous oversight and transparency of democratic institutions that they are readily available for exploitation.

First and foremost, the Kremlin is interested in ensuring that it is able to maximize the economic benefits of its engagement with the region and further enrich members of its inner circle as they seek opportunities beyond the Russian economy. Another equally vital motivation is to weaken the European Union and the West's desirability, credibility, and moral authority, particularly among EU aspirant countries such as Serbia, Ukraine, Moldova and Georgia, in order to reduce their enthusiasm to cooperate with and integrate into these structures. A final motivation is Russia's desire to elevate itself and its model of governance as a more attractive alternative to the U.S.-dominated international order: an illiberal sovereign "democracy" that is economically controlled by a select inner circle.

## BREAKING THE CYCLE OF INFLUENCE

Because Russia's strategy seeks to co-opt and suborn Western democratic institutions and governance, the United States can no longer be indifferent to political and economic developments in Europe or become increasingly antagonistic toward the European Union. Given the stakes, the United States must reconfigure its entire strategy toward Europe. EU as well as NATO members



must prioritize exposing and prosecuting corrupt practices and ensuring its governing institutions are inhospitable to Russian influence through transparency and openness as a key element of its national security and defense. The United States, working closely with other members of NATO and the European Union, must be prepared to dedicate a considerable amount of public policy attention and resources to Europe to combat Russian influence and work to insulate our democracies from future manipulation.

How, then, does Europe and the transatlantic community “inoculate” itself from Russian influence? The case of Latvia provides useful insight into how to build resistance or antibodies to Russian influence. Although Russia’s economic footprint in Latvia has increased modestly over the last decade and Latvian businessmen possess strong connections to Russian entities, compared to its regional peers, Latvia has also experienced greater success in its anticorruption efforts—in large part due to a dedicated focus on transparency, openness, and institutional independence.

In the end, curbing Russian influence for the long term is more about strengthening Western governance and institutions and less about Russian tactics of corruption and exploitation. This is a truly transatlantic challenge and no EU or NATO member is immune to this danger.

## POLICY RECOMMENDATIONS TO RESIST RUSSIAN INFLUENCE

- Elevate and design a specific, high-level task force within the U.S. Treasury Department’s Office of Financial Crimes Enforcement Network (FinCen) that focuses solely on tracing and prosecuting illicit Russian-linked financial flows if they interact with the U.S. financial system.
- Encourage NATO and EU members to task their own financial intelligence units (FIUs) with developing dedicated units that track illicit Russian transactions.
- Prioritize enhanced EU-U.S. financial intelligence cooperation.
- Elevate anticorruption by strengthening institutions as an element of NATO’s Readiness Action Plan.
  - The newly created Assistant Secretary General for Intelligence and Warning should be tasked with monitoring Russian influence in NATO member states.
  - Combating Russian influence should be a prioritized program under the new NATO-EU framework agreement.
- U.S. government assistance to Central and Eastern Europe and the Western Balkans must be completely revamped to prioritize combating Russian influence and strengthening governance.
  - Under the direction of the U.S. State Department, issue an annual analysis of European states at the highest risk of Russian influence.
  - Focus aid programs on maintaining and strengthening investigative journalism and independence of the media environment.

- Provide intelligence when appropriate and financial support to national anticorruption and auditing offices that enable independent investigations of complex and cross-border corruption cases.
- Increase support and efforts to strengthen the independence of the judiciary and prosecution offices to ensure that cases of corruption are swiftly and effectively addressed.
- Strengthen existing policies designed to provide public transparency of state-funded business transactions and to help countries develop them where they do not yet exist.
- EU institutions and its member states should substantially enhance anticorruption and development assistance mechanisms to help the most vulnerable countries build greater resilience to Russian influence.
  - Enhance EU internal benchmarking and governance mechanisms, building on the EU's anticorruption report.
  - Introduce more rigorous benchmarking of rule of law and anticorruption efforts as conditions for pre-accession assistance for the Western Balkans and other accession countries, as planned for 2018.
  - Earmark specific EU-wide and national funds for support of rule of law, anticorruption reforms, and independent journalism, centered on the most vulnerable countries.
  - Enhance European Union oversight of EU development funds and require full disclosure of company ownership when meeting EU diversification requirements.
- National economic policymaking and regulatory governance, transparency, and independence must be strengthened in view of increasing market diversification and competition.
- National antitrust authorities should provide public biannual assessments of the diversification of strategic economic sectors.

# Study Objectives and Methodology

In 2015 CSIS and CSD embarked on a 16-month initiative that sought to develop a strategic assessment that measured the magnitude of the Kremlin's economic influence and its impact on democratic and institutional development as well as policy orientation. This study was unique in that it was a joint transatlantic undertaking, combining the assets of CSIS with CSD's local expertise and expert network. We relied on a team of experts in each of our case study countries to conduct on-the-ground research and provide us with an authentic local perspective around which to shape our analyses. Substantively, our research sought to identify areas of specific European and transatlantic vulnerability in order to provide policy recommendations to the United States and its allies in Europe for responding proactively and effectively to counter Russia's influence and reinforce institutional resilience. We attempted to ascertain, through a rigorous quantitative and qualitative analysis, whether there was a direct correlation between Russian economic influence and a degradation of governance.

To conduct the quantitative component of our research, we sought to compare previously compiled data on national governance with measurements of Russia's economic presence in each country over time. We obtained a measurement of the quality of democratic institutions and governance practices in each case country by using the metrics from Freedom House's *Nations in Transit* reports. We selected *Nations in Transit* due to its comprehensive approach to data collection as well as its consistent provision of relevant, comparable data throughout the duration of the 2004–2014 study period. We used Freedom House's measurements of 1) the perceived levels of corruption, 2) independence of the judiciary, and 3) media independence in each of the five case countries over the 10-year period. These indicators were selected as representative of a country's democratic "health," specifically related to the quality of the executive, legislative, and judicial branches of government as well as the nature of the overall business environment—including the media, energy, and financial sectors. Freedom House ranks countries on a scale of 1 to 7 in each category, with 1 being the best score and 7 being the worst. An increase in a country's democracy score thus signals a deteriorating environment. Based on these scores, Freedom House provides categories to compare the development level of national institutions. Those receiving scores of

1.00 to 2.99 are classified as “Consolidated Democracies; 3.00 to 3.99 are “Semi-Consolidated Democracies; and 4.00 to 4.99 are “Transitional or Hybrid Regimes.”<sup>1</sup> Using these scores and rankings, we developed comparative graphs to analyze and chart the “democracy scores” of our five countries to determine whether there was a decline in these indicators during the study period.

Drawing on the rigorous quantitative analysis conducted by a team of in-country European research consultants, CSIS and CSD conducted a strategic assessment of Russia’s economic footprint in the five case study countries by examining Russia’s corporate presence, direct investment, trade relationships (e.g., bilateral account balance), and private ownership and investments. Turnover, assets, and employment indicators for Russian-owned and controlled companies in each of the country case studies was used to estimate the share of Russian business in the overall economy, as these are the best proxies for the Russian economic footprint as share of GDP and can be easily compared. The analysis also estimated the size of direct investments for each of the selected countries in the post-2004 period. Foreign direct investment (FDI) is presented using euros and includes greenfield investments, mergers and acquisitions (M&A), bilateral trade agreements, and bank and direct government loans. The bilateral trade balance with Russia was also studied to expose strategic dependencies and possible channels of Russian leverage. The four types of economic footprint were presented as a percentage of GDP (turnover was used as a proxy for corporate involvement) of the respective country and then aggregated in order to produce a comparable metric that expresses Russian economic influence as a monetary value. The study drew from 1) available data from official national statistics (e.g., national macroeconomic accounts, commercial registries, stock market and investor relations data) and 2) detailed information obtained through networks of local organizations with economic and overall background knowledge, plus experts with security and/or corporate intelligence backgrounds in each of the selected countries.

We then compared proxy measurements of Russian economic and social influence in the five case countries against each of these democracy indicators over the course of the past decade. In doing so, we sought to identify whether there was an empirical relationship between the level of Russian economic engagement and changes in national governance standards by calculating their statistical correlation. The charts comparing governance and economic trends, as well as the data presenting the metric for Russia’s economic footprint and its constituent parts, have been made available in the Appendix of this report.<sup>2</sup>

The data obtained through our correlation analysis was inconclusive; however, we observed a relationship between Russian economic influence and the region’s governance declines. We found evidence that pointed to clear linkages between Kremlin-linked officials and networks of

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1. For additional clarification about the Nations in Transit methodology, see Freedom House, “Nations in Transit Methodology,” *Nations in Transit 2016*, <https://freedomhouse.org/report/nations-transit-methodology>.

2. Note: Freedom House’s annual *Nations in Transit* reports provide governance scores based on developments over the course of the preceding year, and we have adjusted the data to match the corresponding timeframe. For example, since the 2015 *Nations in Transit* scores measure governance trends in 2014, we used the data from the 2015 report to analyze developments in 2014. Similarly, the data points used to determine each country’s democracy scores in the graphs featured in the case studies (see Appendix) were drawn from the subsequent year’s *Nations in Transit* report.

corruption within the region and could observe examples where Russia or Russian-linked individuals, groups, or entities were responsible for influencing the local political and economic environment or were implicated in scandals. We observed the greatest influence in strategic economic sectors where Russia's economic presence was particularly strong, which in turn strengthened its political influence. It is the discovery of these linkages that form the basis for this assessment and analysis—the specifics of which are accessible in the individual country case studies in the Appendix.



# Introduction: A Model of Russian Influence in Central and Eastern Europe

The evidence and research collected concludes that channels of Russian influence create a circuitous and opaque network that influences sovereign decisionmaking and reduces governance standards. This network-flow model—which we describe as an **“unvirtuous circle” of Russian influence**—can either begin with Russian political or economic penetration and from there expand and evolve but with similar end results: the erosion of governance standards and the credibility of democracy as a model of governance, which in some instances leads to “state capture.”<sup>1</sup> To do so, Russia seeks to gain influence over (if not control of) critical state institutions, bodies, and the economy and to use this power to shape national policies and decisions. Corruption is the lubricant on which this system operates, and in particular it seeks to exploit state resources for its own economic benefit and to establish dangerous channels that coningle public and private-sector interests. For the purposes of this study, we define corruption as the alleged or reported exercise of one’s power, position, or resources in order to exploit or exert undue influence over businesses, individuals, or state bodies and institutions, typically through nontransparent and questionable means. This may include actions that could be deliberate and/or unlawful, but may not necessarily be so. Throughout the body of this report, we will cite examples that support our observations of how this unvirtuous circle works based on open-source facts and information, but these observations do not suggest or accuse any specific individuals of wrongdoing.

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1. We define state capture as “the actions of a small number of firms [or such groups as the military, ethnic groups, and kleptocratic politicians] to shape the rules of the game to their advantage through illicit, nontransparent provision of private gains to public officials.” The definition is expanded to include the point that sovereign control over future policy direction is annulled. For more information, see Joel Hellman et al., “Measuring Governance, Corruption, and State Capture: How Firms and Bureaucrats Shape the Business Environment in Transition Economies,” Policy Research Working Paper 2312, World Bank, April 2000, <http://siteresources.worldbank.org/INTWBIGOVANTCOR/Resources/measure.pdf>.

Malign Russian influence in Central and Eastern Europe primarily follows two tracks: one aimed at manipulating a country by dominating—and abusing—strategic sectors of its economy (which we will refer to as “economic capture”), and another that centers on the cultivation of political relationships with aspiring autocrats, nationalists, populists, Euroskeptic, and Russian sympathizers (or “political capture”). While there are specific patterns of conduct within each track, there is no clear-cut path that Russia appears to follow in any case. Rather, a tactical combination of actors and drivers may be used in pursuit of specific strategic outcomes—all of which depend on the unique conditions present within each country, thus acquiring a Russian “tailor-made” strategy of influence.

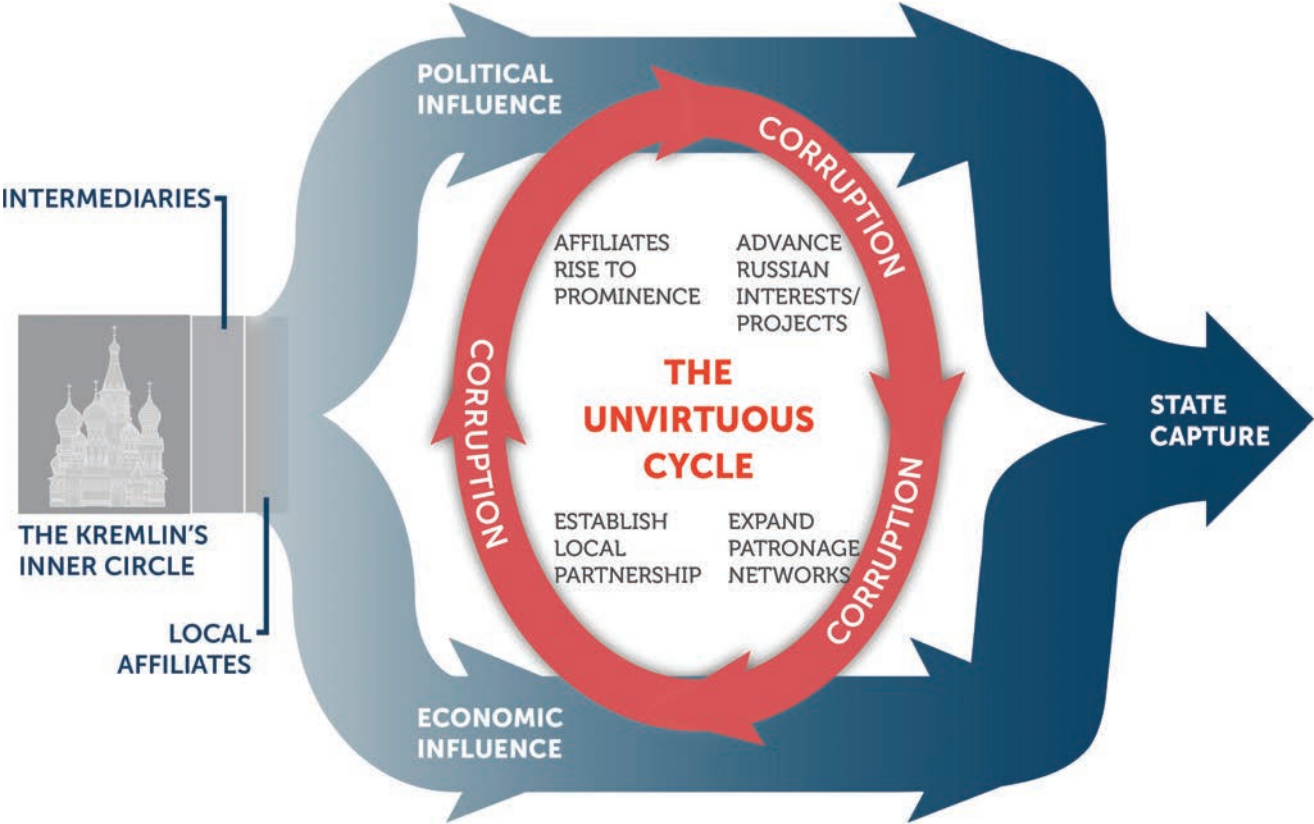
Although these two tracks are not mutually exclusive, they represent the path through which Russian interests successfully penetrate the domestic environment. Depending on the success of either or both tracks, economic and political capture mutually reinforce each other, deepening Russian influence within the country. In Hungary and Slovakia, for example, the political track has been the primary outlet for Russian influence, which has in turn fostered economic influence in sectors of systemic importance through the conclusion of megadeals and large-scale infrastructure projects. This track in turn provides Russia with greater economic leverage that eventually translates into even greater political leverage. Conversely, in Bulgaria, where Russia’s economic footprint is relatively large (which according to our estimates peaked at around 27 percent of GDP), the economic leverage has been used to support pro-Russian businessmen who in turn exert influence over Bulgarian politicians—or enter politics themselves—to protect and enhance their economic influence and advance pro-Russian policies at the national level. Regardless of political or economic entry, the influence produces the same outcome: that of providing Russian agents and entities with levers through which they are able to influence state institutions and impact decisionmaking (state capture) in critical sectors of the economy.

The mechanisms of Russian influence are designed to thrive in Western democracies because they use Western rules and institutions and exploit their systemic weaknesses. By penetrating and utilizing the system from within (e.g., taking advantage of lax ownership disclosure requirements, not investigating corruption allegations, preventing the work of an independent press and judiciary, preventing transparency into political party financing and NGO registration, as well as allowing media outlets to disseminate erroneous information that fosters public confusion and disillusionment), Russian influence can weaken European democratic institutions, erode European unity, and discredit the Western model of democratic governance, using the very same Western rules and regulations.

What is the Kremlin’s ultimate strategic goal as it wields its influence? Clearly, the Kremlin is interested in ensuring that it is able to maximize the economic benefits of its engagement with the region and further enrich members of its inner circle as they seek opportunities beyond the Russian economy. Another motivation is to weaken the European Union, NATO, and the desirability, credibility, and moral authority of Western democracies led by the United States. This motivation is particularly targeted at EU aspirant countries such as Serbia, Ukraine, Moldova, and Georgia to reduce their enthusiasm for their desired Western orientation so that they cooperate and integrate less with the West. A final driver is Russia’s desire to elevate itself and its model of governance as a more attractive and conducive alternative to the U.S.-dominated West: an illiberal and



**Figure 1.1. Channels of Russian Influence**



authoritarian sovereign “democracy” that is economically controlled by the oligarchic capitalism of a select inner circle.

But perhaps Moscow is simply capitalizing on the West’s political and economic crisis of confidence following the 2008 global economic recession? On this question, the statistical analysis is inconclusive but the qualitative evidence reveals that Russia’s economic behavior in the region just *before* 2008 differed from the period *following* the 2008 Georgian-Russian conflict and global recession, in which it was geared toward accelerating and cementing Russian influence in the regional economy. Moreover, in certain case study countries, there appears to be greater involvement of individuals directly linked to the Kremlin’s inner circle in a number of transactions, acquisitions, or scandals, some of which are on a regional scale. These individuals are almost never directly implicated but use opaque and complex channels of corruption and a web of intermediaries—individuals, companies, or organizations—that interface with local affiliates. Frequently, these channels follow nonlinear paths in an effort to obscure a trail leading back to the source. The release of the Panama Papers in 2016 has provided a unique spotlight on the extent and nature of these networks, which link prominent Russian individuals to business partners, politicians, and high-stakes transactions in Central and Eastern Europe via nontransparent webs of affiliates, holding companies, and offshore accounts.

Russia appears to be implementing a vital element of General Valery Gerasimov’s doctrine of New Generation Warfare, which “is primarily a strategy of influence, not of brute force” that is about

“breaking the internal coherence of the enemy system—and not about its integral annihilation.”<sup>2</sup> Russia’s strategy of influence seeks to alter the perception of, if not outright halt (and eventually reverse), Central and Eastern Europe’s Euro-Atlantic enlargement orientation, which breaks U.S. and Western dominance of the international and democratic liberal order, restores Russia’s historic sphere of influence, and returns Russia to a critical position as a coequal with the United States. Just as the West demonstrated the superiority of its economic and political model in the 1989–1991 era that led to the dissolution of the Soviet Union, the Kremlin may be attempting to affect a reverse outcome: the eventual collapse of NATO, the European Union, and U.S. global leadership by actively discrediting the Western liberal democratic system and offering its illiberal managed democracy and *siloviki*-style economic systems as an alternative. This outcome is achieved by influencing and eroding democratic governance from within its own institutions. Once this outcome is achieved and NATO collapses, a new European security architecture can be negotiated.

While we do not assert that Russia is responsible for all the challenges confronting the region, nor is its influence attributable to all organic, domestic political and economic processes, we believe the evidence is both compelling and indicative of a purposeful Russian strategy to influence and break the internal cohesion of the West through Russian investment, economic activity, and malign political engagement. U.S. and European policymakers must understand the vulnerabilities that exist in these societies that can be exploited by Russia and develop the necessary shield or “antibodies” to resist malign foreign influence.

Toward this end, we offer a model based on our findings that attempts to illustrate the channels of Russian influence (Figure 1.1) in Central and Eastern Europe, as well as provide policy recommendations to disrupt these channels. We will highlight the dynamics and mechanisms that drive these channels, as well as the observed outcomes that they have thus far produced.

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2. Dimitry Adamsky, “Cross-Domain Coercion: The Current Russian Art of Strategy,” Proliferation Paper no. 54, Institut Français des Relations Internationales, November 2015, 30, <https://www.ifri.org/en/publications/enotes/proliferation-papers/cross-domain-coercion-current-russian-art-strategy>.

# Russian Political Influence: Eroding Democratic Institutions

Russian political influence centers on **weakening the internal cohesion of societies and strengthening the perception of the dysfunction of the Western democratic and economic system**, which has stagnated since the global financial crisis and reels from the relentlessness of globalization. Europe's crises over the past several years—the Eurozone crisis, the Syrian crisis and subsequent migration crisis, the Ukraine crisis, Brexit, and the failed coup in Turkey—have profoundly challenged the European Union and NATO and laid bare the inherent weaknesses in its institutional structure, making Europe vulnerable to exploitation. After decades of near-constant integration and expansion, the limits of Europe's ability to make its members more stable and prosperous have become evident, revealing deep divisions within Europe over fundamental values. Europe's leaders and existing democratic institutions appear to be incapable of addressing contemporary policy challenges.

**As it was the success and prosperity of Western democracy and capitalism that precipitated the downfall of the Soviet Union during the Cold War, Russia is now instrumental in attempting to dissolve the transatlantic union.** Said differently, at the end of the Cold War, liberalism traveled east to former Soviet satellites. Twenty-five years later, Russian-influenced illiberalism is traveling west through the sinews of democratic institutions. **Capitalizing on and exacerbating existing tensions by encouraging nationalist, Euroskeptic, conservative, and anti-European and anti-American attitudes and movements within European countries**, Russia has utilized a range of drivers that are **organic products of Western democracies** to exert influence in Central and Eastern Europe, using democratically elected individuals in positions of power to challenge the liberal system from within.

As a champion of traditional, conservative, and nationalist values (rooted in Eastern Orthodox Christianity), the Kremlin supports **a cadre of European political parties, individuals, and NGOs**, primarily from the far-right of the political spectrum but in some places with centrist mainstream and leftist elements as well. The Kremlin-sponsored United Russia party has established high-profile partnerships with like-minded parties and groups throughout Europe, and in some

instances Moscow has facilitated financing to these parties prior to their rise to national prominence. With an early strategic interest in establishing cooperative relationships with sympathetic anti-European groups, the Kremlin was well positioned to succeed if and when the domestic political environment became more favorable. For example, a member of the European Parliament from Hungary's far-right Jobbik party, Bela Kovacs, is currently being investigated by EU authorities on charges of Russian espionage, illustrating the reach that individuals and political parties have acquired.<sup>1</sup> Within countries, these political forces tend to be obstructionist within the government and reinforce the fragility inherent within parliamentary democracies by leveraging their parliamentary backing to influence debates of strategic importance to Russia. The resulting paralysis generates support for alternative and more extreme political movements, accelerating political fragmentation.

To further influence the domestic political environment, Russia has **launched a systemic "war on information" campaign** that is designed to confuse, paralyze, and disable its opponents and obscure the truth behind its actions. Russia conducts its disinformation war by generating support for sympathetic parties and its political allies and fomenting nationalist and anti-Western sentiment to justify and deflect attention from its aggressive actions at home or abroad. Toward this end, Russia exploits existing political pressure points such as migration and economic stagnation, blames Western and U.S. operations for all negative international dynamics (such as the attempted July 2016 coup in Turkey), and discredits the current state of Western democracy. Russia has also sought to generate sympathy for itself among domestic electorates by demonstrating that its "managed or sovereign democracy" is a superior model while highlighting its civilizational uniqueness. In some cases, Russia has used selective elements of its historical narrative as it relates to Stalin, the Russian Orthodox Church, or its actions in the Great Patriotic War.

Russia uses a range of tools that are shaped by and specific to the national operating environment. In Latvia, Russia used appeals to a large (approximately 25 percent) ethnic Russian and Russian-speaking minority. In the Slavic world, pan-Slavic nationalism has been resurrected as a political force. The Russian Orthodox Church has become a political instrument to cultivate close ties with the Bulgarian and Serbian Orthodox churches. Russia utilizes its growing empire of state-funded "independent" television, radio, and Internet outlets such as RT and Sputnik and is actively opening new affiliate branches around the world by making strategic acquisitions in local news outlets via opaque intermediaries, thereby gaining greater control over the flow of information. Restrictive media environments and the politically motivated consolidation of the telecommunications sectors indirectly assists this information war, particularly in countries where current governments are sympathetic toward Russian interests.

Thus, the Kremlin's authoritarianism and its model of illiberal "sovereign democracy" reinforces and serves as a source of **inspiration for a new generation of European leaders who seek to maintain and extend their hold on power** by upholding the vision of a political strongman who is the national answer to international threats and chaos. In Hungary, Prime Minister Viktor Orban has directly credited Russia as a model for his own set of illiberal reforms (which include the

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1. Valentina Pop, "European Parliament Set to Lift Immunity of Hungarian MEP," *Wall Street Journal*, October 12, 2015, <http://blogs.wsj.com/brussels/2015/10/12/european-parliament-set-to-lift-immunity-of-hungarian-mep/>.

creation of a new Hungarian constitution). This has been particularly evident in Hungary for the past six years, where leaders have diminished the independence of democratic institutions, such as the media, the judiciary, and the central bank, to regain control. In an attempt to coax voters away from extremist groups, leaders of mainstream political parties mimic nationalist and populist policy stances to maintain their voter base. In Slovakia, leaked diplomatic cables note that Prime Minister Robert Fico hopes to create a centralized system of governance that emulates Putin's "top-down" system.<sup>2</sup> As liberal democratic checks and balances are eroded and power has been concentrated in the executive, these leaders have simultaneously positioned themselves closer to Russia and as political and populist alternatives to the European Union and the United States.

Russia has also been able to rely on **prominent pro-Russian businessmen-turned-politicians** to advance its interests politically, primarily in countries where Russia's economic footprint is significant. Many of these individuals have personal business stakes in Russian business as well as the Russian security apparatus, and they have a strong interest in ensuring that economic and political relations remain favorable. Earlier in the decade, some of Latvia's leading businessmen—who are believed to maintain "complex but often pragmatic and cooperative relations with Russia"<sup>3</sup>—obtained senior-level positions in the government, including the premiership. After Russia's invasion of Georgia in 2008, Transport Minister Ainars Slesers called on the Latvian National Assembly to consider the role that Tbilisi may have had in provoking Russian aggression, allegedly after a meeting with the Russian ambassador.<sup>4</sup> In certain cases, Russian-linked networks may have worked to install affiliates into key offices to safeguard their interests. In Serbia, it is interesting to note that the director of the state-owned gas company, Srbijagas, Dusan Bajatovic, is also a member of parliament (MP), the deputy chairman of the pro-Russian Socialist Party of Serbia, and currently serves on the Committee on Finance, State Budget, and Control of Public Spending. Bajatovic has publicly defended Serbia's energy relationship with Russia, noting that the country "benefits from contracts with Russia," despite having lost €30 million in work on the now-defunct South Stream project, and that Belgrade has no alternative to Russian gas.<sup>5</sup>

Together, these drivers advocate for and protect Russian interests at the local, national, and EU levels and have actively sought to enhance cooperation with Russia despite deepening geopolitical tensions. They have advanced projects and initiatives with Russia through a string of multimillion and multibillion euro "megadeals" that provide Moscow with privileged access to strategic sectors of the national economy such as energy, banking, telecommunications, and transport, where large amounts of state resources are available. The deals typically have some form of protection afforded to them by Russian-affiliated security networks. These drivers strengthen national

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2. Embassy Bratislava, "Fico's Role Model: Vladimir Putin?," WikiLeaks Cable: 09BRATISLAVA70\_a, February 9, 2009, [https://wikileaks.org/plusd/cables/09BRATISLAVA70\\_a.html](https://wikileaks.org/plusd/cables/09BRATISLAVA70_a.html).

3. Agnia Grigas, "Legacies, Coercion and Soft Power: Russian Influence in the Baltic States," Chatham House Briefing Paper, August 2012, [https://www.chathamhouse.org/sites/files/chathamhouse/public/Research/Russia%20and%20Eurasia/0812bp\\_grigas.pdf](https://www.chathamhouse.org/sites/files/chathamhouse/public/Research/Russia%20and%20Eurasia/0812bp_grigas.pdf).

4. Embassy Riga, "Russia-Georgia Clash Worries Baltic States," State's Secrets, *New York Times*, August 15, 2008, [http://www.nytimes.com/interactive/2010/11/28/world/20101128-cables-viewer.html?\\_r=0#report/nato-08RIGA496](http://www.nytimes.com/interactive/2010/11/28/world/20101128-cables-viewer.html?_r=0#report/nato-08RIGA496).

5. "EUR 30mn Spent on South Stream, and We Won't Get It Back," B92, January 13, 2016, [http://www.b92.net/eng/news/business.php?yyyy=2016&mm=01&dd=13&nav\\_id=96688](http://www.b92.net/eng/news/business.php?yyyy=2016&mm=01&dd=13&nav_id=96688).

economic dependence on Russia well into the future, contradicting stated EU diversification and antimonopolistic policies. Any attempts at diversification are delayed for as long as possible if not outright derailed by considerable economic and political pressure exerted on the government by Russian-influenced actors. Russian influence has also begun to challenge the ability of the transatlantic community to respond to Russian military actions in Ukraine and in Syria. This has been most acutely felt in Bulgaria, where requests to deny Russian military aircraft overflight of Bulgarian airspace at U.S. request in September 2015 was met with great political and media resistance. In some instances, pro-Russian parties and politicians have called for their countries to reevaluate their commitment to the European Union and NATO. The preferred end state is a government's inability to independently make decisions based on its national interests as opposed to Russian interests, resulting in state capture.

A captured political system allows third-party actors, "captors," to systematically advance their private (and in this case, Russia's) interests and acquire privileged access to public resources.<sup>6</sup> They achieve this by steering government policies toward furthering their interests rather than the nation's interests. Russia has not fully leveraged its influence or has not done so successfully, which would have resulted in a complete break from the transatlantic consensus. But there are emerging signs that a break is forthcoming. In particular, the debate over the extension of EU sanctions against Russia has been divisive, and with each passing term, EU leaders have grown less willing to automatically roll over sanctions every six months, despite an increasing breakdown of the cease-fire in Eastern Ukraine. In the past six months, senior Russian government officials, including President Putin himself, have visited several European capitals in Southern and Eastern Europe to offer lucrative business deals. Thus far European leaders have maintained solidarity, but they may not indefinitely.

**The common thread among all categories of drivers is endemic corruption.** Numerous politicians affiliated with pro-Russian politicians, political parties, businessmen, and nongovernmental organizations have been implicated in a series of graft, bribery, and public procurement scandals that have reached the highest levels of government. Several high-yielding megaprojects were advanced by governments in cooperation with Russia and state-owned companies in a nontransparent fashion. Politicians and government officials in some cases modified national laws to help the projects circumvent EU regulations, exploit loopholes in the system, and protect monopolistic practices. State funds are typically awarded to affiliates and clients of key political figures after questionable tender procedures. In 2014, the United States went to the extraordinary length to blacklist six senior Hungarian government officials on corruption charges, blaming "Hungary's weakening democratic institutions" for causing an increase in corrupt practices.<sup>7</sup> A former U.S. ambassador to Hungary alleged that Prime Minister Orban personally determined who would receive EU development funds. Opposition voices have further suggested that the decision to select Russia's State Atomic Energy Corporation, Rosatom, to implement the Paks-2 nuclear

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6. Ognian Shentov, Alexander Stoyanov, and Maria Yordanova, eds., *State Capture Unplugged: Countering Administrative and Political Corruption in Bulgaria* (Sofia: Center for the Study of Democracy, 2016).

7. "Hungary PM Orban: U.S. Uses Corruption Charges to Gain Influence," Reuters, December 23, 2014, <http://www.reuters.com/article/us-hungary-usa-idUSKBN0K11VE20141223>.

reaction expansion was made at the very top.<sup>8</sup> The European Commission in 2014 suspended development funding to Hungary after it discovered that previous funds had been mismanaged as Budapest overpriced and overpaid projects due to “a lack of official oversight.”<sup>9</sup> There is also evidence that pro-Russian politicians actively worked to establish protected networks of patronage and corruption in these countries to advance their power and influence while preventing anticorruption investigations.

How Russia exerts its influence abroad represents an extension of its own governing model, which operates on state-sponsored corruption, centers on a vast patronage network protected by security affiliates, and penetrates every aspect of society, including the highest levels of government. By creating an extensive network of similar affiliates within Central and Eastern Europe, Russia can attain substantial economic and political “sphere of influence” benefits.

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8. Zoltán Kovács, “DK Reports Viktor Orbán to OLAF for Corruption,” *Budapest Beacon*, May 24, 2015, <http://budapestbeacon.com/public-policy/dk-reports-viktor-orban-to-olaf-for-corruption/23581>.

9. Zoltán Kovács, “Details Emerge over EC Decision to Suspend Payment of Development Funds to Hungary,” *Budapest Beacon*, April 20, 2015, <http://budapestbeacon.com/public-policy/details-emerge-over-ec-decision-to-suspend-payment-of-development-funds-to-hungary>.

## Russian Economic Influence: Exploiting Capitalism's Weaknesses

If Russian political influence aims to exploit the weaknesses in Central and Eastern European societies and erode liberal institutions, **then Russian economic influence seeks to manipulate sectoral market dynamics and exploit governance loopholes** to generate unfair profits and influence national decisionmaking. **Russia's economic influence in Central and Eastern Europe is derived from its dominance of strategic sectors of the economy.** Because the region is disproportionately reliant on Russian oil and natural gas resources, the energy sector has been the main channel through which Moscow's economic influence is exerted in the region. But Russia's financial networks dating back to the Soviet era have remained largely in place, as they have been allowed to freely integrate into the region's economies and EU countries. Over the course of the past several years (in particular, since the 2008 financial crisis), Russia has become increasingly present in the finance, media and telecommunications, transportation, arms, construction, industrial, and real estate sectors using these preexisting financial, intelligence, and security networks in many countries.

We estimate that, on average, Russia's economic footprint in our five case countries has ranged from about 11 percent of GDP (in the cases of Hungary and Slovakia over the course of the study period) to an astonishing 22 percent in Bulgaria.<sup>1</sup> The full extent of Russia's reach, however, remains unknown as Russia has sought to **conceal its economic activity behind a web of foreign shell companies and offshore accounts.** As a result, the official economic data tends to be skewed. The Netherlands, for example, is listed as the single largest investor in Bulgaria due to the fact that Russian giant LukOil is registered there. In this way, Russia's true presence is masked, and this lack of awareness about the region's structural economic relationship with Russia has left it

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1. According to a report from the German national intelligence service BND to the German parliament, as cited in German media in 2014, Russia controls one-third of Bulgaria economic output; see Gerald Traufetter, "In the Kremlin's Grip: Fears Grow over Bulgaria's Russian Dependence," *Spiegel Online International*, May 12, 2014, <http://www.spiegel.de/international/europe/fears-grow-in-europe-that-russia-will-influence-bulgaria-a-968955.html>.



vulnerable to manipulation. As a result, the potentially negative consequences that Russian investment has on the quality of governance in the recipient country are also obscured.<sup>2</sup>

But the impact of Russian foreign direct investment in the region has been downplayed<sup>3</sup> for a variety of reasons. Not only is the extent of Russian FDI masked by offshore investments, but it is wrongfully compared to that of the entire European Union without taking into account that the bloc is not a unitary entity, and FDI originating from different EU countries is not the result of a common government economic policy. A proper assessment of Russia's FDI footprint must compare Russian activity to that of individual EU countries. Furthermore, Russian companies in the region have tended to be concentrated in a few strategic economic sectors, such as energy and fuel processing and trading, whereas EU countries have a more diversified investment portfolio that spans different manufacturing subsectors, banking, telecommunications, and retail trading. In some cases, this was due to timing. German companies were able to enter many business niches in Hungary, Slovakia, Czech Republic, and Poland during their privatization processes in the 1990s, which reduced the space for Russian investments or takeovers later. However, as commodity prices rose in the 2000s, Russian firms were able to be more proactive. One of the few significant attempts to take over a strategic company in Central Europe was the purchase of the Hungarian national oil and gas company, MOL, by the Russian Surgutneftegas in 2009 (it later sold its stake back to the Hungarian government for a profit of nearly €500 million in 2011).<sup>4</sup> Meanwhile, in Southeast Europe and the Baltic region, Russian energy companies were able to buy key assets that provided it with control over the local energy sector and perpetuated Soviet-era financial and trade networks and interdependencies. Until recently, Western governments overlooked the ability of Russia's use of FDI as a foreign policy tool.

While economic integration and codependence should not automatically present a vulnerability, Russia has leveraged its strong economic presence **to advance its interests by influencing policy-making**. For example, in the oil and gas sector, Russia uses a price determination scheme that depends more on a country's reliance on Russian supplies and the dominant role of a single company on the market rather than on domestic and regional energy demand. In the natural gas sector specifically, due to its near complete dependence on Russia's Gazprom for supply, Bulgaria has accepted contracts that require it to pay much more for its consumption than Germany does. Central and Eastern European countries overall are estimated to be reliant on Russia for 75 percent of their gas import needs and ultimately overpay 10 to 30 percent more for their imports than their Western neighbors. This inequity, in turn, creates a set of levers that Russia can use to manipulate governments and officials. On the one hand, Russia has been able to offer very lucrative delivery, transit, and/or service contracts to regional leaders to entice them into making concessions on other important deals and issues central to its interests in countries. But Russia has also been able

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2. For an overview of the effects of shadowy Russian capital access to EU markets, see Ben Aris, "Russian Money Infects London," *Intellinews*, March 31, 2015, <http://www.intellinews.com/russian-money-infects-london-500445373/?archive=bne>.

3. See, for example, Alexander Libman, *Russische Direktinvestitionen in Eurasien: Macthpolitik mit anderen Mitteln?*, SWP Studies (Berlin: Stiftung Wissenschaft und Politik, 2015).

4. "Hungary Buys Back MOL Stake from Surgutneftegas," *Budapest Business Journal*, May 24, 2011, [http://bbj.hu/business/hungary-buys-back-mol-stake-from-surgutneftegas\\_57986](http://bbj.hu/business/hungary-buys-back-mol-stake-from-surgutneftegas_57986).

to take advantage of the debts that local gas distributors are often forced to incur in order to purchase Russian natural gas as a pretext for the temporary cancellation or suspension of contracts, which have political consequences and have prompted civil protests.

The coincidence of certain national political developments and Russian-linked activities is curious and can only be called extremely fortuitous and advantageous to Russia. In Bulgaria, in 2013 the government collapsed in the wake of street protests over the government's energy policy and a sudden hike in electricity prices. It is believed that Russia financed and supported the protests that reversed the country's pro-shale gas policy, which aimed at reducing Bulgaria's energy dependency on Moscow.<sup>5</sup> Similarly, the collapse of one of Bulgaria's largest banks in the summer 2014 destabilized the government, negatively impacted the public, and led to a significant increase in the Bulgarian public debt. The collapsed bank, Corporate Commercial Bank, was partially owned by Russia's VTB Capital.<sup>6</sup> While Russia has exercised its influence primarily to protect its economic interests throughout the region, increasingly it is using its influence to affect responses to questions of geopolitical significance.

There are **several drivers through which Russia channels its economic influence**. These drivers are highly versatile and can be utilized flexibly to influence the local economy and policy environment. One or a combination of these drivers may be employed depending on the nature of the national and local operating environment (weak regulations and oversight, for example) and the composition of Russia's economic presence there (based on trade and investment ties, as well as the extent of Russia's corporate structure).

First, Russia has sought to maintain its influence **by cultivating a network of local affiliates and power-brokers** who are capable of advocating on Russia's behalf. These affiliates are often wealthy and influential businessmen or former high-ranking public officials who are able to influence decisionmaking. Typically, Russia entices these individuals into its service by offering them lucrative business opportunities in which the Russian government is involved, and provides premium returns to its clients. These awards are doled out through nontransparent public procurement tender processes; through overinflated contracts that often exceed the actual cost of the services procured; or through access to well-paid board positions. Once "captured," these contacts are then used to advance Russia's interests politically and economically. They are often the most vocal advocates of Russian-led projects, and they are strongly opposed to efforts to diversify commerce away from Russia. Russia also possesses a preexisting cadre of Soviet-era contacts (primarily originating through the security services) that it can utilize as well, as many of these networks remain intact and are integrated into the contemporary business and political environment. Russia can call on these agents to channel its influence into the local environment. This channel does not just operate one way, however, and local business affiliates have also been known to rely on their Russian connections to provide vital capital and political backing to acquire additional assets and

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5. Kerin Hope, "Bulgarians See Russian Hand in Anti-Shale Protests," *Financial Times*, November 30, 2014, <https://next.ft.com/content/e011d3f6-6507-11e4-ab2d-00144feabdc0>.

6. Elizabeth Konstantinova, "Bulgaria Seizes Lender Part-Owned by VTB after Run on Bank," Bloomberg, June 20, 2014, <http://www.bloomberg.com/news/articles/2014-06-20/bulgaria-seizes-lender-partowned-by-vtb-after-run-on-bank-2>.

investments in large projects in their national economies. In this way, Russia appears to have created a mutually reinforcing network of patronage that rewards loyalty with loyalty—with increased financial compensation.

Russia has also capitalized on the region's opaque business environment and weak regulations to enable **large Russian companies (including state-owned enterprises)** to manipulate economic conditions in the local environment and deliberately exploit Russia's dominant position in strategic sectors. These entities serve as **intermediaries between Russia and the network of local affiliates, but can also play an important function themselves**. In several instances, they have become major investors in the domestic economy, providing much-needed foreign direct investment, and are among the greatest contributors to national budgets in terms of tax revenues, creating a significant exposure to Russian manipulation. Tax revenues can be withheld during moments of financial and political weakness to challenge the state's solvency and liquidity and precipitate a cash-flow crisis. But by positioning these companies in sectors where there tends to be a significant degree of state intervention, Russia has also provided them with the opportunity to redirect state funds **by exploiting the structural deficiencies in the management of public resources**. Perhaps the best example can be seen in the operations of the Russian state-owned gas giant, Gazprom. Conducting business in each country through a network of intermediaries, Gazprom—facilitated by its near-dominance of regional gas markets and the lack of any viable competitors—is able to influence the financial and market positions for its local distributors in these countries. The European Commission is currently investigating Gazprom's activities in Central and Eastern Europe, having alleged that it abused its dominant market position in breach of EU antitrust rules.<sup>7</sup> This influence can then be used to back up Russia's strategic initiatives or incentivize other local players.

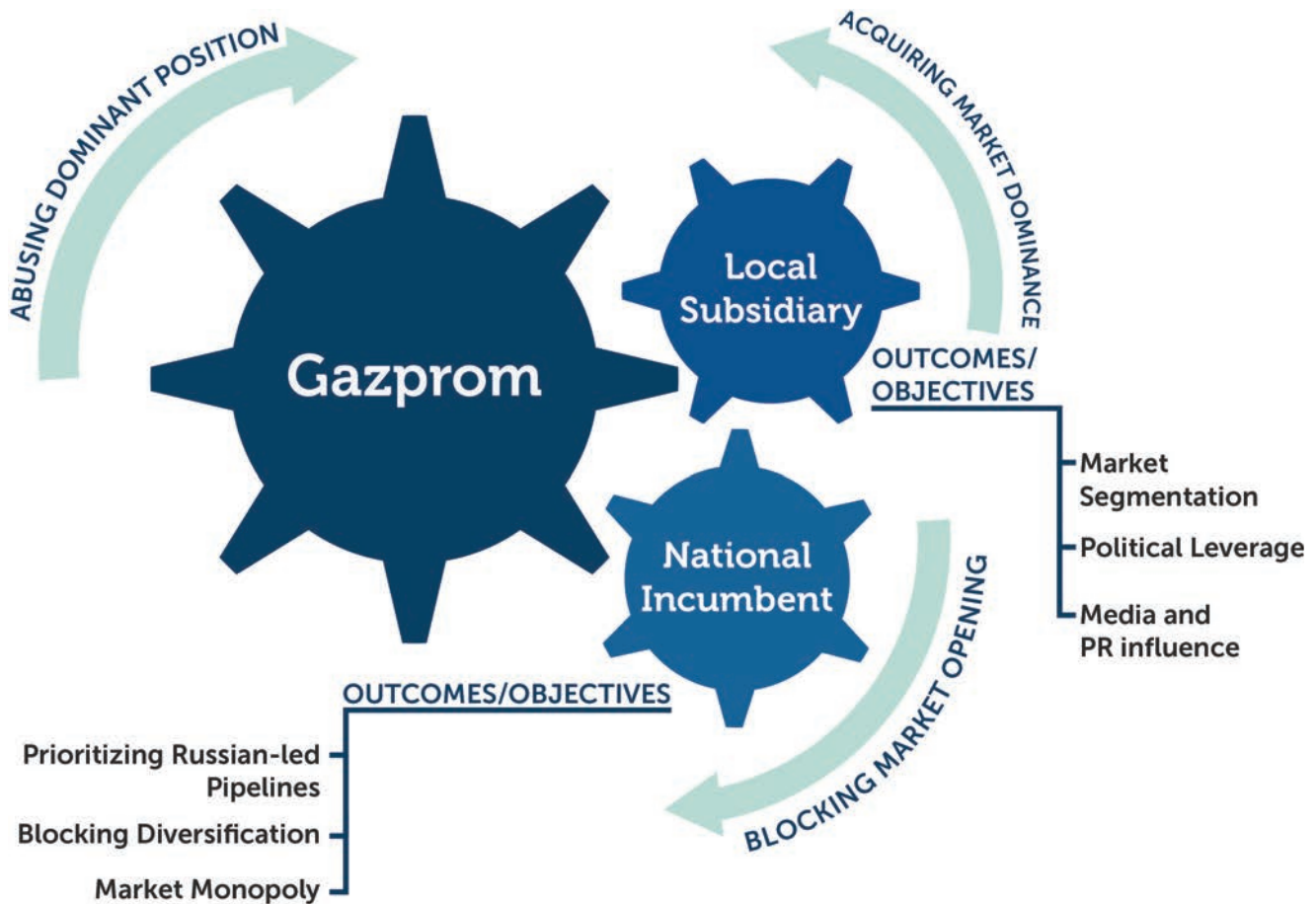
In some cases, surcharge profits have been reinvested into the local economy to finance new projects and maintain infrastructure, as well as to diversify and channel Russian investment into new sectors. There is evidence to suggest that these "profits" may be used to support local political actors and parties in a nontransparent fashion, facilitating greater political influence. These profits are also likely to finance media and protest campaigns that further Russia's political and economic interests. In this way, **Russian companies have been able to commandeer state resources and enhance their "profits" and networks, all in pursuit of Moscow's strategic political objectives**.

Russia has used both corporate intermediaries and its network of local affiliates to create a third driver of Russian influence: **multibillion-dollar megadeals**. Since approximately 2006, Russia has enticed its Central and Eastern European neighbors with a series of structurally significant infrastructure projects that would deepen Russia's economic presence in the region, providing it with greater political leverage and influence that reaches the highest levels of government in some cases. Russia has sought to cast these deals in a "mutually advantageous" light by offering a range of incentives for local actors—for example, by providing affordable financing plans to cover the bulk of the development costs. The grandeur of some of these projects, which local governments have been incapable of evaluating and properly assessing, has allowed Russia and its local backers

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7. European Commission, "Antitrust: Commission Sends Statement of Objections to Gazprom—Factsheet," April 22, 2015, [http://europa.eu/rapid/press-release\\_MEMO-15-4829\\_en.htm](http://europa.eu/rapid/press-release_MEMO-15-4829_en.htm).

**Figure 3.1. Exploiting Economic Governance Deficiencies**



to downplay the sizable real costs (both upfront and future) for the host countries while touting uncertain long-term economic benefits. As these projects have constituted large additional resources loaned by Russia for the local economies, pro-Russian governments and/or political parties in Central and Eastern Europe have rushed to “own” the projects and win popular support.

In reality, however, **these deals are often mired in controversy and corruption**. The inability of local administrations to structure the deals professionally has allowed Russia to turn them into a one-way spiral for inflicting economic pain on the local governments. Once the deal is signed there is practically no way of changing course no matter what market or economic realities would require, making local governments hostage to the Russian side. The prospect of future cash flows and Russia’s ability to use energy dependence as a trading card enable it to structure the large-scale deals in such a way as to appoint well-linked domestic and Russian companies to win the bulk of procurement contracts, creating **substantial rent-seeking opportunities for corrupt officials and businessmen**. Thus, Russia is able to control the execution of the project at nearly every stage. In cases where financing is extended, large-scale liabilities with Russian banks prompt rhetoric that justifies the deals because of “strategic concerns,” the same officials having amended laws and shifted policy priorities to accommodate these Russian-led initiatives. For example, two MPs from the pro-Russian Bulgarian Socialist Party advanced legislation that sought to alter

Bulgaria's energy laws in order to allow the South Stream pipeline project to circumvent EU regulations that would have obstructed it (although the initiative was unsuccessful).<sup>8</sup> Similarly, in Hungary, parliamentarians from Prime Minister Viktor Orban's Fidesz party proposed and passed legislation that "makes it possible for any gas company that is not a certified transmission system operator, to build a gas pipeline," opening the door for Gazprom to do so in the South Stream project.<sup>9</sup>

There are a number of examples highlighting how this works. In Bulgaria, for example, the Russian contractor of the now-defunct Belene nuclear reactor project raised the projected cost from €4 billion to €6.3 billion, providing a questionable explanation of inflation-related costs and raising concern that Russia was financially "rewarding" its affiliates in the region.<sup>10</sup> In 2016 Bulgaria was ordered by international arbitration to pay in excess of €550 million of costs for the construction of the two reactors of Belene, which the Russian side claims it had produced despite Bulgaria's clear stance that it would discontinue the project.<sup>11</sup> Russia is using this strategy of cost infliction on its Bulgarian partner company in the also-now-defunct South Stream case, as it has continued to produce and pile pipelines in 2016 that it says are intended for the South Stream project, despite President Putin's cancellation of the project in December 2014. In Serbia, Russia is reported to have relied on Dusan Bajatovic, an MP and the deputy chair of the pro-Russian Serbian Socialist Party as well as the director of Srbijagas, as "a guarantor of the matters agreed in the [now-defunct and Russian-led] South Stream project," suggesting that he may have advanced Russian interests in Serbia.<sup>12</sup>

Russia has also sought to employ the same tactics in the Paks-2 nuclear reactor in Hungary. Valued at an astonishing €12.5 billion—an amount equal to 12 percent of Hungary's annual GDP—the Paks project was set to be almost entirely financed by Russian capital at a fixed rate. The public procurement procedures for the project were conducted in a nontransparent manner, and it is unclear how and why the Russian offer won the contract. The deal was negotiated in total secrecy, without proper policy and political preparation and without the involvement of the Hungarian state administration. In fact, the Hungarian Parliament adopted a law making almost everything related to the Paks-2 project confidential for up to 30 years.<sup>13</sup> This makes communication with decisionmakers difficult and oversight impossible. Given the scale and scope of the project, as well

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8. "Bulgarian MPs Agree to Change South Stream Status," *Novinite*, April 4, 2014, <http://www.novinite.com/articles/159513/Bulgarian+MPs+Agree+to+Change+South+Stream+Status>.

9. Georgi Gotev, "Hungary Attempts to Bypass EU Law on South Stream," *EurActiv*, November 4, 2014, <http://www.euractiv.com/section/central-europe/news/hungary-attempts-to-bypass-eu-law-on-south-stream/>.

10. "Russia Gives Bulgaria Ultimatum for Belene Nuclear Plant, Sets Price at EUR 6.3 B," *Novinite*, March 16, 2011, <http://www.novinite.com/articles/126304/Russia+Gives+Bulgaria+Ultimatum+for+Belene+Nuclear+Plant,+Sets+Price+at+EUR+6.3+B>.

11. "Bulgaria Loses Belene Nuclear Power Plant Arbitration Court Action," *Sofia Globe*, June 16, 2016, <http://sofiaglobe.com/2016/06/16/bulgaria-loses-belene-nuclear-power-plant-arbitration-court-action/>.

12. Igor Jovanovic, "Serbian Gas Monopoly Facing Restructuring," *Natural Gas Europe*, June 18, 2013, <http://www.naturalgaseurope.com/srbijagas-facing-restructuring>.

13. "Paks Data to be Classified for 30 Years," *Budapest Times*, March 6, 2015, <http://budapesttimes.hu/2015/03/06/paks-data-to-be-classified-for-30-years/>.

as the nature of nuclear energy technology, Russian entities will be required to play an increasingly dominant role in Hungary's nuclear sector well into the future. Hungarian politicians and, indeed, Prime Minister Orban himself may have avoided severing ties with Russia for fear of losing the economic (and political) benefit of these lucrative deals and contracts.

Although not all of these megaprojects have materialized or will materialize in the future, they have partially achieved their goal; namely, to prevent needed structural reform and diversification in energy markets. They have also achieved the capture of influential local policy actors that can later be activated when Russian interests require it. Indeed, the primary objective of Russian economic influence seems to be to cultivate—and expand—its networks so that countries in the region are dependent on Russia for decades despite their Euro-Atlantic orientation and identity. Russian nuclear companies feed strong nuclear energy lobbies consisting of experts, politicians, and engineering consultancies in the countries involved. These lobbies have been able to monopolize the public debate and the policies on nuclear energy and have taken advantage of the governance loopholes to set noncompetitive public tenders for engineering, procurement, and construction contracts to channel substantial funds to well-connected firms in the host country and Russia. The long-term structure of the Paks deal in Hungary, for example, serves as a long-term hedge toward Russia and away from the West.

# The Unvirtuous Cycle of Corruption

In the identification of a distinct sets of drivers, tactics, and instruments, a clear commonality emerges: **both systems of economic and political capture rely on corruption<sup>1</sup> as the conduit through which Russian influence is channeled into the local environment and ultimately expanded.** The drivers of Russian influence seek to exploit existing deficiencies within the democratic fabric of the state. Political influence is secured by fomenting popular discontent and exposing the vulnerabilities of the liberal democratic system of governance. Economic influence is secured by attaining a dominant position in strategic sectors on favorable terms, and then robustly defending this dominant position by all means available. With both tracks, Russian political influence and Russian-linked economic acquisitions gravitate toward sectors where generous state resources and state-owned assets play a critical role in market making. Similarly, agents of Russian influence seek state public procurement contracts to reward their patronage networks.

These tracks are not mutually exclusive; they represent the easiest and most accessible point through which Russian influence can gain entry into the domestic environment (indeed, the groundwork for this entry had already been laid by the time these countries transitioned to capitalism and democracy in the early 1990s). It appears that these networks have been reactivated by the Kremlin to expand its influence, in particular since the global economic crisis in 2008. Embedded locally, Russian influence actively works to expand and deepen its reach, blurring if not eliminating the lines between the two tracks to form a single, all-encompassing, circuitous network that serves the purpose of preventing the state from acting against Russian interests. Once well positioned, agents of Russian political influence can be observed seeking to create channels of economic influence, which can then be used to create national dependency on Russia and

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1. To reiterate, we define "corruption" as the alleged or reported exercise of one's power, position, or resources in order to exploit or exert undue influence over businesses, individuals, or state bodies and institutions, typically through nontransparent and questionable means. This may include actions that could be deliberate and/or unlawful, but may not necessarily be so. The examples we cite support our observations of how this unvirtuous circle works based on open-source facts and information, but these observations do not suggest or accuse any specific individuals of wrongdoing.

provide openings for greater economic investment in the future. Similarly, agents of economic influence appear to create channels to exert greater political influence as they identify new sources to advocate for their interests on the local, national, and international stages.

Logically, those countries in which Russia has a more significant economic footprint tend to demonstrate the greatest signs of “economic capture,” while those with a weaker economic relationship, conversely, demonstrate signs of “political capture.” But where both tendencies can be observed, Russian influence is able to progress to a more advanced stage, resulting in “state capture.”

What are the metrics for political or economic capture? Based on the economic data we collected in our five case countries, we observed that those countries in which Russia’s economic footprint was on average more than 12 percent of its GDP were generally more vulnerable to Russian economic influence and capture. The countries with less than 12 percent of its GDP demonstrated greater susceptibility to Russian political influence. Thus, we conclude that:

*Below the 12 percent GDP economic threshold:*

- Hungary and Slovakia are at greater risk of political influence, which appears to be connected to efforts to deepen or maintain Russia’s economic presence.

*Above the 12 percent GDP economic threshold:*

- In Bulgaria, where Russia’s economic presence averaged over 22 percent of the GDP between 2005 and 2014, there are clear signs of both political and economic capture, suggesting that the country is at high risk of Russian-influenced state capture.

*Above the 12 percent GDP economic threshold, but with varied results:*

- Russia’s economic footprint in Serbia falls above the 12 percent threshold but Russian political influence appears to be more prominent, which amplifies Russia’s economic influence over Belgrade’s decisionmaking.
- Latvia is also above the 12 percent threshold and vulnerable to economic capture, but it has demonstrated greater resistance to Russian political influence in recent years.

What is the interplay between these two tracks? Because **Russian influence is transmitted through the corrosive comingling of public and private interests**, it can be relayed from one track to another. The power to award and reward—primarily through monetary means, but also through monopolistic power and influence—is essential to the transmission function, as it creates loyalty, enabling participants to capture new actors in the domestic environment through the distribution of bribes. The promise and the protection of perpetual enrichment is the incentive that allows this system to operate, and state resources provide an abundant source of wealth on which these drivers can draw. In Eastern Europe, where unemployment is high and economies remain fragile and underdeveloped, this allure is particularly powerful. The “captured” individuals spread their antidemocratic and corruption contagion to others, widening and entrenching this circular system. Thus, Russian influence creates a nearly impenetrable “**unvirtuous cycle**” that expands and sustains itself until its ultimate goal of state capture has been achieved. In certain countries, Russian influence has become so pervasive and endemic that it has challenged national stability as well as a country’s Western orientation and Euro-Atlantic solidarity.



Russia's strategy is simple and straightforward: it exploits the inherent weaknesses within the Western capitalist democratic system. It is the lack of rigorous oversight and transparency of our governance standards that are readily available for exploitation, but Russia is not the only source and driver of corruption. All countries struggle with corruption and corruptible individuals in both the public and private sectors, but Russia uses it as an instrument of statecraft that is **highly adaptable and poised to easily take root in new environments, making nearly all countries susceptible**. Distinctive features of the combined effects of economic and political capture related to Russian interests include the circumvention of established formal rules of transparency and democratic definition of national interests, as national administrations have been replaced by private companies in drafting rules and regulations, while the same private interests eventually become the final beneficiaries of greater access to public resources.<sup>2</sup>

Bulgaria presents an interesting example of how the unvirtuous cycle emerges. A controversial member of the Bulgarian Parliament, Delyan Peevski, controls a business empire spanning at least five economic sectors including media and telecommunications, energy, construction, tobacco, and defense, making him one of the most powerful individuals in the country. His mother, for instance, is thought to be the majority shareholder of Bulgaria's largest tobacco company, Bulgartabac.<sup>3</sup> The assets of his media conglomerate, Balkan Media Holdings, control as much as 40 percent of Bulgaria's print sector and 80 percent of the newspaper distribution.<sup>4</sup> Although Peevski has recently begun to sell off many of his assets, his "newspaper and television empire" was sustained and built using loans extended by Bulgaria's fourth largest bank, the now-defunct Corporate Commercial Bank (CCB),<sup>5</sup> which was partially owned by Russia's VTB Capital.<sup>6</sup>

Peevski's clout derives from his position in the ethnic-Turkish party, the Movement for Rights and Freedoms (MRF), which has been one of the staunchest supporters of Russia's energy policy in Bulgaria (and following the downing of a Russian jet over Syria in 2015, its security policy as well). The MRF has been a kingmaker party since the early 1990s, wielding considerable national influence over key ministries and law enforcement institutions in the country, including the prosecutor's office and the antitrust and financial supervision regulators. In 2013, Peevski was appointed as the head of Bulgaria's national security agency that is responsible for overseeing intelligence activities and specifically charged with guaranteeing that there is "no foreign interference in the

2. These governance deficit patterns have been particularly pronounced in Southeast Europe and are well described in Southeast European Leadership for Development and Integrity (SELDI), *Anticorruption Reloaded: Assessment of Southeast Europe* (Sofia: Center for the Study of Democracy, 2014), [http://seldi.net/fileadmin/public/PDF/Publications/RAR/SELDI\\_Regional\\_Anticorruption\\_Report\\_Final\\_Revised.pdf](http://seldi.net/fileadmin/public/PDF/Publications/RAR/SELDI_Regional_Anticorruption_Report_Final_Revised.pdf).

3. Organized Crime and Corruption Reporting Project, "Bulgaria: Media Tycoon Peevski Withdraws from New Business Projects over 'Media Campaign,'" March 22, 2016, <https://www.occrp.org/en/daily/5077-bulgaria-media-tycoon-peevski-withdraws-from-new-business-projects-over-media-campaign>.

4. Matthew Brunwasser, "After Political Appointment in Bulgaria, Rage Boils Over," *New York Times*, June 28, 2013, <http://www.nytimes.com/2013/06/29/world/europe/after-political-appointment-in-bulgaria-rage-boils-over.html>.

5. Kerin Hope, "Bulgaria Rushes to Nationalise Politically-Connected Bank," *Financial Times*, June 22, 2014, <https://www.ft.com/content/cf0ed87a-fa2b-11e3-a328-00144feab7de>.

6. Elizabeth Konstantinova, "Bulgaria to Boost Capital at Ailing Corporate Commercial Bank," *Bloomberg*, June 22, 2014, <http://www.bloomberg.com/news/articles/2014-06-22/bulgaria-to-boost-capital-at-ailing-corporate-commercial-bank>.

internal affairs of Bulgaria,” although public protests ultimately forced the government to withdraw his nomination.<sup>7</sup>

From inside the parliament, Peevski advocated for pro-Russian policies, such as the construction of the South Stream gas pipeline and the Belene nuclear power plant, but he also may have expanded the system of Russian patronage in Bulgaria as the Bulgarian partner companies selected to work on the now-suspended South Stream pipeline were alleged to have ties to Peevski, although he denies it.<sup>8</sup> The Russian business partner in the consortium was controlled by Genadii Timchenko, a close ally to the Kremlin and featured on the U.S. and EU sanctions list. Russian-linked financial entities including the Corporate Commercial Bank were also meant to finance the bulk of these operations. Thus, not only would Russian-affiliated firms have profited from the contract, but they would have ensured that Russia retained control over the project and Bulgaria’s energy infrastructure well into the future. Peevski was also implicated in the 2014 Bulgarian financial crisis, as it has been claimed that his sudden and unexplained withdrawal of funds from CCB caused the bank to collapse, throwing the government into crisis.<sup>9</sup>

The Peevski case illustrates **the potential extent of these networks and the systemic danger that they pose**. Pro-Russian politicians and businessmen seek to disable a democracy’s ability to conduct oversight, ensure transparency, and provide accountability, which erodes the rule of law and renders the state vulnerable to exploitation and manipulation.

Hungary offers another instructive case. During the early 2000s, Russia increased its sphere of influence in Hungary when Megdet Rahimkulov, a wealthy Russian businessman and former Gazprom executive, gradually acquired shares in the Hungarian energy company, MOL. After Gazprom’s bid to acquire MOL failed, Rahimkulov sold his shares to Austria’s OMV. In 2009, OMV sold its 21.2 percent stake in MOL to Russian company Surgutneftegas, which was reported to be linked to the Kremlin,<sup>10</sup> despite the fact that Hungarian law barred it from exercising ownership rights due to its own nontransparent ownership. According to reports, “Gazprom-related interests were thought to control significant portions of the floating stocks in OMV,” raising the possibility that Gazprom may have influenced the transaction.<sup>11</sup> Surgutneftegas eventually sold its stake back to the Hungarian government in 2011 for €1.8 billion.<sup>12</sup>

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7. “When Protests Succeed: Bulgarian Street Anger Claims Another Victory,” Euronews, June 19, 2013, <http://www.euronews.com/2013/06/19/with-peeovski-out-after-five-days-of-protests-what-is-next-for-bulgaria>.

8. Jim Yardley and Jo Becker, “How Putin Forged a Pipeline Deal That Derailed,” *New York Times* December 30, 2014, [http://www.nytimes.com/2014/12/31/world/europe/how-putin-forged-a-pipeline-deal-that-derailed-.html?\\_r=1](http://www.nytimes.com/2014/12/31/world/europe/how-putin-forged-a-pipeline-deal-that-derailed-.html?_r=1).

9. Kerin Hope, “Unease Grows among Investors in Bulgaria’s Corpbank,” *Financial Times*, August 12, 2014, <https://www.ft.com/content/9cdd7556-213f-11e4-a958-00144feabdc0>.

10. Luke Harding, “Putin, the Kremlin Power Struggle and the \$40bn Fortune,” *Guardian*, December 20, 2007, <https://www.theguardian.com/world/2007/dec/21/russia.topstories3>.

11. “Hungary: Gazprom’s Subtle Attempt to Take Over MOL,” Stratfor, July 5, 2007, <https://www.stratfor.com/analysis/hungary-gazproms-subtle-attempt-take-over-mol>.

12. Vladimir Socor, “Surgut’s Exit From Hungary Is a Success for Europe,” Jamestown Foundation, May 31, 2011, [http://www.jamestown.org/single/?tx\\_ttnews%5Btt\\_news%5D=37987&no\\_cache=1#.V6smVjVRJ2U](http://www.jamestown.org/single/?tx_ttnews%5Btt_news%5D=37987&no_cache=1#.V6smVjVRJ2U).

In Serbia, several Russian businessmen were found to have significant investments and partnerships in Serbia via investments made through offshore accounts, including prominent businessmen Konstantin Malofeev and Igor Rotenberg.<sup>13</sup> Malofeev is on the EU sanctions list (as is Rotenberg's father, Arkady). In Latvia, as recently as April 2015, the families of two of the country's leading businessmen, Andris Skele and Ainars Slesers (former prime minister and transport minister, respectively), were reportedly linked to a strategic transaction that provided a subsidiary of RZD Logistics, the holding company of Russian Railways (then headed by former Russian Railways CEO Vladimir Yakunin), with a 50 percent share in Liepāja oil transit company via an opaque web of companies.<sup>14</sup> The transportation sector is one of Latvia's most profitable and strategic sectors.

What has allowed this Russian-influenced unvirtuous cycle to persist and proliferate undetected? The enabler is **Western complicity in corrupt practices and Russia's exploitation of this complicity to ensure opaqueness and nontransparency**. Russian actors have used extensive business, security, intelligence, and political networks of contacts and companies to create a level of complexity that is designed to obfuscate their activities and relationships throughout the region. Recent leaks such as the Panama Papers highlighted how Russian entities are linked to local actors in the region through a combination of companies and offshore accounts. Although many of these transactions are considered legitimate and legal, they are opaquely designed to exploit and benefit from the loopholes in democratic frameworks with a specific purpose to acquire influence, power, and strategic assets. Where such malfeasance can be identified, it is not obvious and requires deliberate and thoughtful investigation. The West is, in fact, culpable in Russia's acquisition of influence by allowing the Kremlin to systemically exploit these vulnerabilities.

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13. Organized Crime and Corruption Reporting Project, "Serbia: Local Businessmen Show in Leaked Data," April 5, 2016, <https://www.occrp.org/en/panamapapers/serbian-businessmen-in-leaked-data/>.

14. "Russian Railways Expands its Latvian Holdings," Latvia Public Broadcasting, April 9, 2015, <http://www.lsm.lv/en/article/economics/economy/russian-railways-expands-its-latvian-holdings.a124786/>.

## Russian Influence: Intentional or Opportunistic?

Is Russian influence in Central and Eastern Europe intentional, or simply opportunistic? Although the statistical analysis is inconclusive, there is qualitative evidence that suggests that Russia's economic influence in the region before the global financial crisis and the Georgian-Russian conflict was one of opportunity, roughly spanning from 2004 to 2007, as Russia explored its economic interests in the five case study countries. However, the 2007–2008 period represented a notable shift, which appears to be intentional, whereby Russian investment and its economic amplifiers (such as structural dependencies in key sectors) were designed to deepen Russia's influence in Central and Eastern Europe. In 2007, President Putin's historic speech at the Munich Security Conference signaled the beginning of a new era of confrontation between Russia and the United States and Europe. A year later, the 2008 Russian-Georgian conflict was the physical manifestation of this new confrontation. Senior Russian officials publicly underscored the weakness of the European project and Europe's inability to economically sustain the regions of Central and Eastern Europe that were lagging behind in the aftermath of the 2008 global economic crisis, providing a growing body of evidence that a new policy agenda was geared toward undermining the West. Thus, Russian attempts to expand its economic influence in the region is viewed as a critical tool in support of this new policy approach. For example, it was the post-2008 period when Russia began pushing through multibillion-dollar megadeals, such as the South Stream pipeline and the Paks nuclear reactor in Hungary, providing the Kremlin with additional levers through which to exert influence. Although these projects were discussed before 2007, traction toward their realization was only gained after this period. These deals were led by Russian state-owned or financed companies such as Gazprom and Rosneft and the financials behind these deals were not designed for profit generation but to secure a strategic position. Attempts to acquire a stake in the Hungarian energy major MOL fit this pattern.

But has corrupt Russian influence been deliberately cultivated, or is it simply a unique export of Russia's particular economic model? In her book *Putin's Kleptocracy*, Karen Dawisha describes Russia today as a "mafia state" ruled by "an interlocking network of associations and clan-based politics centered on Putin," which serves the purpose of "strengthening Putin's hold on power,

silencing critics, and maximizing . . . economic benefits.”<sup>1</sup> This network is hierarchical and far-reaching, consisting of politicians at all levels (including high-level ministers), intelligence and security officials, businessmen, prominent companies, state-owned enterprises, and organized criminal elements. According to Dawisha, state institutions—including the Russian Federal Security Bureau (FSB)—are responsible for maintaining these networks which have become so intertwined that “one cannot differentiate between the activities of the government and organized crime groups.” Corruption lubricates the activity of this system as “it is the basis for upward mobility in Russia,” and the reward of “access to illicit wealth” in exchange for loyalty is what allows this network to expand and grow.<sup>2</sup>

The lengths that are taken to protect these networks demonstrate their high value and importance to the Kremlin. In 2011, Latvian authorities uncovered and foiled a plot by a Russian smuggling group to assassinate the deputy chief of Latvia’s anticorruption agency, Juta Strike, as the agency became increasingly effective and successful at rooting out corruption. Coincidentally, this plot was uncovered at around the same time that the agency exposed the alleged crimes of Latvia’s three wealthiest businessmen (believed to maintain strong Russian business interests), two of whom at the time held public office.<sup>3</sup> The entity believed to be behind the assassination plot is Solntsevo, a Russian crime group known as one of Russia’s most powerful.<sup>4</sup> Diplomatic cables report that the criminal group is protected by the FSB.<sup>5</sup>

There is a high number of transactions, acquisitions, or scandals involving individuals closely linked to Russian President Vladimir Putin’s inner circle. Russian billionaire Konstantin Malofeev, a known Putin associate, was found to have “formed a partnership” with a prominent Serbian businessman, Milan Popovic, via “a web of companies.”<sup>6</sup> Like many of President Putin’s associates, Malofeev is a self-proclaimed Russian patriot whose worldview centers on nationalism and conservative Slavic and Orthodox values, and who has stated that he “wants the Russian Empire back.”<sup>7</sup> Malofeev is listed on the EU sanctions list, has been accused of directly financing pro-Russian separatist rebels in Eastern Ukraine, and was the previous employer of the current “prime minister” of the Donetsk People’s Republic, Alexander Borodai.<sup>8</sup> Beyond Ukraine, Malofeev has been associated with a number of deals and acquisitions throughout Central Europe, including efforts to acquire

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1. Karen Dawisha, *Putin’s Kleptocracy: Who Owns Russia?* (New York: Simon & Schuster, 2015).

2. Brian Whitmore, “The Putin Syndicate,” Radio Free Europe/Radio Liberty, June 9, 2015, <http://www.rferl.org/content/the-putin-syndicate/27062453.html>.

3. “Time up for Tycoons,” *Economist*, September 13, 2011, <http://www.economist.com/blogs/easternapproaches/2011/09/latvian-elections-oligarchs-exit>.

4. “Attempt to Kill Strike Said to be Linked with Russian Smugglers,” Baltic News Network, February 8, 2011, <http://bnn-news.com/attempt-kill-strike-linked-russian-smugglers-16873>.

5. “US Embassy Cables: Moscow Mayor Oversees Corrupt System, Says US,” *Guardian*, February 12, 2010, <https://www.theguardian.com/world/us-embassy-cables-documents/248674>.

6. Organized Crime and Corruption Reporting Project, “Serbia: Local Businessmen Show in Leaked Data,” April 5, 2016, <https://www.occrp.org/en/panamapapers/serbian-businessmen-in-leaked-data/>.

7. Courtney Weaver, “Malofeev: The Russian Billionaire Linking Moscow to the Rebels,” *Financial Times*, July 24, 2016, <https://next.ft.com/content/84481538-1103-11e4-94f3-00144feabdc0>.

8. Ibid.

Bulgaria's largest telecom company, which was partially owned by the VTB-backed and now-defunct Corporate Commercial Bank.<sup>9</sup> It has been suggested that Malofeev is interested in purchasing media outlets in Serbia.<sup>10</sup>

Malofeev also has been identified as an associate of the former head of Russian Railways, Vladimir Yakunin, who was previously a member of the Kremlin's inner circle.<sup>11</sup> Yakunin is known to be a close associate of his former Latvian counterpart, the CEO of Latvian Railways, Ugis Magonis. In March 2016, Magonis was arrested for his alleged involvement in a €500,000 cross-border bribery scheme and it has been reported that these funds could have been intended for Yakunin.<sup>12</sup> Yakunin is currently on the U.S. sanctions list in connection with Russia's illegal annexation of Crimea. (Interestingly, Magonis actively campaigned to keep Yakunin's name off the EU sanctions list.) Yakunin has also been linked to two of Latvia's wealthiest men and former senior government officials, Andris Skele and Ainars Slesers, through a significant business transaction in which a Russian Railways holding company acquired a 50 percent stake in a Latvian rail carrier, Liepājas Naftas Transits, via its subsidiary.<sup>13</sup>

In at least three out of the five case study countries, we have readily identified strategic deals, investments, and relationships conducted by two of the Kremlin's closest associates through local oligarchs and entities via a web of shell companies, intermediaries, or nontransparent transactions. What emerges from the case studies is a picture of an extensive Russian network that thrives on corruption and patronage and whose goal is to acquire influence or control of state-owned companies in strategic sectors, typically through lucrative megaprojects. These investments can be used to facilitate—if not produce outright—economic or political instability. In some cases, Russian-influenced networks appear to reach the pinnacle of government decisionmaking. A particularly vivid example—albeit outside the five case study countries—can be found in NATO and EU member Croatia where, in June–July 2016, the Croatian government was forced to resign after a series of damaging corruption scandals broke. Shortly after the government's collapse, local media reported that Tomislav Karamarko, the former deputy prime minister from the HDZ (Croatian Democratic Union) party, secured a party donation of \$350,000 from the Foundation of New Generations, which is connected with several companies financed by Russia, for costs associated with the November 2015 parliamentary election.<sup>14</sup>

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9. Organized Crime and Corruption Reporting Project, "Bulgaria's Largest Telecoms Firm Shares Bought by Group Linked to Sanctioned Oligarch," March 23, 2015, <https://www.occrp.org/en/component/content/article?id=3792:bulgaria-s-largest-telecoms-firm-bought-by-group-linked-to-sanctioned-oligarch>.

10. Branka Mihajlovic, "Russian Seeking Serbian Media Outlet?," Radio Slobodna Evropa, February 14, 2016, <http://www.slobodnaevropa.org/a/russian-seeking-serbia-media-outlet/27551794.html>.

11. Weaver, "Malofeev."

12. "Oleg Ossinovski—A Pawn in Corruption Case with Magonis," *Baltic Course*, August 20, 2015, <http://www.baltic-course.com/eng/transport/?doc=109649>.

13. "Russian Railways Expands Its Latvian Holdings," Latvia Public Broadcasting, April 9, 2015, <http://www.lsm.lv/en/article/economics/economy/russian-railways-expands-its-latvian-holdings.a124786/>.

14. Vedran Pavlic, "Media Reports: HDZ Paid Ifo Institute with Donation from Russian Sources," *Total Croatia News*, July 12, 2016, <http://www.total-croatia-news.com/item/13000-media-reports-hdz-paid-ifo-institute-with-donation-from-russian-sources>.

These local corruption and patronage networks frequently interact with other affiliated entities in Central and Eastern Europe, which deliberately reduces the economic competitiveness of these countries. Many of these cross-border networks date back to Soviet times. These networks survived the collapse of the Warsaw Pact and eventually thrived throughout the region through nontransparent privatization. They eventually benefited enormously from exploitation of Russia's abundant natural resources and significant amounts of capital flight into the European Union. These networks have become dangerous conduits of political and economic influence in EU member states as they consolidate through a combination of state-sponsored racketeering, extortion, renationalization, and forced changes of ownership with linkages to the Kremlin's inner circle.

Therefore, if this sophisticated network of corruption is an essential component of the Kremlin's playbook, what are the most effective counterstrategies and policies of societal resistance to pursue?

## Resisting Russian Influence and Policy Recommendations

Malign Russian influence can be likened to a virus that attacks democracies. After inconspicuously penetrating a country through what appears to be a harmless and most likely legal business transaction, the virus begins to spread purposefully through local networks, quietly taking hold of its democratic host. For years (if not decades), the virus of Russian influence was typically undetected or ignored due its opaque design. Democratic institutions are able to function as normal. The virus initially thrives as it gradually works its way through the host apparatus clandestinely, which can be seen in the 2004–2008 study period, slowly infecting different strategic sectors of the economy (energy, financial, media and infrastructure sectors) and regions. Over time, the host countries' economies and institutions become compromised to such a point when the very institutions—anticorruption offices, interior ministries, prosecutor's offices—that are designed to combat corruption and monopolistic practice are fully disabled, allowing Russian influence to rapidly spread to the point where the infected democracy is rendered incapable of resisting Russian influence, which then allows for the Kremlin's effective control over the government. If the host democracy resists, the government can be brought down by exposing the extent of the virus, which may be a temporary setback to the Kremlin but has the added benefit of further eroding public confidence, trust, and credibility in democratic systems, which enhances the popularity of extreme parties that are anti-European and anti-American. There is an undeniable elegance to these “win-win” tactics for the Kremlin; it is the perfect strategy to erode the foundations of democracy from within, powerfully discrediting the Western model of governance while elevating the Kremlin's model of governance.

How, then, does Europe and the transatlantic community inoculate itself from this virus? Can the West develop a “vaccine” that creates the necessary “antibodies” to endure only mild forms of the virus or prevent this form of governance illness altogether? It is neither wise nor desirable to halt economic and political engagement with Russia or contact and investment between Russian people, businesses, and the government. But it is essential to be acutely aware of and promote strong governance hygiene against the Kremlin's playbook of influence and its many channels and



networks that represent a real and present danger to democracies. How can the West best protect its institutions, economic systems, and societies?

Because corruption plays a central role in sustaining and propagating Russian influence, it is essential to stop the virus's transmission mechanism. Corruption is enabled by a lack of transparency as well as institutional opaqueness and dysfunction, allowing these networks to operate and grow undetected until the body is overcome. Therefore, democracies must attack these corrupt practices and make their governing institutions inhospitable to corruption by making transparency and openness key elements of national security and defence.

There is nothing new about fighting corruption or strengthening institutions, but these efforts must take on greater urgency. Rather than being largely contained at the local level, corruption has become more globalized and multifaceted and exists on a far larger and more complex scale than previously understood—as the Panama Papers,<sup>1</sup> the International Olympic Committee,<sup>2</sup> and FIFA<sup>3</sup> scandals attest. Countries with weak institutions, practices, laws, and regulations and highly restrictive media environments are extremely vulnerable. Existing anticorruption laws and regulations are vague on enforcement mechanisms and implementation proceedings, thereby providing little protection against Russian influence. Investigative bodies suffer from a narrow scope and a limited mandate that prevents understanding the globalized nature of the corrupt networks and hinders their ability to conduct sweeping investigations to root out corrupt networks. In several cases, political oversight obstructs corruption investigations because the implicated networks extended to the highest levels of government. As media ownership becomes more concentrated and media environments become greatly restricted, investigative journalism—an essential element of openness and transparency—disappears.

In the rare cases where anticorruption efforts have succeeded in bringing charges against officials, courts have proved lenient and incapable of punishing the culprits. Undeniably, judges and prosecutors are also susceptible to corruption and have been linked to corrupt networks themselves, degrading the ability of state institutions to conduct investigations and prosecute offenses insulating officials from prosecution.<sup>4</sup> Trials are often highly complex, lengthy, and delayed because of the opaque nature of the networks, allowing officials to often go unpunished and their corrupt networks and practices to continue unabated.

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1. International Consortium of Investigative Journalists (ICIJ), "The Panama Papers," 2016, <https://panamapapers.icij.org/>.

2. Sean Ingle, "Tokyo Olympic Games Corruption Claims Bring Scandal Back to the IOC," *Guardian*, May 11, 2016, <https://www.theguardian.com/sport/2016/may/11/tokyo-olympic-games-2020-ioc-international-olympic-committee-corruption-bid-scandal>.

3. "Fifa Corruption Crisis: Key Questions Answered," BBC News, December 21, 2015, <http://www.bbc.com/news/world-europe-32897066>.

4. Philip Gounev and Tihomir Bezlev, *Examining the Links between Organised Crime and Corruption* (Sofia: Center for the Study of Democracy, 2010), <http://www.csd.bg/fileSrc.php?id=20428>.

And it is not simply Russian funds that can be used to perpetuate the malign virus of corruption. As much as “80 percent of the EU budget is managed by national or regional governments,”<sup>5</sup> and EU funds—which are designed to economically strengthen EU members—are believed to have been implicated in procurement scandals. For example, it has been suggested in Bulgaria that EU funding may have been used to erode media independence.<sup>6</sup> In countries where Russian political influence has penetrated decisionmaking circles, there is a distinct danger that EU money could be used to advance the Kremlin’s interests. Russian influence is clearly adaptive. Taking EU economic diversification requirements into account, Russian-influenced networks and affiliates have actively worked to circumvent EU rules and laws, going so far as national parliamentarians seeking to modify their national laws to prevent energy diversification. For example, foreign and Russian investors are known to register shell companies in EU member states in cooperation with local affiliates in order to avoid detection and bypass the European Union’s foreign ownership restrictions.

Since Central and Eastern Europe’s accession to NATO and the European Union, there is no longer sustained policy focus by the European Union or the United States on anticorruption efforts and institutional capacity building in these countries. And because of this, anticorruption efforts have suffered from a lack of political will, investment, and focus. In countries that have succumbed to Russian influence, government leaders have little interest in acting against Russian interests and supporting their national interests. In the rare case when they do, the institutions have been sufficiently weakened to prevent enforcement (unless they can be used against a political adversary). Members of parliament have immunity, which is difficult to lift. Even when investigations produce compelling evidence against officials, they are frequently able to mobilize their networks to stave off prosecution. As we have already noted, the system was designed to protect itself from transparency and openness.

But there is some positive news related to building resistance or antibodies to Russian influence. The case of Latvia provides useful insight. Although Russia’s economic footprint in Latvia has increased modestly over the last decade (representing 16 percent of GDP in 2014) and Latvian businessmen possess strong connections to Russian entities, Latvia has done better than most of the case study countries in its anticorruption efforts and has maintained the strongest democratic governance scores. First, there is greater historic sensitivity to Russia, which may make both the Latvian government and society more aware of Russian interaction, despite ethnic Russian populations and interrelations. Latvia has also been successful in battling corruption due to the success of its anticorruption agency, the Corruption Prevention and Combating Bureau (KNAB), although it is far from perfect. The agency has struggled to prevent corruption in the private sector and state-owned enterprises and has itself been subject to internal controversies (the questionable reform program of a new KNAB director caused the country to experience a decline in its corruption

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5. European Commission, “EU Budget in My Country: Hungary,” February 7, 2014, [http://ec.europa.eu/budget/mycountry/HU/index\\_en.cfm](http://ec.europa.eu/budget/mycountry/HU/index_en.cfm).

6. European Commission, “Annex to the EU Anti-Corruption Report: Bulgaria,” February 3, 2014. [http://ec.europa.eu/dgs/home-affairs/what-we-do/policies/organized-crime-and-human-trafficking/corruption/anti-corruption-report/docs/2014\\_acr\\_bulgaria\\_chapter\\_en.pdf](http://ec.europa.eu/dgs/home-affairs/what-we-do/policies/organized-crime-and-human-trafficking/corruption/anti-corruption-report/docs/2014_acr_bulgaria_chapter_en.pdf).

score in 2010, although the director was dismissed in 2011).<sup>7</sup> Nonetheless, it has effectively shone a light on corruption networks within Latvia and has held many of the country's leading politicians and oligarchs accountable for their actions, which, according to an EU progress report, "sets an example for others" and "is a crucial element in preventing high-level corruption."<sup>8</sup> It was KNAB's investigation into the so-called Oligarchs Case that generated public information regarding the actions of senior-level officials and businessmen that led Latvian voters to remove them from power in 2011. Greater transparency and public exposure is key to breaking the unvirtuous cycle of Russian influence and reducing the level of contagion.

The main reason for KNAB's relative success vis-à-vis its regional counterparts is its relative independence. KNAB's director does not report to the parliament but to a special commission.<sup>9</sup> While placing this type of office beyond the reach of parliament would appear to be undemocratic in that parliaments should have overall oversight of governing institutions, one compelling reason for doing so was the complicity of key parliamentarians in corruption. KNAB's independence thus helped to break the influence cycle. KNAB also benefited from strong and courageous leadership,<sup>10</sup> which ensured early progress on investigations that allowed KNAB to gain credibility, withstand political backlash, and establish the institution's independence. Strong political leadership beyond KNAB was also needed—such as that demonstrated by Latvian President Valdis Zatlers when he dissolved the government in response to its unwillingness to address the allegations of corruption and ushered in snap elections that demonstrated the lack of tolerance for high-level corruption. KNAB has also been able to rely on an effective judiciary over the course of the decade, and one of its early priorities was to tackle corruption in the court system to ensure fair prosecution. Since 2003, KNAB has brought charges against four judges and four prosecutors for offering or accepting bribes to sway the outcomes of official proceedings.<sup>11</sup>

In sum, Latvia's anticorruption efforts succeeded because of a dedicated focus on transparency, openness, and institutional independence that created an environment that allowed Latvian democracy to fight the Russian influence virus even as it reached senior levels of government. KNAB's relative independence was invaluable and allowed the body to conduct investigations in the face of political opposition. Most important, the enhanced transparency KNAB provided empowered the Latvian electorate to reject corruption. Can these measures be implemented elsewhere with similar success? In countries where the Russian influence virus has advanced throughout

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7. Freedom House, "Freedom in the World Report—Latvia," 2011, <https://freedomhouse.org/report/nations-transit/2011/latvia>.

8. European Commission, "Annex 14 to the EU Anti-Corruption Report—Latvia," February 3, 2014, [http://ec.europa.eu/dgs/home-affairs/what-we-do/policies/organized-crime-and-human-trafficking/corruption/anti-corruption-report/docs/2014\\_acr\\_latvia\\_chapter\\_en.pdf](http://ec.europa.eu/dgs/home-affairs/what-we-do/policies/organized-crime-and-human-trafficking/corruption/anti-corruption-report/docs/2014_acr_latvia_chapter_en.pdf).

9. Ibid.

10. Gabriel Kuris, "Surmounting State Capture: Latvia's Anti-Corruption Agency Spurs Reforms, 2002–2011," *Innovations for Successful Societies*, Princeton University, October 2012, [https://successfulsocieties.princeton.edu/sites/successfulsocieties/files/Policy\\_Note\\_ID215.pdf](https://successfulsocieties.princeton.edu/sites/successfulsocieties/files/Policy_Note_ID215.pdf).

11. Corruption Prevention and Combating Bureau, "10 Years of Corruption Prevention and Combating in Latvia," October 18, 2012, [http://www.knab.gov.lv/uploads/eng/knab\\_10\\_gadi\\_eng.pdf](http://www.knab.gov.lv/uploads/eng/knab_10_gadi_eng.pdf).

government institutions and strategic sectors of the economy, it will be difficult to find the political will to significantly advance anticorruption efforts as the ruling elites may themselves be complicit in corruption or channeling Russian influence.

The first step to returning a democracy to a clean bill of health is to diagnose the extent of Russian influence in its institutions and economy and to identify the most vulnerable element of that influence. Simultaneously, the United States and the other members of NATO and the European Union must collectively recognize that **Russian influence is not just a domestic governance challenge, but a national security threat**, and efforts to counter it must thus be treated as such. Left unchecked this influence over time will compromise the integrity of Central and Eastern European democracies and will dramatically impact U.S. foreign policy goals by eroding NATO and the European Union—ultimately undermining the Western democratic model.

Given that several NATO and EU members may already be compromised, the United States and Europe must be prepared to dedicate a considerable amount of policy attention and financial resources to combating this influence and developing greater resiliency against this malign virus. In 2015, the United States demonstrated the power of attacking the democratic blight of corruption when it helped to launch, in partnership with Europe, an international investigation against FIFA over bribery and corruption that led to the arrest of 14 FIFA executives and the resignation of FIFA President Sepp Blatter, casting a shadow over preparations for Russia to host the 2018 FIFA World Cup tournament. American leadership could similarly help drive transatlantic efforts at rooting out Russian-involved global corruption networks. Exposure of the so-called Panama Papers further exposed the links and corruption to close associates of the Kremlin, including Arkady and Boris Rotenberg, who built a multibillion-dollar fortune through lucrative contracts with state-owned companies,<sup>12</sup> and musician Sergey Roldugin.<sup>13</sup>

While Europe has had the most prolonged exposure to Russian influence, and weaker and less well developed institutions in Central and Eastern Europe have left it susceptible to Russian influence, the United States is not immune. Enhancing transparency and the effectiveness of the Western democratic tools, instruments, and institutions is critical to resilience against Russian influence. Loopholes in the quality of governance in Central and Eastern European countries, which Russia has used to cultivate and expand its influence in Europe, must be closed and continuously monitored in the future. In the end, curbing Russian influence in the long run is more about strengthening good governance and democratic institutions and less about Russia's tactics of corruption and exploitation. It is clear though that countries that have been subject to both political and economic capture might be unable to effectively counterbalance malign Russian influence without the active support and pressure from their allies and partners in NATO and the European Union. The ultimate responsibility for implementing these changes, however, lies with national governments and, importantly, the publics to which they are ultimately held accountable.

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12. ICIJ, "Panama Papers: The Power Players: Arkady and Boris Rotenberg," April 3, 2016, [https://panamapapers.icij.org/the\\_power\\_players](https://panamapapers.icij.org/the_power_players).

13. Roman Anin, Olesya Shmagun, and Dmitry Velikovskiy, "The Secret Caretaker," Organized Crime and Corruption Reporting Project, April 3, 2016, <https://www.occrp.org/en/panamapapers/the-secret-caretaker/>.

Toward this end, we offer the following policy recommendations:

- **Elevate and design a specific, high-level task force within the Treasury Department’s Office of Financial Crimes Enforcement Network that focuses solely on tracing and prosecuting illicit Russian-linked financial flows if they interact with the U.S. financial system.** The United States should dedicate a specific unit to tracing and mapping illicit Russian financial activity. Presently, FinCEN is primarily focused on anti-Daesh and terrorism financing investigations, but the body is also charged with the task of safeguarding the U.S. financial system from money laundering and national security threats—including kleptocrats and rogue regimes. A unit dedicated exclusively to the understanding and identification of Russian financial activity would be an important contribution to breaking the unvirtuous circle of Russian influence. This unit should place liaison officers in key U.S. embassies in Europe and closely cooperate with European financial and intelligence officials to uncover and prosecute these networks. The information collected by this unit, when applicable, should be made publicly available through a database that could help expose beneficial ownership of companies and opaque business transactions of systemic importance.
- **Encourage NATO and EU members to task their own financial intelligence units with developing dedicated units that track illicit Russian transactions.** In light of the recent string of tragic terrorist attacks in Europe, the European Commission has proposed amendments to the Anti-Money Laundering and Countering Terrorist Financing Directive to strengthen the European Union’s internal financial intelligence capacity, collection, and transparency. Although not yet enshrined in EU law, the amendments take significant steps to enhance requirements on beneficial ownership disclosure and provide FIUs with more authority. The Commission also suggests the creation of automated, centralized mechanisms, such as an interconnected central registry of bank and payment accounts, to facilitate cross-border access to information and faster detection of suspicious transactions.<sup>14</sup> These measures should be swiftly adopted and implemented by the European Council and Parliament and expanded to include provisions that enable EU authorities to trace and analyse questionable financial activity originating and ending in Russia. Toward this end, EU and NATO member (and aspirant) states should be encouraged to develop such capacity within their own national FIUs.
- **Prioritize enhanced EU-U.S. financial intelligence cooperation.** An EU-U.S. Summit should be held on the margins of the 2017 NATO Summit, and one of its top agenda items must be preventing undeclared, cross-border money flows invested in strategic areas or economic sectors of the economy. This can be prioritized by enhancing law enforcement and tax inspection bodies to detect the layering, unregulated transfer pricing mechanisms and contraband energy flows that destabilize financial systems and strengthen corrupt networks. One initiative should be the creation of a specific U.S.-EU cell that ensures effective cooperation between revenue authorities, customs, and law enforcement agencies.

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14. European Commission, “Anti-Money Laundering and Countering Terrorist Financing: Stronger Rules to Respond to New Threats,” July 2016, [http://ec.europa.eu/justice/criminal/document/files/aml-factsheet\\_en.pdf](http://ec.europa.eu/justice/criminal/document/files/aml-factsheet_en.pdf).

- **Elevate anticorruption by strengthening institutions as an element of NATO’s Readiness Action Plan.** The preamble to the North Atlantic Treaty affirms that NATO members “are determined to safeguard the freedom, common heritage and civilization of their peoples, founded on the principles of democracy, individual liberty and the rule of law.” Article 2 of the treaty states that members “will contribute toward the further development of peaceful and friendly international relations by strengthening their free institutions, by bringing about a better understanding of the principles upon which these institutions are founded, and by promoting conditions of stability and well-being.” The national security implications of Russian influence make the success of anticorruption efforts essential to NATO’s mission of collective security and alliance unity. At the 2016 NATO Summit in Warsaw, Poland, alliance members committed to enhancing NATO’s capacity to confront hybrid challenges.
  - The newly created Assistant Secretary General for Intelligence and Warning should be tasked with monitoring Russian influence in NATO member states.
  - Combating Russian influence should be a prioritized program under the new NATO-EU framework agreement. As the alliance looks ahead to the 2017 NATO Summit in Brussels, Belgium, one deliverable could be the recognition of the impact of Russian influence and national security and the development of a robust anticorruption and governance strengthening framework. This framework would create guidelines for auditing and transparency requirements and legislation, develop effective anticorruption investigative bodies, and encourage scrutiny of the ownership structures of NATO and EU members’ media sectors and political party financing.
- **U.S. government assistance to Central and Eastern Europe and the Western Balkans must be completely revamped to prioritize combating Russian influence and strengthening governance.** As the Treasury Department’s role is to root out malign Russian economic influence, the role of the U.S. Agency for International Development (USAID) and the State Department must be to strengthen governance practices. In the past, U.S. assistance to the region was designed to help facilitate these countries’ eventual membership in the European Union, but it was discontinued after their accession. USAID continues to run a multitude of programs in the Western Balkans region—including Serbia, where its work primarily centers on judicial reform and government accountability via a \$21.8 million five-year initiative. Its success, however, appears to be limited to low-level corruption and has not addressed the country’s deteriorating media environment. USAID should consider rebooting its institutional development aid to Central and Eastern European countries, and its existing programs must be redesigned and reprioritized to more effectively address the following areas:
  - The State Department should issue an annual analysis of European states at the highest risk of Russian influence.
  - Aid programs should be focused on maintaining and strengthening investigative journalism and independence of the media environment. In many countries, the consolidation of the media in the hands of a few powerful oligarchs has raised serious concerns about the objectivity of the information presented to the public.

Government policies designed to penalize critics and hinder the opposition have also contributed to state-sponsored censorship in places like Hungary and Slovakia.

- The United States should provide intelligence when appropriate and financial support to national anticorruption and auditing offices that enable independent investigations of complex and cross-border corruption cases. Anticorruption agencies should also be equipped with the capacity to conduct ongoing investigations into criminal networks. Despite USAID's current program, Serbia's anticorruption agency has been criticized for only addressing political party financing discrepancies and lacking the resources necessary to carry out sweeping investigations beyond isolated cases.<sup>15</sup>
- Increased support and efforts are needed to strengthen the independence of the judiciary and prosecution offices to ensure that cases of corruption are swiftly and effectively addressed.
- There must be a strengthening of existing policies designed to provide public transparency of state-funded business transactions and to help countries develop them where they do not yet exist. For example, legislation in Slovakia that enhances procurement transparency through public disclosure has seen the number of tenders with single bidders decline from "over half to less than one-third."<sup>16</sup> But a number of exemptions remain, and as many as 10 percent of all published contracts are incomplete due to insufficient oversight. These loopholes should be addressed to further enhance anticorruption legislation.
- **EU institutions and member states should substantially enhance anticorruption and development assistance mechanisms to help the most vulnerable countries build greater resilience to Russian influence.** The European Union is by far the largest single donor for the Western Balkans and its new member states. As democratic and rule-of-law standards have eroded in Hungary, Slovakia, and Bulgaria, the European Union has been unable to formulate rapid and strong responses to these challenges, which reduces the union's cohesion and is seized on by those who wish to capitalize on the situation. With this in mind, the European Union should:
  - **Enhance EU internal benchmarking and governance mechanisms built around its anticorruption report.** The European Union should augment the report's follow-up mechanisms and make individual country recommendations more specific (including with comments on third-country capture risks). Compliance with these recommendations should be linked to EU development assistance penalties. At the Directorate-General (DG) Migration and Home Affairs, DG Justice, and European Anti-Fraud Office (OLAF), resources and mechanisms for oversight and country assistance should be increased substantially using funds designated for regional development and the

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15. European Commission, "Commission Staff Working Document: Serbia 2015 Report," November 10, 2015, [http://ec.europa.eu/enlargement/pdf/key\\_documents/2015/20151110\\_report\\_serbia.pdf](http://ec.europa.eu/enlargement/pdf/key_documents/2015/20151110_report_serbia.pdf).

16. Gabriel Sipos, "Once Riddled with Corruption, Slovakia Sets a New Standard for Transparency," Open Society Foundations, June 2, 2015, <https://www.opensocietyfoundations.org/voices/once-riddled-corruption-slovakia-sets-new-standard-transparency>.

common agricultural policy. The EU should maintain disciplinary mechanisms for a member state after accession to the European Union. Country-specific recommendations related to governance failures should be more rigorously followed up with focus of resources and penalties for national governments that fail to meet minimum standards.

- **Introduce more rigorous benchmarking of rule-of-law and anticorruption efforts as conditions for pre-accession assistance for the Western Balkans** and other accession countries, as planned for 2018. The Commission should support and facilitate in its annual accession progress reports the development of independent civil society monitoring mechanisms, based on successful regional networks previously developed through the Civil Society Facility of the Instrument for Pre-Accession Assistance. In particular, it should support the development of a state capture risk diagnostic and monitoring instrument. In addition, the European Union should work toward strengthening the role of its delegations in the pre-accession countries to deliver clear and more effective messages on governance, anticorruption efforts, and reforms.
- **Earmark specific EU-wide and national funds for support of rule of law, anticorruption reforms, and independent journalism**, centered on the most vulnerable countries. Particular attention should be paid to diagnosing, exposing, and dealing with state capture risks. National governments should commit to revamping the EU antifraud and antitrust services to make them more effective in this respect.
- **Enhance European Union oversight of EU development funds and require full disclosure of company ownership when meeting EU diversification requirements.** The EU must develop more transparent requirements for providing financial and ownership details of intended larger-scale projects (above €50 million) prior to approval, as well as conduct spontaneous independent evaluations and assessments to determine whether the proposed project costs are reasonable for the stated scope. Because EU project supervision is primarily conducted by member states themselves, projects only come under scrutiny from Brussels if serious irregularities are observed after the fact. To identify suspicious transactions the EU must conduct its own due diligence procedure for all national tenders over a specified limit before the release of funds.
- **National economic policymaking and regulatory governance, transparency, and independence should be strengthened** in view of increasing market diversification and competition in key business sectors such as energy, banking, and telecommunications. All countries in Central and Eastern Europe have considerably lower governance and regulatory quality rankings than their Western European peers. Closing this governance gap, in particular in relation to quality of regulatory oversight, public procurement management, and state-owned enterprises governance, is critical to reducing the vulnerability to Russian influence. In particular, countries from the region should substantially enhance the transparency of national policymaking and implementation, allowing for capture anomalies to be quickly spotted and dealt with. In this respect the performance of national administrations should be assessed regularly with a specific focus on the integrity and loyalty of employees of



government and state-owned firms. This assessment should also cover, and in even greater detail, the prosecution and judiciary.

- **National antitrust authorities should provide public biannual assessments of the diversification of strategic economic sectors**, particularly the energy sector, aided by tax and customs authorities and other agencies to clearly establish final beneficial ownership and linkages to other market players and determine potential national security threats. EU governments should disclose final beneficial ownership and offshore havens to strengthen the transparency, knowledge, and understanding of their national economic base in relation to Russian influence. A good example in this respect has been the work/annual report of the Czech national intelligence service BIS. Central and Eastern European governments should aim to publish such annual reports with specific Russian influence sections.

# Appendix. Case Studies

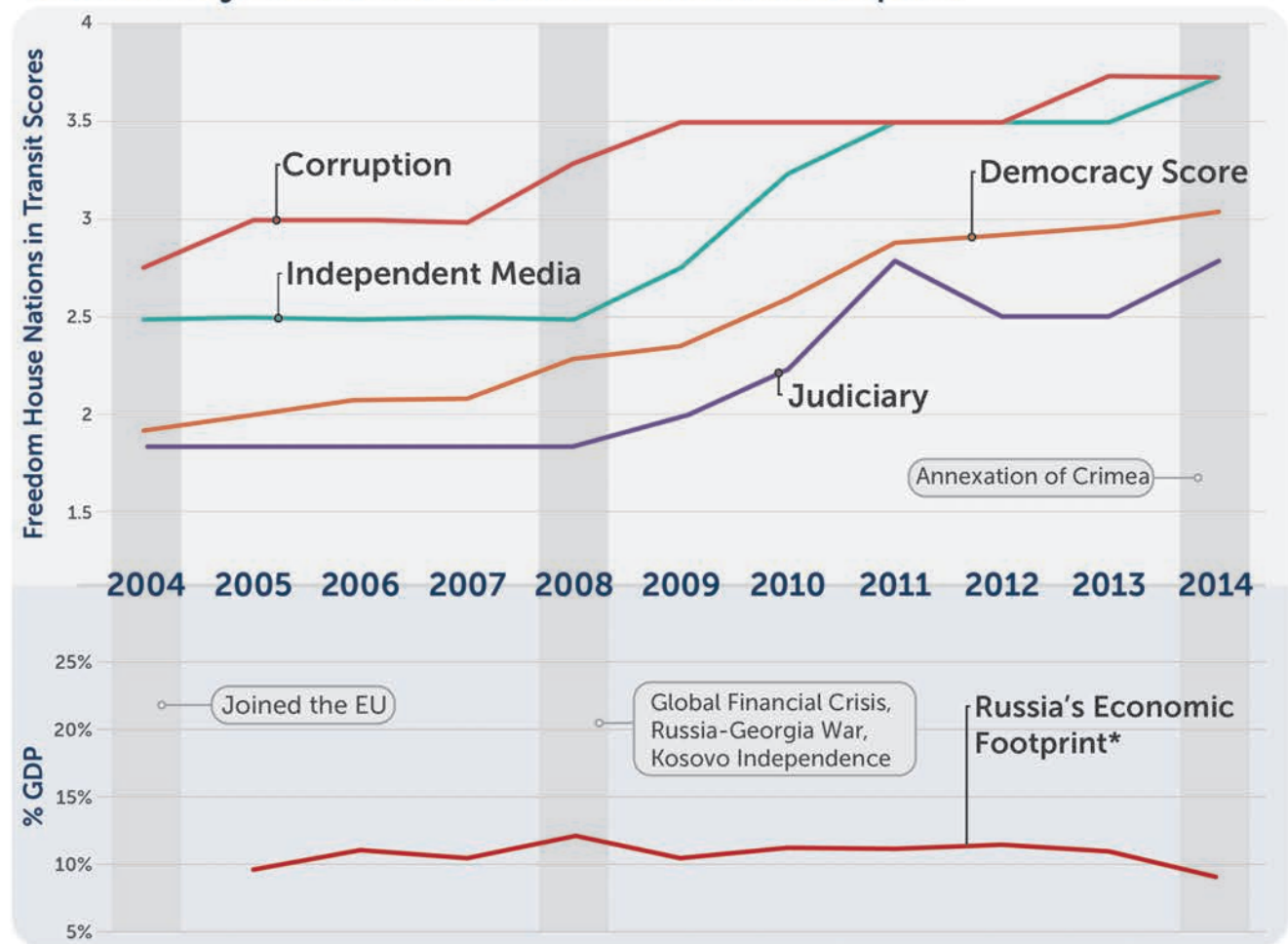
## HUNGARY: EARLY ILLIBERALISM ADOPTER

Of the five case countries considered under the scope of this project, Hungary has experienced the most dramatic reversal in national policy orientation during the 2004–2014 period. At the beginning of the study period, Hungary was among the best performers in Central Europe in terms of its good governance practices and was steadfast in its Euro-Atlantic orientation, having acceded to NATO in 1999 and the European Union in 2004. Yet, as the decade progressed, Hungary experienced a marked deterioration in democratic governance standards following its 2010 parliamentary elections. The center-right Fidesz majority government under the leadership of Hungarian Prime Minister Viktor Orban has taken steps to consolidate the government's control over and restrict democratic institutions and has advocated for an illiberal approach toward governance. The Orban administration has revised the Hungarian constitution five times since 2010 by redefining voting and election laws, and the Fidesz-led parliament has passed legislation that increases the government's control over Hungary's judiciary, media, and central bank. The government has also been criticized for passing laws that fail to protect civil liberties and the rights of minorities. This institutional consolidation has coincided with a shift in Hungary's foreign policy attitudes toward Russia.

There have been two significant shifts in Hungary's political landscape over the 2004 and 2014 study period. The first was the collapse of the Hungarian political left due to incidents of corruption, the release of damaging taped conversations of the former prime minister, fiscal mismanagement, and the global economic crisis, which paved the way for the center-right Fidesz party to become the country's preeminent political force following parliamentary elections in 2010. Fidesz won 227 out of 386 seats, which when combined with the 36 seats won by its junior coalition partner awarded Fidesz a two-thirds majority in parliament—a reality that has allowed the Orban government to pursue its policy agenda unobstructed. The second development was the rise of the far-right, ultranationalist Jobbik party, which has rapidly grown in popularity since its inception in the early 2000s to become a leading pro-Russian, anti-NATO, and anti-Semitic voice that today is Hungary's second largest opposition party in the National Assembly with 24 seats. Thus,

Figure A.1. Hungary

### Democracy Scores vs. Russia's Economic Footprint



Source: Freedom House, CSD Calculations

### Economic Data

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
FDI stock from Russia as share of GDP (%)	0.0	0.0	0.7	0.0	1.4	1.7	0.0	0.0	0.0	0.1
Operating Revenue of Russian Controlled Companies as a share of Total Operating Revenue for the Economy (%)	3.7	4.4	3.8	4.9	3.2	3.5	3.8	3.7	3.2	2.5
Oil and Gas imports from Russia as a share of GDP (%)	3.9	5.0	4.2	5.9	4.1	4.7	5.8	5.8	5.9	4.7
Exports to Russia as a share of GDP (%)	1.0	1.7	2.1	2.4	2.2	2.6	2.5	2.6	2.5	2.0
*Russia's Economic Footprint	8.6	11.2	10.8	13.3	11.0	12.5	12.2	12.2	11.6	9.2

Source: CSD Calculations based on data from EUROSTAT, National Central Banks, and Corporate Registers and Databases.

Hungary's governance changes can be ascribed to two internal political motivations: Prime Minister Orbán's strong desire, once returned to power in 2010, to first ensure that Fidesz's very thin "majority" leadership remained in power and, second, to simultaneously use Jobbik's rising popularity as a justification for the continuation of Fidesz rule as a safeguard against Jobbik, while ensuring that Jobbik does not become a true political rival to Fidesz.

Russia shares an interest in encouraging Jobbik's success. Although Jobbik began as an anti-Russian party (due to the Soviet's brutal ending of the 1956 Hungarian Uprising and harsh communist rule), it made a decidedly pro-Russian turn following the ascendancy of party member and financier Bela Kovacs in 2005. Now one of Jobbik's three European Parliament members, Kovacs, who is currently under investigation by European authorities on charges of Russian espionage,<sup>1</sup> has ties to Russia and advocates for Jobbik to cultivate even closer relations with the Kremlin.<sup>2</sup> In 2006, Kovacs became the party's foreign policy adviser and personally orchestrated Jobbik party leader Gabor Vona's first trip to Russia in 2008.<sup>3</sup> It is believed that Kovacs was Jobbik's single greatest patron in the party's early years, personally sustaining it before the party had entered parliament, and was eligible to receive government funding. Although direct channels are difficult to uncover, it appears that Russia may have invested in Jobbik to create a political alternative to Hungary's centrist parties; if Jobbik would succeed in becoming Hungary's largest political party it could severely damage or potentially terminate Hungary's membership in Euro-Atlantic institutions. Since then, Jobbik's president Vona has visited Moscow and the Russian Duma in 2013, and Jobbik members were also selected alongside politicians from other European far-right parties to observe the separatist "elections" in Crimea and Donetsk, which they deemed to be free and fair in opposition to EU and U.S. policy.

How the rise of Jobbik has directly impacted decisionmaking in Hungary, however, is less obvious. It is unclear how much of the Hungarian government's policies stem from Prime Minister Orbán's desire to politically outmaneuver Jobbik or if Orbán believes that a Euro-Atlantic path is no longer viable for Hungary, thus is hedging that nationalism and authoritarianism are a better future course for Hungary (as well as the long-term sustainment of his leadership). Since 2010, Orbán has become a champion of Euroskepticism in Central Europe and a vocal defender of national sovereignty against the creeping reach of "Eurocrats" in Brussels. In many cases, he has positioned Hungary in opposition to the Commission and European integration, as evidenced by his strong opposition to the joint migration burden sharing scheme (on October 2, 2016, Hungary will hold a referendum on the question of whether to accept the EU refugee quotas). Like Jobbik, Orbán was once, in his formative years, staunchly anticommunist and was considered a leading "freedom fighter" against Russian oppression. In opposition, Orbán was a strong critic of the Hungarian

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1. "Parliament Lifts Hungarian MEP's Immunity over Russia Spy Probe," EurActiv, October 15, 2015, <http://www.euractiv.com/section/europe-s-east/news/parliament-lifts-hungarian-mep-s-immunity-over-russia-spy-probe/>.

2. Valentina Pop, "European Parliament Set to Lift Immunity of Hungarian MEP," *Wall Street Journal*, October 12, 2015, <http://blogs.wsj.com/brussels/2015/10/12/european-parliament-set-to-lift-immunity-of-hungarian-mep/>.

3. Attila Juhasz, Lorant Gyori, Peter Kreko, and Andras Deszo, *"I am Eurasian": The Kremlin Connections of the Hungarian Far-Right* (Budapest: Political Capital, March 2015), [http://www.politicalcapital.hu/wp-content/uploads/PC\\_SDI\\_Boll\\_study\\_lamEurasian.pdf](http://www.politicalcapital.hu/wp-content/uploads/PC_SDI_Boll_study_lamEurasian.pdf).

socialist government's growing economic relations with Moscow. However, since 2010, Orban has reversed his stance and advocated for significant Russian projects, investments, and interests. He has expressed his strong opposition to the EU sanctions regime over Russia's annexation of Crimea. In September 2014, Hungary also temporarily ceased to supply reverse flows of natural gas to Ukraine after Russia reduced its supply following a meeting between Prime Minister Orban and Gazprom's CEO.<sup>4</sup> Moreover, the Hungarian foreign minister has stated that because Russia does not pose a threat to Hungary, there should be no NATO forces on Hungarian soil, although Hungary will host a NATO Force Integration Unit.<sup>5</sup> This last sentiment is similar to Jobbik's stance, which "condemns the Hungarian government's voluntary commitment to host a command center to help coordinate deployment of NATO's rapid response force . . ." because "under U.S. leadership, NATO is taking a series of demonstrative and aggressive steps in our region."<sup>6</sup>

Before 2010, Russia's economic footprint in Hungary was limited (see Figure A.1). Hungary's economic relationship with Russia was an average of 11 percent of GDP and insignificant between 2004 and 2014, with the most significant transactions occurring in the energy sector. But while Hungary remained highly reliant on Russian gas imports, its overall energy dependence on Russia began to decline as resource consumption shifted away from hydrocarbons. Russia's ability to use its networks and business connections in Hungary to advance its interests also appears to have produced limited results. Megdet Rahimkulov, a wealthy Russian businessman and former Gazprom executive, gradually acquired shares in the Hungarian energy company, MOL. After Gazprom's bid to acquire MOL failed, Rahimkulov sold his shares to Austria's OMV. In 2009, OMV sold its 21.2 percent stake in MOL to Russian company Surgutneftegas, which was reported to be linked to the Kremlin,<sup>7</sup> despite the fact that Hungarian law barred it from exercising ownership rights due to its own nontransparent ownership. According to reports, "Gazprom-related interests were thought to control significant portions of the floating stocks in OMV," raising the possibility that Gazprom may have influenced the transaction.<sup>8</sup> Surgutneftegas eventually sold its stake back to the Hungarian government in 2011 for €1.8 billion.<sup>9</sup>

The most significant Russian economic shift in Hungary occurred in 2014, a year before Hungarian Parliament elections, when the Orban government awarded the Russian state-owned nuclear

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4. Neil Buckley, "Hungary Halts Flow of Gas to Ukraine," *Financial Times*, September 26, 2014, <https://next.ft.com/content/7c5d2bf0-4552-11e4-ab86-00144feabdc0>.

5. Krisztina Than, "Hungary Joins Other NATO Allies to Host Command Center," Reuters, October 2, 2015, <http://www.reuters.com/article/us-hungary-nato-idUSKCN0RW1KE20151002>.

6. Márton Gyöngyösi, "Jobbik Condemns the Activation of a NATO Command Center in Hungary," Jobbik: Movement for a Better Hungary, [http://jobbik.com/jobbik\\_condemns\\_the\\_activation\\_of\\_a\\_nato\\_command\\_center\\_in\\_hungary](http://jobbik.com/jobbik_condemns_the_activation_of_a_nato_command_center_in_hungary) (accessed August 23, 2016).

7. Luke Harding, "Putin, the Kremlin Power Struggle and the \$40bn Fortune," *Guardian*, December 20, 2007, <https://www.theguardian.com/world/2007/dec/21/russia.topstories3>.

8. "Hungary: Gazprom's Subtle Attempt to Take Over MOL," Stratfor, July 5, 2007, <https://www.stratfor.com/analysis/hungary-gazproms-subtle-attempt-take-over-mol>.

9. Vladimir Socor, "Surgut's Exit from Hungary Is a Success for Europe," Jamestown Foundation, May 31, 2011, [http://www.jamestown.org/single/?tx\\_ttnews%5Btt\\_news%5D=37987&no\\_cache=1#.V6smVjVRJ2U](http://www.jamestown.org/single/?tx_ttnews%5Btt_news%5D=37987&no_cache=1#.V6smVjVRJ2U).

operator Rosatom a sole-source contract (which the Hungarian government has not made publicly available)<sup>10</sup> to construct two new nuclear reactors at the Paks facility for €12.2 billion—a deal that alone is equivalent to 12 percent of Hungary’s total GDP in Russian financing for the project. Prime Minister Orbán is believed to be the ultimate authority on all public procurement contracts in Hungary, raising the possibility that he personally may have played a role in advancing this deal. Few details about the specifics of the contract are known, however, as the Hungarian Parliament has restricted access to related information for at least 30 years into the future.<sup>11</sup> The Paks contract represents a pattern of Russian economic behavior in the region: the conclusion of a nontransparent and potentially lucrative contract in the energy sector with a government (a year) prior to national elections. Orbán was reelected prime minister in 2015.

What is also striking about Hungary’s post-2010 development is the substantial increase in levels of corruption in Hungary. Transparency International describes Hungary as a “centralized form of corruption that has been built up and made systematic.”<sup>12</sup> Because corruption is a key amplifier of Russian influence and a lubricant to the unvirtuous cycle, this is a worrying trend that also appears to ape a Russian model of development. Certainly the Hungarian government and parliament have been efficient in passing legislation that prevents transparency and oversight of large, state investment projects. In addition to preventing public scrutiny of the Paks-2 reactor deal, the parliament also modified national laws to enable uncertified companies to construct gas pipelines as part of the now-defunct South Stream project, circumventing EU regulations designed to prevent market manipulation to Gazprom’s benefit.<sup>13</sup> That Hungarian MPs have actively reduced barriers that resist corrupt and monopolistic activities that work against Hungarian sovereignty is highly troubling, particularly as it appears that it is purposeful government policy. Therefore, we view Hungary as willing and vulnerable to Russian channels of economic and political influence.

Is Hungary’s increased economic dependency on Russia, combined with Prime Minister Orbán’s attraction to authoritarian and illiberal models of governance and increasing skepticism (if not outright rejection) of Euro-Atlantic policy initiatives, simply the product of political expediency or a purposeful change in policy orientation due to Russian influence? The close linkage of energy contracts and lucrative economic deals suggests that the Hungarian government’s desire to create domestic economic benefits takes precedence over its Euro-Atlantic orientation for the time being. It also suggests that the strength of Russia’s energy ties can induce policy changes such as Hungary’s cessation of reverse natural gas flows to Ukraine. However, Prime Minister Orbán’s interests may surpass immediate economic benefits or political expediency and

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10. Andrew Byrne, “Hungary and Russia Confirm Nuclear Deal,” *Financial Times*, December 9, 2014, <https://next.ft.com/content/48dae3d0-7fc7-11e4-adff-00144feabdc0>.

11. “Paks Data to be Classified for 30 Years,” *Budapest Times*, March 6, 2015, <http://budapesttimes.hu/2015/03/06/paks-data-to-be-classified-for-30-years/>.

12. Transparency International, “Hungary’s Anticorruption Performance is Deteriorating—Concludes the 2015 Global Survey of Transparency International,” January 27, 2016, [http://transparency.hu/cpi\\_2015\\_eng?bind\\_info=index&bind\\_id=0](http://transparency.hu/cpi_2015_eng?bind_info=index&bind_id=0).

13. Georgi Gotev, “Hungary Attempts to Bypass EU Law on South Stream,” *EurActiv*, November 4, 2014, <http://www.euractiv.com/section/central-europe/news/hungary-attempts-to-bypass-eu-law-on-south-stream/>.

encompass something greater. In November 2015, Orban urged Europe to develop a global strategic framework that awards a “proper place” for Russia,<sup>14</sup> indirectly endorsing President Putin’s “Eurasian Union”—a free-trade area stretching from Lisbon to Vladivostok—and seeking deeper economic and political integration with Russia (as opposed to the United States and Europe). Hungary appears to be an early adopter of a political alternative to Western liberalism that is grounded in nationalist, conservative, Christian values and over which a strong leader retains total control. It is extraordinary to contemplate that Hungary may believe its future is better served by an illiberal model of governance more than 25 years after the country left the Warsaw Pact.

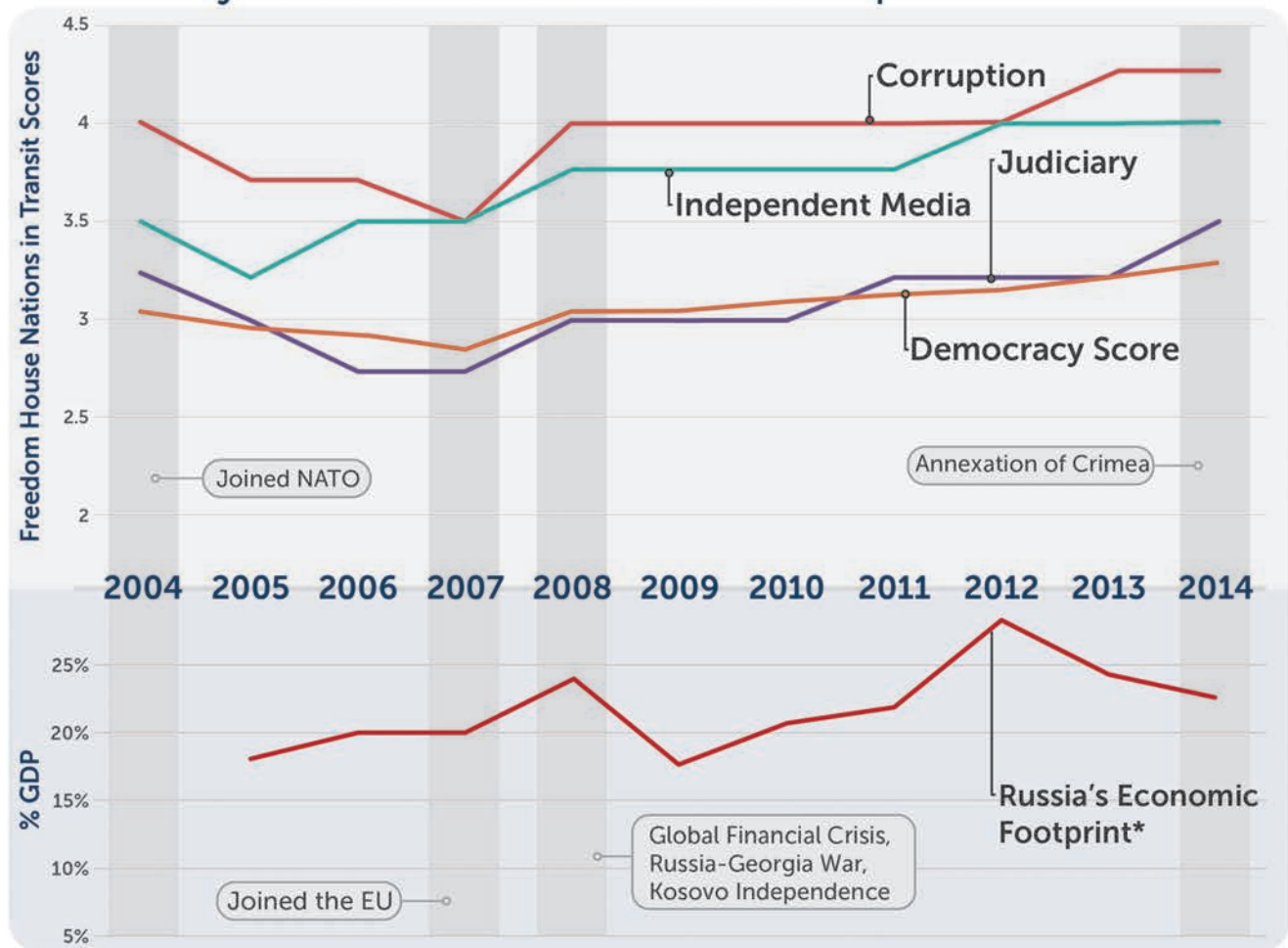
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14. Matthew Kaminski, “Viktor Orbán: Putin Has No Personality,” *Politico*, November 11, 2015, <http://www.politico.eu/article/viktor-orban-putin-has-no-personality/>.

# BULGARIA: WHAT STATE CAPTURE LOOKS LIKE

Figure A.2. Bulgaria

## Democracy Scores vs. Russia's Economic Footprint



Source: Freedom House, CSD Calculations

## Economic Data

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
FDI stock from Russia as share of GDP (%)	0.8	0.9	1.6	2.2	2.8	3.2	3.6	4.3	4.3	4.4
Operating Revenue of Russian Controlled Companies as a share of Total Operating Revenue for the Economy (%)	5.4	9.1	7.8	8.2	6.4	7.0	7.9	8.5	7.4	6.6
Oil and Gas imports from Russia as a share of GDP (%)	9.4	11.1	10.8	11.7	6.9	8.6	9.4	12.0	10.7	12.2
Exports to Russia as a share of GDP (%)	1.3	1.5	2.4	2.7	2.5	2.8	2.7	2.7	2.6	1.2
*Russia's Economic Footprint	16.9	22.7	22.7	24.8	18.5	21.6	23.5	27.5	24.9	24.4

Source: CSD Calculations based on data from EUROSTAT, National Central Banks, and Corporate Registers and Databases.



Few European countries are as closely interconnected historically, culturally, and economically to Russia as Bulgaria. A Slavic, Orthodox nation that largely owes its independence to the support of the Russian czars during the twilight of the Ottoman era, Bulgaria's relationship with Russia dates back centuries and its bond only grew stronger during the Soviet era, going as far back as the Bulgarian leader Todor Zhivkov, who repeatedly sought to make Bulgaria the 16th Soviet republic. Despite membership in NATO (2004) and the European Union (2007), Bulgarians remain largely sympathetic toward Russia. As the case in Slovakia shows, for many Bulgarians, being both pro-European and pro-Russian is not mutually exclusive but a national necessity that has manifested itself in the country's policies.

Bulgaria's high exposure to Russian influence, however, seems to have had greater negative side effects, most significantly in Bulgaria's energy policy decisions. These linkages provide the Kremlin with considerable leverage over current and future decisionmaking in Sofia and are a reason for concern about Bulgaria's future policy orientation. Russia engages in political opportunism, shifting its attention to newly popular parties when old allies decline in importance.

There does not appear to be a single, primary driver of Russian political influence in Bulgaria but rather an interplay of reinforcing networks of influence that range from corrupt politicians and like-minded political parties to energy majors and Bulgarian oligarchs. Politically, the Kremlin's closest ally in Bulgaria is Ataka ("Attack"), a far-right, ultranationalist, xenophobic party. Rising to prominence in 2005 amid widespread frustration over national stagnation, Ataka calls for Bulgaria to repudiate its Euro-Atlantic trajectory and to embrace Moscow. In 2014 party leader Volen Siderov launched Ataka's European parliamentary election campaign in Moscow, accusing the United States of instigating "a third World War,"<sup>15</sup> urging the Bulgarian government to say "no to EU homosexuality," and urging Bulgarians to remember that "it is Mother Russia that liberated us." U.S. diplomats have stated that Ataka works closely with the Russian Embassy in Sofia.<sup>16</sup> Ataka was once the fourth largest party in the Bulgarian Parliament, but support for Ataka began to decline in 2014.

The most prominent pro-Russian group, however, is still the mainstream Bulgarian Socialist Party (BSP)—the successor to the Communist Party, which is also the second biggest party in Parliament and leads the opposition. It is important to distinguish that, unlike Ataka, BSP is not anti-European—in fact, it was the socialist government of Prime Minister Sergei Stanishev that brought Bulgaria into the European Union in 2007. The party has found it difficult to condemn Moscow over its actions in Ukraine (as recently as June 2016, BSP leader Kornelia Ninova called for sanctions against Russia to be lifted while attending a United Russia congress),<sup>17</sup> but at the same time BSP signed an association agreement with an increasingly suppressed Russian opposition in April 2016.<sup>18</sup>

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15. Griff Witte, "Putin Could Be a Winner in European Parliamentary Vote if Far Right Gains Ground," *Washington Post*, May 19, 2014, [https://www.washingtonpost.com/world/putin-could-be-a-winner-in-european-parliamentary-vote-if-far-right-gains-ground/2014/05/18/4de276e9-9ee3-4366-9102-81e91e03f182\\_story.html](https://www.washingtonpost.com/world/putin-could-be-a-winner-in-european-parliamentary-vote-if-far-right-gains-ground/2014/05/18/4de276e9-9ee3-4366-9102-81e91e03f182_story.html).

16. Embassy Sofia, "Progress on U.S. Military Access, but Tough Issues Remain," WikiLeaks Cable: 05SOFIA1796\_a, October 17, 2005, [https://wikileaks.org/plusd/cables/05SOFIA1796\\_a.html](https://wikileaks.org/plusd/cables/05SOFIA1796_a.html);

17. Georgi Gotev, "Bulgarian Socialist Leader Meets Blacklisted Senior Russian Official," EurActiv, June 28, 2016, <https://www.euractiv.com/section/global-europe/news/bulgarian-socialist-leader-meets-blacklisted-senior-russian-official/>.

18. "Bulgarian Socialist Party Signs Co-operation Agreement with a Just Russia Party," *Sofia Globe*, April 23, 2016, <http://sofiaglobe.com/2016/04/23/bulgarian-socialist-party-signs-co-operation-agreement-with-a-just-russia-party/>.

The ethnic-Turkish party, Movement for Rights and Freedoms (MRF), and the relatively new center-left Alternative for Bulgaria (ABV) have both voiced support for Russian policies, particularly related to Russian-led energy deals. This has led to a strange political coalition of sorts that has led a Bulgarian parliamentarian to suggest that BSP, DPS, and ABV are working to form a pro-Russian coalition to challenge the government.<sup>19</sup> BSP and ABV leaders also attended a United Russia congress in June 2016,<sup>20</sup> and ABV leader and former Bulgarian president, Georgi Parvanov, said that if his party wins presidential elections this fall “the new head of state will restore ties with Russia.”<sup>21</sup>

The only major Bulgarian political parties that have shown some resistance to an overt relationship with Russia is the center-right GERB (Citizens for European Development of Bulgaria), the largest party in the National Assembly and segments of the loose Reformist Bloc, one of GERB’s junior coalition partners. So far, the government has been committed to Bulgaria’s European integration.<sup>22</sup> President Rosen Plevneliev is constitutionally independent and Foreign Minister Daniel Mitov is not party-affiliated. Both have issued strong rhetoric condemning Russia, with the former publicly stating that Russia is waging a “hybrid warfare campaign aimed at destabilizing the whole of Europe.”<sup>23</sup> Yet Prime Minister Boyko Borisov (GERB) has been careful to avoid alienating his pro-Russian coalition partners and large segments of the Bulgarian public.

The proximity of many powerful Bulgarian economic networks to Russia is underpinned by Russia’s significant economic presence in Bulgaria. Of all the case countries examined, Bulgaria is the one in which Russia has the most significant economic footprint (which peaked at around 27 percent of GDP in 2012, as shown in Figure A.2). This figure has since declined due to oil prices, EU sanctions against Russia, and Russian countersanctions. Russia dominates the Bulgarian energy sector as Russia’s state-owned company Gazprom is Bulgaria’s sole natural gas provider. In addition, the Russia state-owned nuclear company Rosatom and its subsidiaries have a dominant position in the country’s nuclear energy sector, responsible for reactor fuel supply and nuclear waste management, while the Russian private oil major Lukoil controls Bulgaria’s only oil refinery and over 50 percent of the wholesale fuels market.<sup>24</sup> Russian FDI has multiplied nearly fourfold over the course of our study period, soaring from 0.8 percent of GDP in 2005 to 4.4 percent in 2014, although unpublished estimates suggest that this value may in actuality be in excess of

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19. Mariya Cheresheva, “Ministerial Departures Weaken Bulgaria Coalition,” *Balkan Insight*, May 12, 2016, <http://www.balkaninsight.com/en/article/bulgaria-ex-deputy-pm-declares-resigning-over-a-partisan-decision-05-11-2016>.

20. “Bulgaria’s Rivaling Socialist Parties to Attend United Russia Congress,” *Novinite*, June 25, 2016, <http://www.novinite.com/articles/175125/Bulgaria’s+Rivaling+Socialist+Parties+to+Attend+United+Russia+Congress>.

21. “Bulgaria Needs Presidential System, ABV Leader says,” *Novinite*, May 15, 2016, <http://www.novinite.com/articles/174485/Bulgaria+Needs+Presidential+System,+ABV+Leader+Says>.

22. “Bulgarian MPs Approve New Cabinet, Ministers Sworn In,” *Novinite*, November 7, 2014, <http://www.novinite.com/articles/164611/Bulgarian+MPs+Approve+New+Cabinet%2C+Ministers+Sworn+In>

23. Lawrie Holmes, “Russia Plans a ‘Hybrid Warfare’ Campaign Aimed at Destabilising Europe, Says Bulgarian President,” *Independent*, November 14, 2015, <http://www.independent.co.uk/news/world/europe/russia-plans-a-hybrid-warfare-campaign-aimed-at-destabalising-europe-says-bulgarian-president-a6734981.html>.

24. Ognian Shentov, Alexander Stoyanov, and Maria Yordanova, eds., *State Capture Unplugged: Countering Administrative and Political Corruption in Bulgaria* (Sofia: CSD, 2016), <http://www.csd.bg/artShow.php?id=17723>.

11.2 percent.<sup>25</sup> Russian FDI is also concentrated in other strategic sectors such as finance, telecommunications, real estate and the media. Bulgaria's pro-Russian political parties have sought to conclude lucrative deals with Russian entities while in government, specifically on mega-energy projects such as the South Stream pipeline and the now-defunct Belene nuclear reactor proposal.

It is the dominance of FDI by Russia in strategic sectors of Bulgaria's economy that is effectively used by the Kremlin to advance its interests in Bulgaria and ultimately the European Union. Currently, Lukoil Neftohim is the largest company in Bulgaria with 2014 revenues of roughly €3.3 billion. Together with its wholesale and retail fuel-distributing subsidiaries, Lukoil is also the largest taxpayer controlling indirectly roughly one-quarter of all budget revenues in the country. The Lukoil Group of companies also makes up around 9 percent of Bulgaria's GDP.<sup>26</sup> Meanwhile, Gazprom, which supplies close to 97 percent of Bulgaria's gas needs, also owns 50 percent in the country's largest retail gas distribution company, Overgaz, and has also expanded its presence on the fuels market via its subsidiary, Gazprom Neft.

Russia's influence in the energy sector in Bulgaria has been most entrenched in nuclear energy, which makes up around 20 percent of the total final primary energy consumption and around 34 percent of the total electricity generation in the country. All nuclear power is produced by the Soviet-built Kozloduy Nuclear Power Plant. It is fully dependent on the import of reactor fuel from Russia via the Russian company TVEL, a subsidiary of Russia's Rosatom, and ships all of the plant's spent fuel back to Russia for processing. The supply contract with TVEL dates back to 2002 and stipulates that the Russian company is assigned the task of taking care of the entire life cycle, from purchase to disposal, of the fuel used in the Kozloduy power plant.

To maintain Russia's economic dominance and to avoid scrutiny of its business transactions, the Kremlin uses a complex and opaque network of colluding officials within the governing apparatus and business community. The requirement for transactional opaqueness has created a vicious circle of increased Russian economic influence in Bulgaria and a decline in national governance standards. Russian economic influence in Bulgaria has often been seen as bordering on state capture, which allows Russian state and private interests to affect the course of governance. Such practices have been manifested in the management of state-owned companies, the large energy infrastructure projects, the distribution of public procurement contracts, the approval process of mergers and acquisitions, the circumvention of EU law through legal changes, and the exploitation of corporate governance loopholes to block policy initiatives against Russian corporate and strategic interests.

Prior to Bulgaria's accession to NATO and the European Union, the country posted steady improvements in its democratic governance standards. Both institutions prioritized the institutionalization of anticorruption measures before membership. But, following membership into both institutions, external pressure eased at the same moment that the onset of the global economic crisis began. After 2008, Bulgaria experienced a reversal in its democratic health that has

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25. This percentage is based on an analysis of the FDI data from the Central Bank, considering the ultimate beneficial ownership of the companies investing in Bulgaria.

26. LukOilNeftohim, "The Company," <http://www.lukoil.bg/Main.do;jsessionid=25ABAFE7583DC79C312CD63B9CBE7EC3?actionName=facts>.

continued to worsen throughout the decade. The inability of the state to combat corruption or improve the country's economic situation (Bulgaria's per capita GDP is the lowest in the European Union and unemployment has remained above 10 percent since 2010) has fueled disillusionment with the governing elite, splintering Bulgarian political parties and creating political volatility and paralysis. The prevalence of political volatility, fragmentation, and popular unrest has created opportunities for external actors to fund nascent politicians, political movements, and new political entities that espouse nationalism, xenophobia, and Euroskepticism. No Bulgarian political party apart from GERB in 2009 has emerged with a stable majority over the past decade (Bulgaria has had six governments including two interim cabinets), which allows pro-Russian political parties like Ataka and the MRF to destabilize coalition governments when desired.

As Russia has gained considerable influence over Bulgaria's economy, it has used its dominant position in strategic sectors to strengthen existing relationships and cultivate new ones with corrupt businessmen and local oligarchs. These businessmen, in turn, are linked to prominent politicians over whom they exert considerable control. The politicians cut deals that benefit businesses and deepen their power within the country's corrupt networks and over state institutions. Increasingly, the middle step is removed and the pro-Russian local businessman enter politics themselves and attain positions of prominence within state institutions to directly promote pro-Russian business interests and politics. Accompanied by the Kremlin's sponsored political parties and rapidly formed organizations that support Russian policies on any given topic, pro-Russian actors succeed in influencing Bulgaria's national policy debate and government, which directly benefits Russia. Should there be an instance where the European Union or NATO request that Sofia take steps that are perceived to work against Russia's interests, the Bulgarian government would come under enormous pressure from pro-Russian parties, prominent businessmen, and organizations that mobilize a full range of tools to change the policy in Moscow's favor.

Bulgaria has demonstrated a mixture of policy resistance and capitulation. In the case of the South Stream pipeline, the Bulgarian Parliament attempted to circumvent EU energy law by introducing legal amendments that would have allowed the start of construction of the Gazprom-led pipeline on European territory.<sup>27</sup> Later, declassified documents showed that Gazprom officials had sent an official letter to the Bulgarian Energy Holding advising the company how to amend the energy law in Gazprom's interest.<sup>28</sup> But Bulgaria has continued to support the maintenance of EU sanctions. In the case of the United States requesting that Bulgaria not allow Russian military overflights over Bulgaria to implement its military buildup in Syria in September 2015, the Bulgarian government agreed not to allow the overflights but came under tremendous political pressure for its decision.

The depth, breadth, and cyclical nature of these networks suggests that Bulgaria is at an advanced stage of state capture and is both at high risk and highly vulnerable to Russian policy influence.

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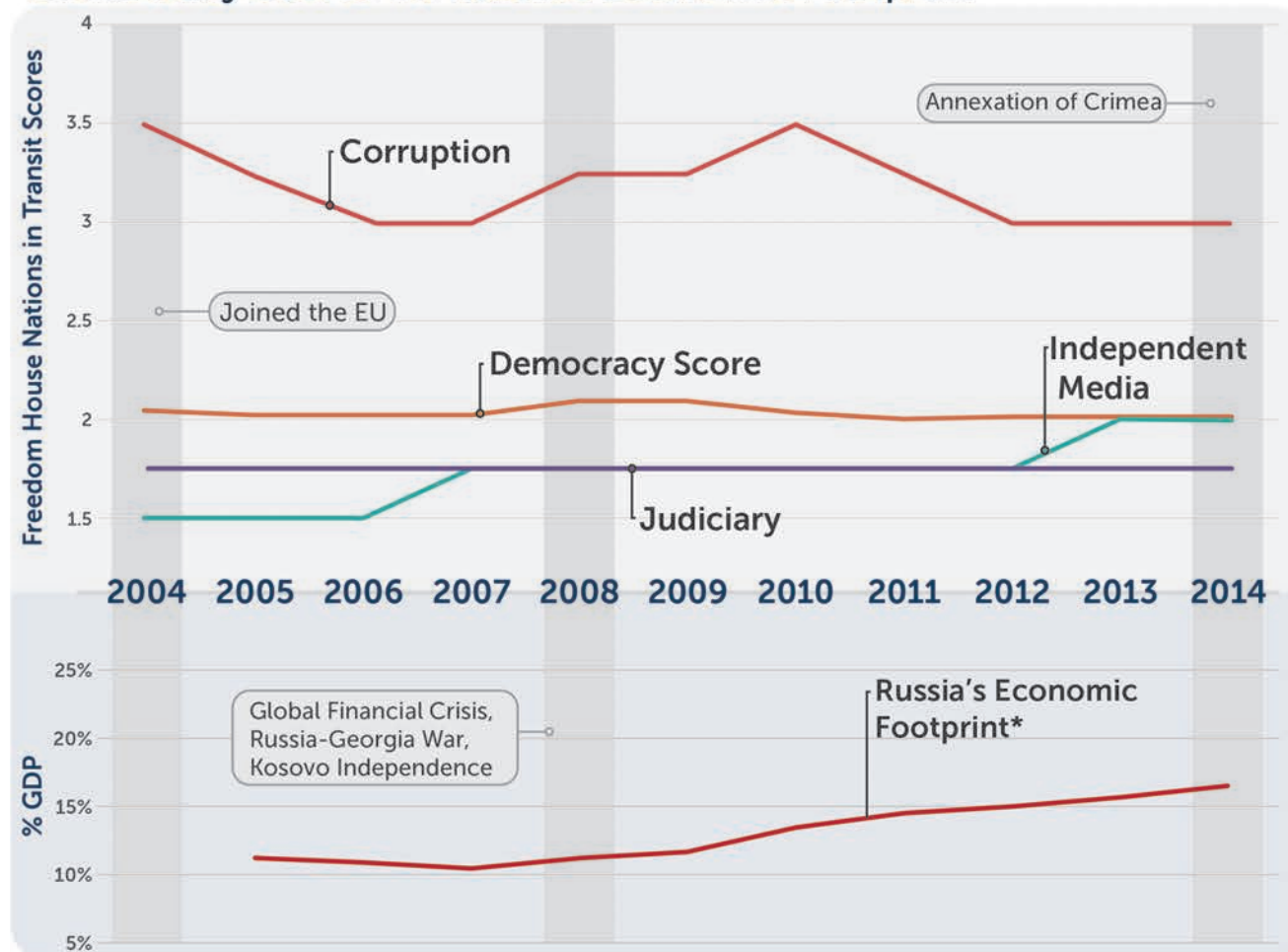
27. Ruslan Stefanov and Martin Vladimirov, "Bulgaria and the South Stream Pipeline Project: At the Crossroads of Energy Security and State Capture Risks," *Südosteuropa Mitteilungen* 54 (May–June 2014): 54–72, <http://www.csd.bg/artShow.php?id=17256>.

28. Tanya Ilieva, "The Reformist Bloc Showed How 'Gazprom' is Writing Bulgarian Laws" (РБ показа как компания на "Газпром" пише български закони), BTV, November 24, 2014, <http://btvnovinite.bg/article/bulgaria/ikonomika/rb-pokaza-kak-kompanija-na-gazprom-pishe-balgarski-zakoni.html>.

# LATVIA: HOW TO BREAK THE UNVIRTUOUS CYCLE

Figure A.3. Latvia

## Democracy Scores vs. Russia's Economic Footprint



Source: Freedom House, CSD Calculations

## Economic Data

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
FDI stock from Russia as share of GDP (%)	2.7	2.4	1.6	1.6	2.0	1.9	1.9	2.2	2.4	3.6
Operating Revenue of Russian Controlled Companies as a share of Total Operating Revenue for the Economy (%)	4.9	5.1	4.7	5.0	5.4	5.3	5.5	5.2	5.2	5.6
Oil and Gas imports from Russia as a share of GDP (%)	1.9	1.8	1.9	2.8	2.6	2.7	2.6	2.6	2.5	2.2
Exports to Russia as a share of GDP (%)	2.5	2.6	2.6	2.7	2.4	3.9	4.5	5.1	5.0	4.7
*Russia's Economic Footprint	12.0	11.9	10.8	12.2	12.4	13.8	14.5	15.0	15.1	16.0

Source: CSD Calculations based on data from EUROSTAT, National Central Banks, and Corporate Registers and Databases.

Of the five case countries under consideration, Latvia is the only country that was an integral part of the Soviet Union during the communist era. In 1940, following the Molotov-Ribbentrop Pact with Nazi Germany, an independent Latvia was claimed by and incorporated into the Soviet Union after the conclusion of the Second World War. For more than six decades as a Soviet republic, Latvia was directly integrated into Soviet economic and political structures. Latvia is also the only case country to share a 168-mile<sup>29</sup> border with Russia and is host to one of the largest ethnic Russian communities in the European Union and NATO; nearly 25 percent of all Latvians boast Russian lineage and 37 percent of Latvian citizens are native Russian speakers. Many ethnic Russians in Latvia migrated during the Soviet era, and the community maintains close relations with family members in Russia, with Russia granting visa-free travel. Ethnic Russians in Latvia rely almost exclusively on Russian language media outlets for their news and entertainment, which are increasingly controlled by entities close to the Kremlin, making these populations susceptible to state-directed media campaigns.

Latvia is highly dependent on Russia economically (second only to Bulgaria). Russia's economic footprint in Latvia, over the course of the study period, has expanded from 12 percent in 2005 to 16 percent in 2014 (see Figure A.3). Latvia is 100 percent dependent on Russia for its fossil energy needs. One-half of all existing deposits in Latvian banks come from Russia and other post-Soviet countries. Russia is also Latvia's third-biggest export market. Nearly 11 percent of Latvia's GDP derives from Latvia's transportation sector, which transports goods and resources to and from Russia via its many Baltic ports. This dependency not only provides Russia with a great deal of economic leverage over Latvia but it creates a conducive environment where Latvian businesses, oligarchs, and politicians—and on occasion organized crime networks—establish close yet opaque links to Russian entities. Leaked diplomatic cables state that “many people in Latvia, including key political figures, have very lucrative business relationships with Russia that they fear losing.”<sup>30</sup> Three of Latvia's most prominent businessmen—Aivars Lembergs, the mayor of Ventspils; Andris Skele, the former prime minister; and Ainars Slesers, the former minister for transport and the economy—have been described possessing “complex but often pragmatic and cooperative” relationships with Russia.<sup>31</sup> The 2015 arrest of the CEO of Latvian Railways, Ugis Magonis, in connection with an alleged €500,000 bribe that may have been intended for the Russian railways chief, highlights the potential power and durability of this network.<sup>32</sup>

Local businessmen in Latvia with links to Russia may have used their influence in certain sectors to further Russian interests (for example by portraying the government as unable to perform its

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29. Associated Press, “The Latest: Thousands More Migrants Reach Slovenia,” *Business Insider*, October 20, 2015, <http://www.businessinsider.com/ap-the-latest-thousands-more-migrants-reach-slovenia-2015-10>.

30. “Russia-Georgia Clash Worries Baltic States,” A Selection from the Cache of Diplomatic Dispatches, *New York Times*, August 15, 2010, <http://www.nytimes.com/interactive/2010/11/28/world/20101128-cables-viewer.html#report/nato-08RIGA496>.

31. Agnia Grigas, “Legacies, Coercion, and Soft Power: Russian Influence in the Baltic States,” Chatham House Briefing Paper, August 2012, [https://www.chathamhouse.org/sites/files/chathamhouse/public/Research/Russia%20and%20Eurasia/0812bp\\_grigas.pdf](https://www.chathamhouse.org/sites/files/chathamhouse/public/Research/Russia%20and%20Eurasia/0812bp_grigas.pdf).

32. “Estonian Newspaper: Magonis Was Only a Courier,” Baltic News Network, August 19, 2015, <http://bnn-news.com/estonian-newspaper-magonis-courier-132044>.

functions well, with the solution to all these problems being closer cooperation with Russia in both the political and economic realms). In the energy sector, Juris Savickis, the CEO of Itera Latvija (subsidiary of the Russian Itera)<sup>33</sup> and a former KGB officer, has spoken out against the liberalization of the natural gas market in Latvia in favor of the current arrangement, noting that after the changes Russia would still remain the sole provider albeit at prices 20 to 30 percent higher.<sup>34</sup> Curiously, in 2002 it was reported that President Putin was “considering Juris Savickis . . . for the position of board chairman of the Russian gas monopoly, Gazprom” and that “Savickis and Putin have had a good relationship since the mid-1980s.”<sup>35</sup> Beyond energy, Itera Latvija has financed initiatives in the sports sector, for example by sponsoring a popular hockey team,<sup>36</sup> which could be seen as an attempt by the company to cultivate soft power. Juris Savickis is also the largest shareholder in one of Latvia’s biggest road transportation companies, Nordeka.<sup>37</sup>

It could be easily assumed that the existence of these networks could negatively impact Latvia’s democratic institutions and reduce the transparency and rule-of-law measures that could influence Latvian decisionmaking. Yet Latvian national policy has proved resilient to the potential malign influence of the Russian-linked oligarchic networks. While Russia has succeeded in influencing economic decisions (such as the significant delay of the gas market liberalization reform) in Latvia, the country remains deeply committed to its Euro-Atlantic orientation; has supported the continuation of sanctions against Russia—despite the economic backlash; has been consistent on policies related to NATO and Ukraine; and has encouraged greater NATO force presence in Latvia, in contrast to other Central European peers. How has Latvia withstood the pressures of Russian economic influence, and how can other countries in the post-Soviet space emulate its experience?

There are two possible factors that have contributed to the development of Latvian antibodies to malign Russian influence. First, Latvia has more successfully deepened its nascent democratic institutions and reinforced the rule of law. Unlike other case study countries, Latvia’s democracy scores have improved steadily during the study period, with the most dramatic change in the area of fighting corruption. Latvia’s score declined from a high of 3.5 to 3.0 by 2014 due to the efforts of KNAB—Latvia’s Corruption Prevention and Combating Bureau, an independent investigative entity. Since its 2003 inception, KNAB has brought forward more than 194 cases of high-level corruption for prosecution, levying charges against 492 people, most notably what became known as the 2011 “Oligarch Scandal” that resulted in voters rejecting politicians that were

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33. “Elering Bought Itera Latvija’s 10% Stake,” *Baltic Course*, September 25, 2015, <http://www.baltic-course.com/eng/energy/?doc=111021>.

34. “Gas Boss: Competition Will Drive Prices Up 30%,” *Public Broadcasting of Latvia*, August 24, 2015, <http://www.lsm.lv/en/article/economics/economy/gas-boss-competition-will-drive-prices-up-30.a142687/>.

35. “Latvian Gas Company President Might Head Russia’s Gazprom,” *Transitions Online: Regional Intelligence*, April 17, 2002, <http://www.tol.org/client/article/4171-latvian-gas-company-president-might-head-russias-gazprom.html>.

36. Alla Petrova, “Itera to Continue Sponsorship of Riga ‘Dinamo,’” *Baltic Course*, December 6, 2010, <http://www.baltic-course.com/eng/energy/?doc=34627>.

37. “On the Results of the Final Takeover Bid of AS ‘Nordeka’ Shares—Announcement of Juris Savickis,” *Nasdaq GlobeNewswire*, April 14, 2015, <https://globenewswire.com/news-release/2015/04/14/724193/0/en/On-the-results-of-the-final-takeover-bid-of-AS-Nordeka-shares-announcement-of-Juris-Savickis.html>.

allegedly connected to the named oligarchs.<sup>38</sup> In addition to leading criminal investigations, KNAB has also spearheaded efforts to advance legislation that made political party finances more transparent, reduced conflicts of interest, and improved disclosure standards with regard to officials' income and lobbying activities. While corruption remains a challenge in Latvia, KNAB's role, particularly related to grand political corruption associated with the violation of the rules for transparency and accountability, has reduced Latvia's vulnerability to malign Russian influence despite the strong economic links. The reason for the Latvian success is that one of the primary transmission mechanisms for Russian influence is corruption from opaque business transactions that could be used to mold the politicians' decisionmaking. Latvia's relatively strong and independent judiciary has also been critical in ensuring effective prosecution of cases of corruption.

Second, Latvia's population composition, which has been perceived as a natural vulnerability, has in fact played a role in heightening the awareness of the Russian challenge. While Latvia's ethnic Russian community is rather receptive and sympathetic to Russian information, the vast majority of ethnic Latvians maintain a healthy skepticism toward and acute awareness of Russia as they seek to retain their distinct identity and language as well as recall their experience of Soviet occupation, which stands in stark contrast to the Russian narrative of liberation from Nazi Germany. Ethnic Latvians have remained cautious in their dealings with Moscow and are very sensitive to Russia's implementation of its long-standing compatriot policy toward ethnic Russian populations abroad. There are 300,000 "noncitizens" in Latvia who are mainly ethnic Russians (particularly those who immigrated during the Soviet era) and have not been granted Latvian citizenship or the right to vote. Some ethnic Russians see the citizenship process as an effort to reduce their Russian heritage by requiring them to learn the Latvian language.<sup>39</sup> Other ethnic Russians do not want to give up their visa-free travel to Russia. Since Russia's 2014 annexation of Crimea and incursions into Eastern Ukraine, ethnic Latvians have only grown more apprehensive regarding Russia's hybrid warfare tactics and attempts to interfere in the life of ethnic Russian communities in Latvia.

To navigate these more difficult political and institutional waters, Moscow's principal political ally in Latvia is the center-left Harmony party. Founded in 2010 as a center-left coalition comprised of five like-minded parties, Harmony rose to prominence as an advocate and political voice for Latvia's ethnic Russian community and the expansion of their rights. Harmony's support base primarily consists of ethnic Russians and is seen as the "Russian party." While Harmony has tried to recast itself as a social democratic party and minimized pro-Russian rhetoric outlook (experts believe maintaining a moderate platform is part of a Kremlin strategy to ensure that pro-Russian groups are considered legitimate to obtain power),<sup>40</sup> it asserts a pro-Russian foreign policy. For example, party leader Nils Ushakovs, the 38-year-old mayor of Riga, is a vocal opponent of the EU

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38. Corruption Prevention and Combating Bureau, "10 Years of Corruption Prevention and Combating in Latvia," October 18, 2012, [http://www.knab.gov.lv/uploads/eng/knab\\_10\\_gadi\\_eng.pdf](http://www.knab.gov.lv/uploads/eng/knab_10_gadi_eng.pdf).

39. John D. Stoll, Charles Duxbury, and Juris Kaza, "In Latvia, Tensions Mount under Russia's Gaze," *Wall Street Journal*, May 5, 2014, <http://www.wsj.com/articles/SB10001424052702304163604579531713356133936>.

40. Mike Winnerstig, ed., *Tools of Destabilization: Russian Soft Power and Non-military Influence in the Baltic States* (Stockholm: Swedish Defence Research Agency [FOI], 2014), <http://www.foi.se/report?rNo=FOI-R--3990--SE>.



sanctions regime against Russia but has reaffirmed his support for Ukraine's territorial integrity. Harmony has established a partnership with President Putin's ruling United Russia party, and it is believed to have previously received funding from the Kremlin.<sup>41</sup> Some Latvian officials have backed this assertion based on classified evidence estimating that Russia transferred an estimated \$1 million to Harmony in 2005 via "compatriot institutions."<sup>42</sup> Because of its pro-Russian stances, other Latvian centrist parties steer clear of Harmony when formulating governing coalitions, fearing that cooperation would raise questions about Russian influence. In 2014, Harmony emerged from national parliamentary elections as the largest party in the Saeima with 24 seats out of 100, but it was kept out of government by a coalition of centrist and right-wing parties (including the nationalist National Alliance) due to its views on Russia.

While this is a largely positive assessment regarding Latvia's political and economic resilience, it also suggests that there is societal vulnerability regarding Russia's Compatriot Policy. The Kremlin has stated that "Russia will always defend [the interests of Russians and Russian-speakers abroad] using political, diplomatic, and legal means."<sup>43</sup> The crisis in Ukraine was also evidence that the Kremlin has added military means to its list of tactics to resolve the concerns of ethnic Russians abroad, which could be deployed to address questions related to Latvia's ethnic Russian "noncitizens." The Kremlin and Russian-owned media outlets operating in the region have highlighted the challenges faced by ethnic Russians in the Baltics, with a Foreign Ministry official stating in 2014 that "we will not tolerate the creeping offensive against the Russian language that we are seeing in the Baltics."<sup>44</sup> Yet despite the lingering questions about their legal status, ethnic Russians are not subject to overt persecution. As one ethnic Russian remarked when asked about Russia's Compatriot Policy: "Protection from what? Gays and freedom from censorship? All enemies of Baltic Russian speakers are imaginary. Russian national rhetoric uses these images to produce divergence in multiethnic societies."<sup>45</sup>

Many Latvians understandably are concerned that Russia will exploit divisions within their society to create a pretext to discredit and indirectly challenge the government. Could Russia's tactics as it annexed Crimea and its use of "little green men" happen in Latvia? For example, what if Moscow offered Russian passports to "noncitizens" in Latvia with the promise of better pensions if they accept Russian citizenship?<sup>46</sup> Would these actions lead the Latvian government to take action that

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41. Anders Aslund, "Latvia Says No to Populism," Peterson Institute for International Economics, October 4, 2010, <https://piie.com/blogs/realtime-economic-issues-watch/latvia-says-no-populism>

42. Winnerstig, *Tools of Destabilization*.

43. "Transcript: Putin Says Russia Will Protect the Rights of Russians Abroad," *Washington Post*, March 18, 2014, [https://www.washingtonpost.com/world/transcript-putin-says-russia-will-protect-the-rights-of-russians-abroad/2014/03/18/432a1e60-ae99-11e3-a49e-76adc9210f19\\_story.html](https://www.washingtonpost.com/world/transcript-putin-says-russia-will-protect-the-rights-of-russians-abroad/2014/03/18/432a1e60-ae99-11e3-a49e-76adc9210f19_story.html).

44. "Russia Sees Need to Protect Russian Speakers in NATO Baltic States," *Moscow Times*, September 16, 2014, <http://www.themoscowtimes.com/news/article/russia-sees-need-to-protect-russian-speakers-in-nato-baltic-states/507188.html>.

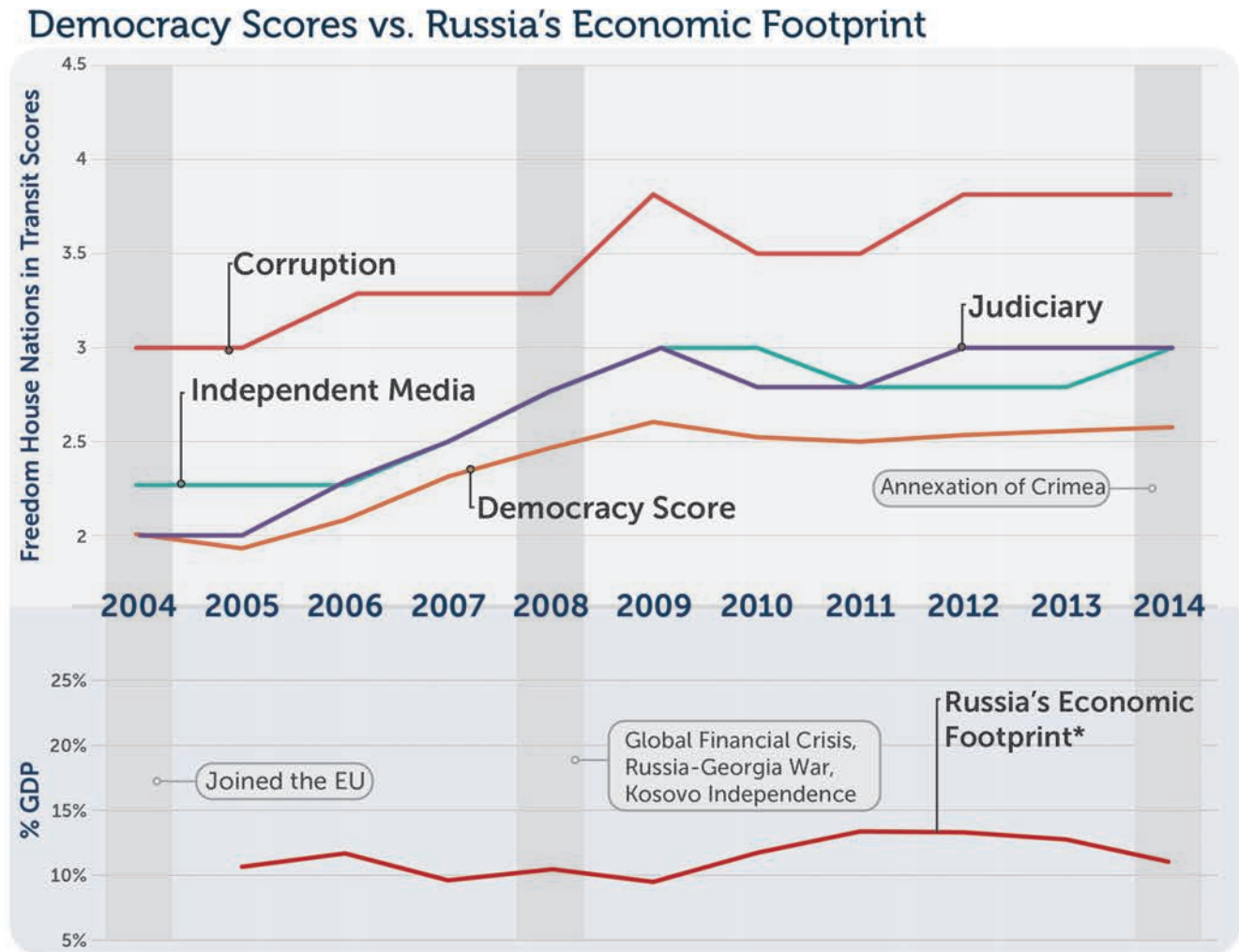
45. Agnia Grigas, "The New Generation of Baltic Russian Speakers," EurActiv, November 28, 2014, <http://www.euractiv.com/section/europe-s-east/opinion/the-new-generation-of-baltic-russian-speakers/>.

46. Stoll, Duxbury, and Kaza, "In Latvia, Tensions Mount under Russia's Gaze."

negatively impacts its ethnic Russian community, which would give the Kremlin the pretext that these populations must be protected from persecution by the Latvian state? The likelihood of such a conflict remains low at present, but the political momentum that this concern generates could manipulate the political environment and mobilize the electorate, providing the Kremlin with a unique lever with which it can pressure Latvian officials.

# SLOVAKIA: POLITICAL CAPTURE IN ACTION

Figure A.4. Slovakia



Source: Freedom House, CSD Calculations

## Economic Data

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
FDI stock from Russia as share of GDP (%)	0.0	0.0	0.0	-0.1	-0.1	-0.3	-0.4	-0.4	-0.4	-0.4
Operating Revenue of Russian Controlled Companies as a share of Total Operating Revenue for the Economy (%)	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.3
Oil and Gas imports from Russia as a share of GDP (%)	9.4	9.8	7.2	7.5	7.2	9.1	11.5	10.8	10.7	8.4
Exports to Russia as a share of GDP (%)	1.0	1.2	1.7	2.8	2.2	2.9	3.0	3.7	3.5	2.8
*Russia's Economic Footprint	10.5	11.1	9.0	10.3	9.4	11.9	14.2	14.3	14.0	11.1

Source: CSD Calculations based on data from EUROSTAT, National Central Banks, and Corporate Registers and Databases.

Slovakia has seen a steady decline in its democratic governance rankings over the course of the past decade. While this erosion has been less pronounced than its regional peers (notably Hungary), Slovakia has experienced a weakening of its judicial independence, free speech and civil liberties, and national democratic governance. It has also notably continued to suffer from persistently high levels of corruption, both within the business community and at the highest levels of government. Like Hungary, much of this democratic erosion has coincided with the rule of a single party and leader—that of the Direction–Social Democracy (SMER) party under the guidance of Prime Minister Robert Fico. Slovakia has had great difficulty in dismantling communist-era networks and shrugging off authoritarian and nationalistic-style leadership of Slovakia’s post-communist leader, Vladimir Meciar. Although significant reform progress was made between 1998 and 2006 under the leadership of Mikulas Dzurinda and the center-right Slovak Democratic and Christian Union–Democratic Party (SDKU), many Slovaks did not enjoy the economic benefits, which exposed the less firmly planted roots of Slovakia’s liberal, democratic tradition. The premiership of Robert Fico, with its Meciar-like tendencies (particularly its admiration of Moscow), began to reverse Slovakia’s reform momentum with an increase in opaque and unfair policies and practices.

Has Slovakia’s flirtation with a more illiberal governance approach (accompanied by pro-Russian Slavism) been induced by Slovakia’s economic relationship with Russia? There are several factors at play related to the erosion of Slovakian democracy and its institutions, combined with a more conciliatory policy orientation vis-à-vis Moscow. Slovakia’s economic relationship with Russia is a factor. There are strong links to Russia in strategic sectors of the Slovak economy, foremost among them the energy sector (see Figure A.4). The country is almost entirely reliant on imports of natural gas supplies from Russia and serves as a major transit hub bringing Russian gas into Europe. Indeed, the Slovak national budget “relies to a significant extent on revenue from transit fees associated with Russian gas.”<sup>47</sup> The arms sector is also heavily reliant on Russian trade. Yet beyond these vulnerable sectors, Russia’s economic presence in Slovakia is relatively insignificant in terms of trade and FDI, pointing to other areas of influence.

On closer examination, it appears that prominent Slovak political figures and close associates of Prime Minister Fico may be linked to business interests with Russian connections. For example, Jaroslav Haščák, the head of the prominent company Penta Investments, is reported to have privately met with Fico himself, and “Penta magnates” contributed €40,000 in financing of Fico’s SMER party.<sup>48</sup> In 2009, Polish intelligence authorities accused Penta of being a fund linked to Russian secret services (although the firm vehemently denied the charges).<sup>49</sup> Thus, Russia may be able to use established interest groups and corrupt networks to reach senior government decisionmakers, which could equal the impact of higher levels of economic activity.

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47. U.S. House of Representatives, “Congressional Record—House: Putin’s Influence in Europe,” March 22, 2016, <https://www.congress.gov/crec/2016/03/22/CREC-2016-03-22-pt1-PgH1502-2.pdf>.

48. “The Multi-Million Euro Gorilla,” *Economist*, January 27, 2012, [http://www.economist.com/blogs/eastern\\_approaches/2012/01/scandal-slovakia](http://www.economist.com/blogs/eastern_approaches/2012/01/scandal-slovakia).

49. Penta Investments, “Penta Continues to Appeal to Minister Szczyglo,” press release, August 20, 2009, <http://www.pentainvestments.com/en/press-release/penta-continues-to-appeal-to-minister-szczyglo-6IJ3gM.aspx>.

U.S. Embassy Bratislava diplomatic cables have suggested that Prime Minister Fico seeks to emulate Putin's highly centralized top-down authority structure. Prime Minister Fico attended a United Russia rally in Moscow the evening that Putin declared his return to the Kremlin as president in 2011. Prime Minister Fico also has actively sought to cooperate with, if not outright co-opt, the far-right, nationalist and conservative Slovak National Party (SNS) over the course of the past two decades. It is difficult to understand how these two very different ideological parties are able to cooperate. Since its inception in 1990, SNS has consistently maintained a pro-Russian and anti-NATO platform. SNS is believed to have received financial support from Russian entities.<sup>50</sup> Before her removal from SNS, former vice-chair Anna Belousovova (who previously served as the chair of the Slovak-Russian association for several years and is married to a prominent Russian businessman) has publicly called for deeper economic relations between Russia and Slovakia. SNS officials have sided repeatedly with Moscow; for example, Belousovova sided with Russia in response to Estonia's decision to relocate a Soviet-era statue in 2007, condemning it as "a sign of fascism, racism, and Nazism,"<sup>51</sup> and during the 2008 Georgian-Russian conflict accused Tbilisi of first action and committing genocide in South Ossetia.<sup>52</sup> Politics may make for very strange bedfellows, but it appears that nationalism, illiberal tendencies, and remaining in power are the common bonds between SNS and SMER.

Despite a series of high-profile corruption scandals involving SNS, Fico has relied on the far-right as a coalition partner in his first government between 2006 and 2010 and recently invited the group to once again join SMER in a ruling coalition after emerging with a plurality in the March 2016 elections (albeit in a greatly weakened position). It appears that Prime Minister Fico may have used SNS support to concentrate his power and influence while in office.

While SNS is the longest-standing pro-Russian political party in Slovakia, its fluctuating popularity since 2010 has led to a fracturing of the far-right, spawning new extreme, anti-Western groups. The Slovak ultranationalist group, L'SNS (The People's Party—Our Slovakia), is one such example. Although nascent, such movements could present possible future avenues for Russian influence as established political parties continue to lose popularity at the national level. L'SNS won 14 seats in the March 2016 elections—just one less than SNS—making it a force to watch. Party leader Marian Kotleba's rhetoric has alarmed Western leaders for its neo-Nazism affinity and anti-Western orientation. Although possessing no known links to the Kremlin, Kotleba has referred to Slovakia's EU accession as the day Slovakia lost its independence, and has condemned NATO as a "terrorist organization."<sup>53</sup>

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50. Peter Kreko et al., *Marching towards Eurasia: The Kremlin Connections of the Slovak Far-Right* (Budapest: Political Capital, January 2015).

51. "Slovak MP Says Estonian Actions Smack of 'Fascism,'" Sputnik International, May 3, 2007, <http://sputniknews.com/world/20070503/64859380.html>.

52. Luba Lesná, "Responses to Georgia and Russia Differ," *Slovak Spectator*, August 18, 2008, <http://spectator.sme.sk/c/20030172/responses-to-georgia-and-russia-differ.html>.

53. Rob Cameron, "Marian Kotleba and the Rise of Slovakia's Extreme Right," BBC, March 6, 2016, <http://www.bbc.com/news/world-europe-35739551>.

Slovakia's political environment remains unstable, fragmented, and vulnerable to exploitation, and as Europe's migration crisis exposes deep rifts between members of the European Union, there may be opportunities for the Kremlin to exacerbate nationalist, xenophobic sentiment. This, in turn, could destabilize the government and produce political paralysis. Thus far, Prime Minister Fico has upheld European solidarity and provided Ukraine with reverse gas flows following Russia's shut-off of its gas in 2014. Fico has not used his connections to the Kremlin to secure more economically attractive gas contracts for Slovakia from Russian firms after repeated attempts (unlike in Hungary). But Russia's future support for Slovakia's far-right political groups could further weaken Prime Minister Fico and his SMER party and could induce Fico to take even greater steps toward illiberalism in an effort to maintain power.<sup>54</sup> As is the case in Hungary, Fico may seek to align himself more closely with the Kremlin in the future to rebuff Western protests regarding his illiberalism. Bratislava has demonstrated its willingness to contradict Euro-Atlantic interests such as rhetorically condemning EU sanctions against Russia and not formally recognizing the independence of Kosovo.<sup>55</sup>

It appears that the Kremlin's main instruments of political influence in Slovakia stem from opportunism to exploit existing authoritarian and nationalistic tendencies and weak institutional structures through its connections to powerful individuals and networks of corruption, while enjoying the support of sympathetic political parties. While there is little evidence to suggest that the Kremlin has directly created these channels through covert operations over the past decade, these connections nonetheless pose a significant vulnerability to Slovak democratic institutions and society and thus prepare the groundwork for the Kremlin to further destabilize the political environment and challenge European and transatlantic unity in the future.

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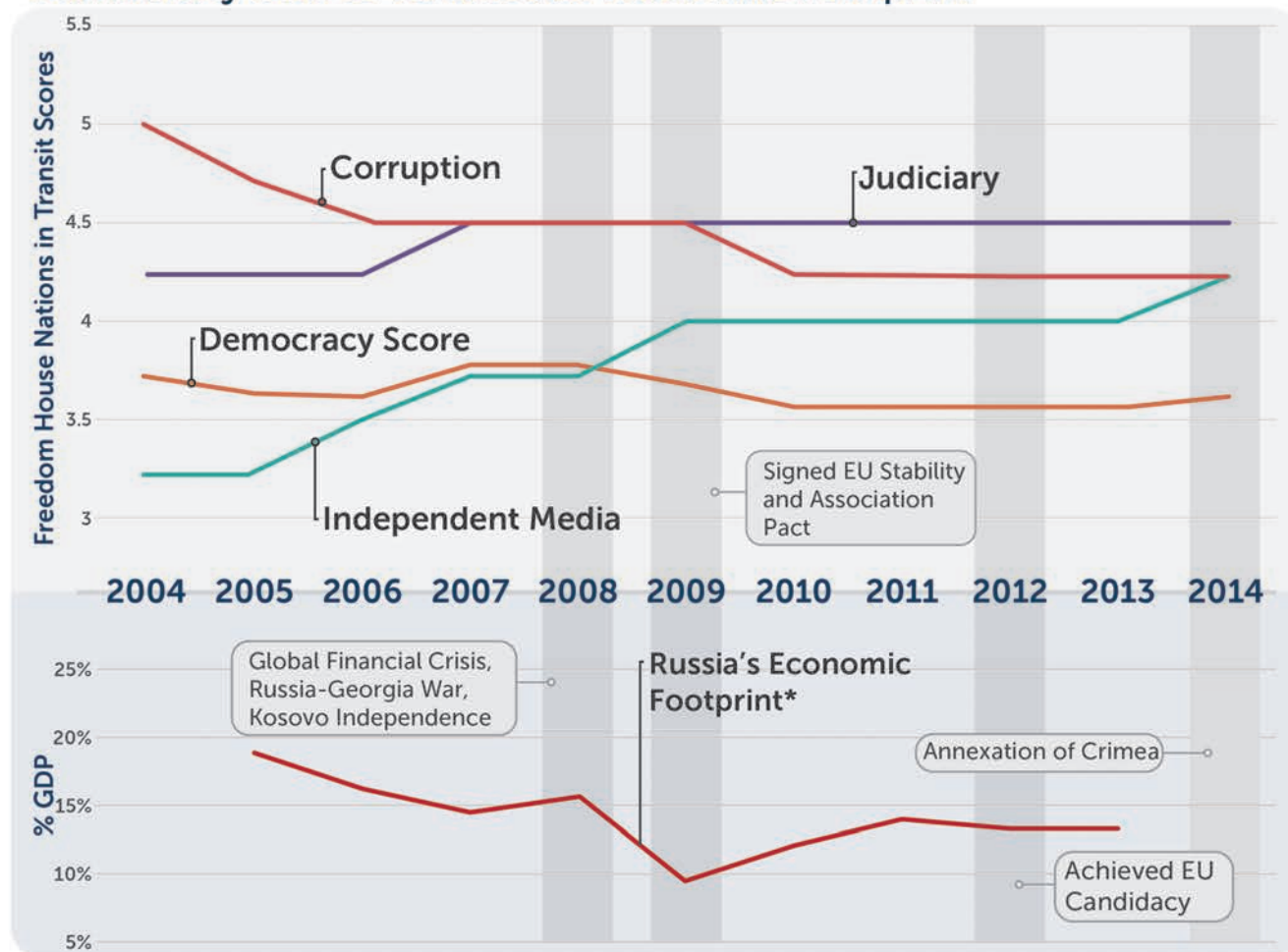
54. Henry Foy, "Robert Fico Secures Deal to Form Slovakia Government," *Financial Times*, March 16, 2016, <https://next.ft.com/content/296e472a-eb97-11e5-9fca-fb0f946fd1f0>.

55. "Fico: Slovakia Will Not Recognize Kosovo," *InSerbia*, April 3, 2015, <http://inserbia.info/today/2015/04/fico-slovakia-will-not-recognize-kosovo/>.

# SERBIA: PREVIEW OF COMING ATTRACTIONS

Figure A.5. Serbia

## Democracy Scores vs. Russia's Economic Footprint



Source: Freedom House, CSD Calculations

## Economic Data

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
FDI stock from Russia as share of GDP (%)	0.3	0.3	0.3	0.3	0.3	2.6	2.3	2.6	2.5	2.8
Operating Revenue of Russian Controlled Companies as a share of Total Operating Revenue for the Economy (%)	11.6	9.2	8.3	8.2	4.3	5.2	5.8	5.4	6.1	N/A
Oil and Gas imports from Russia as a share of GDP (%)	5.4	5.7	4.9	5.6	3.6	4.3	4.4	3.7	2.8	4.1
Exports to Russia as a share of GDP (%)	1.0	1.2	1.4	1.5	1.0	1.7	2.2	2.5	2.9	2.9
*Russia's Economic Footprint	18.4	16.3	14.9	15.6	9.3	13.7	14.7	14.2	14.2	N/A

Source: CSD Calculations based on data from EUROSTAT, National Central Banks, and Corporate Registers and Databases.

Shaped and bound by their shared Slavic, Orthodox Christian, and linguistic heritage for centuries, Serbia and Russia have maintained a strong partnership, with Russia serving as the traditional sponsor and protector of its Slavic Balkan cousins. In the 1800s, Russia's support of pan-Slavism and Serbian nationalism encouraged and enabled the Serbs to break free from Ottoman rule and gain independence. In 1914, Russia came to Serbia's aid after Austria-Hungary declared war against it in response to the assassination of Archduke Franz Ferdinand by a Serbian nationalist—the very trigger that ignited the “Balkan powder keg” and the First World War. Although Yugoslav leader Josip Broz Tito distanced himself from Soviet patronage, following the breakup of Yugoslavia, Russia again assumed its historic role as champion of the Serbian cause, providing Serbia with a powerful voice at the United Nations Security Council by blocking UN resolutions in response to its wartime offenses, condemning U.S. and NATO-led military interventions against Serbia, and attempting to prevent the breakaway and eventual independence of Kosovo. The Kremlin has continued to deepen and enhance its bilateral ties with Serbia even as Serbia has sought to become a member of the European Union.

One clear manifestation of these deep ties is Russia's economic relationship with Serbia. Over the past two decades Russia has heavily invested in strategic sectors of the Serbian economy and Russia is Serbia's single most important supplier of natural resources—80 percent of Serbia's natural gas demands are met by Russia.<sup>56</sup> As a result, Serbia pays one of the highest gas import prices in Europe. In 2008 Russia and Serbia concluded an intergovernmental agreement on energy cooperation that envisioned Russian firms funding large-scale infrastructure and utilities projects, including the acquisition of the largest local oil and gas company, Naftna Industrija Srbije (NIS), by Russia's state-owned Gazprom Neft.<sup>57</sup> The latter finalized its acquisition of a 51 percent stake in the company in 2009.<sup>58</sup> Through NIS, Gazprom gained access to other enterprises in the Serbian economy, including its 12.7 percent stake of the state-owned chemical company, HIP-Petrohemija.

Russia's Lukoil also has acquired a dominant position in Serbia's oil industry through its \$134 million acquisition of the largest distributor, Beopetrol, and its network of 180 filling stations. Russia is also invested heavily in large-scale infrastructure projects in Serbia; for example, by committing \$800 million for enhancements to its railway system.<sup>59</sup> In the financial sector, Russia's largest state-owned banks Sberbank and VTB have become prominent players. Since 2003, Sberbank has opened 33 branches and acquired almost €1 billion in assets. VTB only entered the market in 2012, and despite being a small player on the market, it brokered Serbia's sale of \$750

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56. Bernd Rajal and Aleksandra Petrovic, “Serbia,” in *Oil & Gas Regulation 2016* (London: International Cooperative Legal Guides, 2016), <http://www.iclg.co.uk/practice-areas/oil-and-gas-regulation/oil-and-gas-regulation-2016>.

57. Neil MacDonald, “Serbia Backs Russia Gas Deal,” *Financial Times*, January 22, 2008, <https://www.ft.com/content/c845c9d4-c942-11dc-9807-000077b07658>.

58. Gazprom Neft, “Gazprom Neft Completes the Acquisition of 51% of NIS Shares,” February 3, 2009, <http://www.gazprom-neft.com/press-center/news/2739/>.

59. Andrew Byrne, “Serbia Caught between Russia and the West,” *Financial Times*, December 3, 2014, <http://www.ft.com/cms/s/0/b44d6260-7ac6-11e4-b630-00144feabdc0.html#slide0>.



million in Eurobonds that same year.<sup>60</sup> The former prime minister and head of the Socialist Party of Serbia, Ivica Dacic, also considered creating a joint investment fund with VTB for the acquisition of assets in Serbia and facilitating Serbian exports into Russia.<sup>61</sup> While this investment has been positive for Serbian growth, the mutuality of the benefits it provides is ambiguous. For example, according to its privatization agreement Lukoil pledged to invest an additional €93 million into the Beopetrol's infrastructure after making the acquisition; however, Serbia's Anti-Corruption Council<sup>62</sup> reported that instead Lukoil used Beopetrol's funds to "give itself a €105 million loan," which is around 90 percent of what it had just paid to purchase the state-owned company.<sup>63</sup>

Russia may have relied on a network of local affiliates to exploit its economic relationship with Serbia. For instance, the director of Serbia's gas company Srbijagas, Dusan Bajatovic, is also the deputy chairman and an MP for the Socialist Party of Serbia and one of the country's leading pro-Russian voices. It is interesting that in recent years Srbijagas has become heavily indebted to the tune of €1 billion—a vulnerability that Russia may have used to exert pressure on Belgrade, particularly since the onset of the Ukraine crisis. Shortly after the official state visit of President Putin to Belgrade in 2014, Gazprom cut the gas deliveries to Serbia by 30 percent, citing outstanding debt by Srbijagas to the Russian major as justification.<sup>64</sup> The Panama Papers also highlighted the connections between several prominent Serbian businessmen and Russian entities and individuals. Most notably, the leak revealed Milan Popovic "formed a partnership" with Konstantin Malofeev, a member of Vladimir Putin's inner circle.<sup>65</sup>

As Russia tightens its economic grasp over Serbia, Belgrade has attempted to deepen its economic engagement with the European Union. In 2008, Serbia signed a Stabilization and Association Agreement (SAA) with the European Union and has since become an EU candidate country. A newly reelected Serbian Prime Minister Aleksandar Vucic, who campaigned on a pro-EU and anticorruption platform, promised that his country would aim to accede to the union no later than 2020. Serbia's EU membership is growing in popularity, with a recent poll suggesting that 48 percent support Serbia's EU aspirations (while the population is very skeptical of potential NATO

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60. Djordje Daskalovic, "VTB Capital Steps into CEE Eurobond Market as Lead-Manager of Serbia's Issue," SeeNews, November 26, 2012, <https://seenews.com/news/vtb-capital-steps-into-cee-eurobond-market-as-lead-manager-of-serbias-issue-318366>.

61. Government of the Russian Federation, "Talks between Dmitry Medvedev and Serbian Prime Minister and Minister of Internal Affairs Ivica Dačić," transcript, April 10, 2013, <http://archive.government.ru/eng/stens/23855/>.

62. Anticorruption Council, "The Privatisation of Beopetrol," Government of Serbia, September 30, 2013, <http://www.antikorupcija-savet.gov.rs/sr-Cyrl-CS/izvestaji/cid1028-2379/izvestaj-o-privatizaciji-beopetrola-ad>. As of 2016, the Council still upholds its claims despite vehement objections from Lukoil. See, for example, Dusan Pavlovic, "Beopetro Literally Bought Itself," *Danas*, April 27, 2016, <http://www.antikorupcija-savet.gov.rs/sr-Cyrl-CS/radio-televizija-i-stampa/cid1037-3112/beopetrol-je-bukvalno-kupio-samog-sebe>.

63. Stefan Dojcinovic, Dragana Peco, and Atanas Tchobanov, "The Mayor's Hidden Property," Organized Crime and Corruption Reporting Project, October 19, 2015, <https://www.occrp.org/mayorsstory/The-Mayors-Hidden-Property/index.html>.

64. "Russia Reduces Gas Flow to Serbia over Unpaid Debt," Novinite, November 1, 2014, <http://www.novinite.com/articles/164467/Russia+Reduces+Gas+Flow+to+Serbia+over+Unpaid+Debt>.

65. Organized Crime and Corruption Reporting Project, "Serbia: Local Businessmen Show in Leaked Data," April 5, 2016, <https://www.occrp.org/en/panamapapers/serbian-businessmen-in-leaked-data/>.

membership).<sup>66</sup> However, Serbia's economy has stagnated as it transitions from a centralized to a market economy and lags behind other Western Balkan economies; Serbia's 2015 per capita GDP is significantly lower than Croatia's and Slovenia's (\$5,143 compared to \$11,536 and \$20,714, respectively).<sup>67</sup>

It is important to note that to many Serbs, pro-European sentiment is not incompatible with pro-Russian sentiment. Serbian public opinion appears to be closer to that of Bulgaria, where it is preferred that closer relations with Russia can occur from within the European Union. But, from a geopolitical standpoint (without the physical border with Russia), Serbia seems to be in a similar situation to Ukraine, where the former government desired strong ties with both East and West without sacrificing the relationship with the other. Does Serbia pit its traditional defender against the liberal West? How will Serbia now balance the requirements placed on it by the European Union with its long-standing support of Russia?

Thus far, the direction of Serbian foreign policy has favored Russia. Serbia has refused to participate in the EU sanctions regime against Russia after its annexation of Crimea and military incursions into Eastern Ukraine, despite the request that EU candidate countries follow EU policies.<sup>68</sup> Serbia has also enhanced security cooperation with Russia, has been linked with the purchase of a Russian-made S-300 air defense system,<sup>69</sup> has conducted bilateral military exercises with Russia, and has obtained observer status in the Russian-led Collective Security Treaty Organization (CSTO) in 2015.<sup>70</sup>

Russia has sought to keep its closest European partner within its geopolitical orbit, which culminated in Russian President Putin's official state visit to Belgrade in October 2014. But Russia continues to underscore its fidelity toward Serbia by its ongoing backing of Serbia's international claims following the breakup of Yugoslavia. In 2015, Russia vetoed a UN resolution condemning the massacre of Bosnian Muslim men and boys by Serbian forces in the city of Srebrenica as genocide. Russia has also demanded that Kosovo, a primarily ethnic-Albanian region that in 2008 declared its independence from Serbia and was supported by the United States and a majority of European countries, remain part of Serbia's territory and refuses to recognize its independence. The European Union, however, has made the normalization of relations with Kosovo a mandatory condition for Serbia's eventual accession to the bloc. While there has been positive steps to advance

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66. "48% of Serbian Citizens in Favor of Joining the EU," *European Western Balkans*, February 1, 2016, <https://europeanwesternbalkans.com/2016/02/01/48-of-serbian-citizens-in-favor-of-joining-the-eu/>.

67. World Bank, "GDP per Capita: Slovenia, Croatia, and Serbia," [http://data.worldbank.org/indicator/NY.GDP.PCAP.CD?contextual=default&end=2015&locations=RS-HR-SI&name\\_desc=false&start=2015&view=bar&year=2013](http://data.worldbank.org/indicator/NY.GDP.PCAP.CD?contextual=default&end=2015&locations=RS-HR-SI&name_desc=false&start=2015&view=bar&year=2013).

68. "Serbian Envoy Rejects NATO or Endorsing EU Sanctions against Russia," Radio Free Europe/Radio Liberty, February 13, 2016, <http://www.rferl.org/content/serbia-wont-join-nato-endorse-eu-sanctions-against-russia-moscow-ambassador-says/27549850.html>.

69. Jaroslaw Adamowski, "Serbia Names New Defense Minister, Eyes Missile Defense Deal with Russia," *Defense News*, March 4, 2016, <http://www.defensenews.com/story/defense/international/europe/2016/03/04/serbia-defense-minister-missile-deal-russia/81323174/>.

70. "Парламентские делегации Республики Сербия и Исламской Республики Афганистан получили статус наблюдателей при Парламентской Ассамблее ОДКБ," Организация Договора о коллективной безопасности, December 4, 2013, [http://www.odkb-csto.org/news/detail.php?ELEMENT\\_ID=1776](http://www.odkb-csto.org/news/detail.php?ELEMENT_ID=1776).

Serbian-Kosovar dialogue and recognition, the issue remains politically volatile in Serbia, and Russia has effectively used it to enhance public support for Russia's policies and to support irredentist Serbian politicians who are Euroskeptic and hope to delay Serbia's EU accession. Kosovo is also effectively used by Russia to highlight the hypocrisy of the West's commitment to preserving states' territorial integrity in some cases while supporting the principle of self-determination in others. This has served to both discredit the West as well as justify Russia's own foreign policy actions in Georgia and Ukraine, with Russia citing Kosovo as a precedent.

It is not surprising that Serbia's nationalist parties are in sync with Russian policies. Russian Duma members have called Serbian nationalists accused of war crimes as "Serb martyrs." The ultranationalist far-right Serbian Radical Party (SRS) is the most vocally pro-Russian proponent in the Serbian political spectrum. SRS maintains close ties to Russian political parties from across the spectrum, and although it denied receiving funding from the Kremlin in 2011, its deputy chairman noted, "We get political support from Russia; we need no other kind of support."<sup>71</sup> This support had not translated into popular support in Serbia until recently when the SRS, which was shut out of the National Parliament in the 2014 elections, returned to the political scene in April 2016, winning 22 seats and showing a marked resurgence in public support. Many pro-European Serbian political parties are also sympathetic toward Moscow, however. The Socialist Party of Serbia—which commands just 29 out of 250 seats but is Serbia's second largest political party—and its leader, current Foreign Minister Ivica Dacic, have repeatedly defended Serbia's close relationship and has credited Russia with bolstering Serbia's international position vis-à-vis Kosovo, noting that "if it were not for Russia, Serbia would be in a much more difficult situation."<sup>72</sup>

The Serbian Progressive Party, which is currently the largest party in the parliament with 96 out of 250 seats, has a more balanced policy approach between Russia and the European Union and for the past several years has become the Serbia's leading proponent of EU membership. But the Progressive Party maintains active ties with President Putin's United Russia. Serbian President Tomislav Nikolic has stated that Serbia is a "declared friend of Russia in the Balkans."<sup>73</sup> In 2013, Nikolic signed a Strategic Partnership Agreement between Russia and Serbia that committed to "promote large-scale collaboration in all key areas."<sup>74</sup> Prime Minister Aleksandar Vucic has visited Moscow following his party's electoral victories (including the most recent one in 2016)<sup>75</sup> and Moscow called for Vucic to "include people who are determined to maintain and strengthen

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71. "Re: US/RUSSIA/BELARUS/SERBIA—Serbian Parties, Far Right Groups Deny Receiving Funds from Russia," WikiLeaks, March 11, 2013, [https://wikileaks.org/gifiles/docs/72/723539\\_us-russia-belarus-serbia-serbian-parties-far-right-groups.html](https://wikileaks.org/gifiles/docs/72/723539_us-russia-belarus-serbia-serbian-parties-far-right-groups.html).

72. Ministry of Foreign Affairs of the Republic of Serbia, "Ministers Dacic and Lavrov Discuss Bilateral Relations, Political Situation and Migrant Crisis," April 1, 2016, <http://www.mfa.gov.rs/en/press-service/statements/15304-ministers-dacic-and-lavrov-discuss-bilateral-relations-political-situation-and-migrant-crisis>.

73. Marija Ristic, "EU, Russia Pressure Serbia over Ukraine Crisis," *Balkan Insight*, May 6, 2014, <http://www.balkaninsight.com/en/article/eu-russia-pressure-serbia-over-ukraine-crisis>.

74. President of Russia, "Interview to Politika Newspaper," October 15, 2014, <http://en.kremlin.ru/events/president/news/46806>.

75. Gordana Knezevic, "Moscow's Long Arm in Belgrade," Radio Free Europe/Radio Liberty, June 1, 2016, <http://www.rferl.org/content/moscow-long-arm-belgrade/27772003.html>.

further relations between Serbia and Russia” in his future cabinet.<sup>76</sup> It was recently announced that the Socialists would return again as a coalition partner, with Dacic as foreign minister.

Prime Minister Vucic has taken tangible steps to advance Serbia’s integration with the European Union, including enhanced cooperation with Kosovo. Yet Serbia’s democratic performance has failed to improve during his premiership, despite his strong rhetorical commitment to accelerate Serbia’s EU aspirations. Serbia’s score for media independence declined after Vucic’s assumed the premiership, related to the government’s efforts to restrict and control the country’s already opaque media sector. In fact, since 2008 Serbia has failed to significantly improve its governance standards at all. Judicial independence slightly improved in 2007 but has plateaued since (see Figure A.5). Media independence has steadily declined, and anticorruption measures have barely improved over the past decade. Despite its political rhetoric about its desire to be a future member of the European Union, Serbia’s democratic governance performance does not match this rhetoric.

If there is stated political will at the most senior levels of the Serbian government to reform, why isn’t more progress being made on its reform agenda? Much of Europe’s attractiveness emanates from the appeal of its perceived economic and democratic success; if Serbia draws closer to the European Union yet does not reform, EU credibility is weakened. Are there forces that wish to prevent reform, making Serbia ineligible for future EU membership? Is this an attempt to demonstrate that “joining the EU does not bring any desired outcomes” such as enhanced governance and representation?<sup>77</sup>

Making the European Union and the West an unattractive alternative seems to be a key thematic approach the Kremlin has exploited through its extensive media presence, official rhetoric, and through the Eastern Orthodox Church. By highlighting the West’s economic and political dysfunction while simultaneously highlighting a better and more historically authentic and traditional approach that is fully compatible with Serbia’s (and indeed, the broader region’s) interests, culture, and values, Russia erodes the credibility of Western institutions and norms and offers itself as a solution. For example, Russian Orthodox Patriarch Kirill has accused the West of launching a mass propaganda campaign that “intentionally twisted information about the [Slobodan] Milosevic regime’s atrocities against Kosovar Albanians”<sup>78</sup> during the NATO bombing campaign, further stating that Kosovo Serbs are the victims of the “unacceptable injustice, double standards and lies of the policy that declares commitment to ideals of humanism, protection of human rights.” During an April 2016 meeting with Serbian Foreign Minister Dacic, Russian Foreign Minister Sergey Lavrov, commenting on Europe’s migration crisis, said, “We know that Serbia is under pressure . . . we will provide assistance . . . to help it overcome the problem,” alluding to Europe’s mismanagement of the crisis and Russia’s willingness and ability to help when Brussels has clearly

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76. “Serbia under Pressure from Russia over Its EU Goals,” AP News, May 26, 2016, <http://bigstory.ap.org/article/0e586a4ba43c4e0caafd2a68e4b67acf/serbia-under-pressure-russia-over-its-eu-goals>.

77. Jelena Milic, “The Russification of Serbia,” in *Mapping of Russian Influence in Serbia during 2013 and 2014* (Belgrade: Center for Euro-Atlantic Studies, 2014), <https://www.ceas-serbia.org/Mapping-Russian-influence-in-Serbia.pdf>.

78. Vecernje Novosti, “K. Serbs Victims of Geopolitical Game—Russian Patriarch,” B92, January 29, 2012, [http://www.b92.net/eng/news/politics.php?yyyy=2012&mm=01&dd=29&nav\\_id=78525](http://www.b92.net/eng/news/politics.php?yyyy=2012&mm=01&dd=29&nav_id=78525).

failed to do so.<sup>79</sup> The most recent polls available show that sowing the seeds of doubt about the West has had an affect: Only 30 percent of Serbs believe that EU membership would be “a good thing” for their country,<sup>80</sup> while 94 percent believe that “Serbia’s interests are best served by maintaining strong relations with Russia.”<sup>81</sup>

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79. Ministry of Foreign Affairs of the Republic of Serbia, “Ministers Dacic and Lavrov Discuss Bilateral Relations, Political Situation and Migrant Crisis.”

80. “48% of Serbian Citizens in Favor of Joining the EU.”

81. Center for Insights in Survey Research, “Survey of Serbian Public Opinion,” December 3, 2015, [http://www.iri.org/sites/default/files/wysiwyg/serbia\\_november\\_2015\\_poll\\_public\\_release.pdf](http://www.iri.org/sites/default/files/wysiwyg/serbia_november_2015_poll_public_release.pdf).

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