BUSINESS – STATE RELATIONS IN RUSSIA [1]

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> "The economic system of Russia has undergone such rapid changes that it is impossible to obtain a precise and accurate account of it.... Almost everything one can say about the country is true and false at the same time."
> John Maynard Keynes, 1925

The Russian economy has gone through a wrenching decade, with unpredictable developments that brought risk and opportunity in equal measure. Political crises (the struggle for power between Yeltsin and the parliament in 1993, Yeltsin's bid for re-election in 1996, and the search for a successor in 1999) were interspersed with economic crises (privatization scandals, bank crises, and the August 1998 financial crash). Since 1998, the crises seem to have receded, and GDP has been growing at around 7% a year. But fear of a return of the earlier chaos still shapes the mind-set of many political and economic actors, to which has been added a new fear – of growing state authoritarianism.

Two positive trends nevertheless emerged during the 1990s. First, Russia became a market economy, albeit one with "Russian characteristics." Seventy percent of economic activity takes place in legally independent private corporations, and a similar proportion of economic transactions take place through market-clearing prices. The centralized, command economy was smashed, although elements of such a model persist at local level in some regions (such as Tatarstan or Kalmykiya).

Second, Russia has become much more integrated into global economy than was the Soviet Union. Trade went from 17% of GDP in 1990 to 48% in 2004.[2] And most of this trade is with Europe, not with the former Soviet states. Now the Commonwealth of Independent States only accounts for 15% of Russia's export and 23% of it imports.

This external opening has been the most dynamic and successful aspect of Russia's market transition. But Russia's charge into the global market was led by the energy sector. Clearly, Russia's comparative economic advantage lies in energy, and energy-intensive industries such as metals and chemicals. Energy accounts for 60% of her export earnings. Whether energy accounts for 9% of the entire Russian economy, as Goskomstat reports, or 25%, as the World Bank calculates, it has been driving the post-1998 economic recovery.

But the energy sector faces several important challenges which, if not resolved, will severely hamper Russia's future economic development. A major factor hindering the implementation of

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[2] World Bank, *From Transition to Development*, (April 2004), www.worldbank.org.ru. The 48% share in part reflects the under-valued exchange rate. The World Bank's purchasing power estimate for 2002 boosted Russian GNI from $306 billion to $1,165 billion. This would accordingly reduce the share of trade in GDP.

an effective energy strategy has been Russia's turbulent political economy this past decade, with a struggle for supremacy between new private businesses (the "oligarchs") and the Russian state.

This article begins by reviewing the political evolution of business-state relations over the past decade, before turning to specific aspects of business-state relations. It then discusses some of the main challenges facing Russian economic development.

THE EVOLUTION OF STATE-BUSINESS TIES IN THE 1990s

After 1991 Russia very rapidly gave birth to several dozen successful and internationally prominent business corporations. In 15 years Russia went from a society where entrepreneurship was a crime, to one which had produced 36 individual billionaires, the third highest number in the world.[3] In a World Bank study of industrial concentration, the country's 23 largest firms were estimated to account for 30% of Russia's gross domestic product, and these firms were effectively controlled by a mere 37 individuals.[4] By international standards, this is an astonishing concentration of wealth and industrial power in such a large country, all the more surprising given that this entire economic elite did not exist 15 years ago.

Yet in July 2003 prosecutors started arresting top executives of Russia's largest oil company, Yukos, on various fraud charges. And on 25 October 2003 the richest man in Russia, Yukos head Mikhail Khodorkovsky, was himself jailed on vague charges of tax evasion, and he stayed in prison for the duration of his trial, which began in June 2004.[5] One could not ask for a more vivid illustration of the limits of business independence in Russia. The fact that business evolved into a narrow oligarchy made it relatively easy for the state to recapture the commanding heights of the economy under Vladimir Putin. But even as late as 2003, mnost observers assumed that the system of oligarchic capitalism had stabilized: few foresaw Putin's crackdown.

The first phase (1992-94)

The first period of chaotic liberalization and voucher privatization saw the rapid emergence of a multitude of independent economic actors – from street traders, now allowed to buy and sell in public markets, up to factory directors, now free to "privatize" their still state-owned factory cash flows by routing sales through intermediary firms. This process saw a leakage of power from state to non-state actors, and from the federal center to the regions. Individual regional leaders signed bilateral "treaties"with President Boris Yeltsin on the division of reponsibilities with the federal center, beginning with Tatarstan in 1994. (By 1996 46 of Rusia's 89 regions had signed such treaties.) The period also saw the breakdown of respect for the law and a surge of crime and corruption.

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[3] "Rising tide," *Forbes*, 15 March 2004. Some of the people on the list complained that *Forbes* exaggerated their wealth, although Boris Berezovsky said he was richer than *Forbes* reported. (*Vedomosti*, 13 May 2004) Forbes listed 25 billionaires in February, then increased the number to 36 in May, reflecting new estimates of their stock holdings. They counted zero Russian billionaires in 2000, and 17 in 2003.
[4] World Bank, *From Transition to Development*. (draft) April 2004, www.worldbank.org.ru. See also the explanation of the report by the lead author Christof Ruehl, World Bank press conference, Federal News Service, 7 April 2004. The study was conducted in 2003 and was looking at company structure as of 2001.
[5] Natalya Byanova and Andrei Litvinov, "Russian pogrom against the oligarchs," *Gazeta*, 24 December 2003.

While market forces penetrated large sections of economic activity, the Russian economy as a whole was only partially marketized by the Yeltsin reforms. In the face of runway inflation, a cash squeeze, and the breakdown of bank credits, a parallel economy sprang up, where factories traded goods with each other through physical barter or using pseudo-currencies such as bills of exchange. This parallel economy accounted for perhaps half of all business-to-business transactions.[6]

Alarmingly, businesses started using criminal groups and not the courts to enforce contracts and secure their property rights.[7] This criminalization of Russian business was a highly volatile process that opened the door to a later counter-offensive by state security organs.[8] The lack of a firm legal basis for their rapidly-acquired wealth made the new business elite vulnerable to attack by the state, the guardian of legality (especially in the Russian historical context). The rapidity and rapaciousness of their enrichment meant that they lacked a strong social basis of support, such that when the state came knocking on their door it would be with public approval, not approbation.

The second phase (1995-98)

The first phase of "wild privatization" was followed by a period of gradual consolidation. More powerful competitors pushed out their weaker rivals, and economic power was concentrated in the hands of a small number of individuals. These figures headed business corporations, but had close connections to the political leadership at national or regional level. Russia had dismantled an autocracy, but instead of rule by the many (democracy) it had arrived at rule by the few (oligarchy).

Most of these oligarchs headed private corporations formed on the basis of former state enterprises, such as regional oil companies, banks or metallurgical plants. They typically made their first million through commodity trading, importing scarce goods or financial brokering, and then grew by acquiring state assets as they were privatized.[9]

A pivotal event in the transition to oligarchy were the loans for shares auctions in 1995-96, when key firms such as Norilsk Nickel and the Sibneft oil company were sold off at bargain prices to politically-favored businessmen. In return these oligarchs helped Boris Yeltsin win re-election in June 1996 by putting their financial and organizational resources at the president's disposal. Above all, it was the mobilization of their press and TV empires which pulled Yeltsin through to victory.

The oligarchic consolidation in 1994-96 coincided with a degree of macroeconomic stabilization. Inflation came down from 1500% in 1992 to 25% in 1996 and 12% in 1997. GDP even recorded

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[6] Alena V. Ledeneva, *Russia's Economy of Favours: Blat, Networking and Informal Exchanges* (Cambridge University Press 1998); David Woodruff, *Money Unmade: Barter and the Fate of Russian Capitalism* (New York: Cornell University Press, 1999).
[7] Federico Varese, *The Russian Mafia* (New York: Oxford University Press, 2002).
[8] Yulia Latynina, "Who is the biggest loser?," *Moscow Times*, 29 October 2003.
[9] See Rose Brady, *Kapitalizm: Russia's Struggle to Free its Economy* (New Haven: Yale University Press, 1999); Chrystia Freeland, *Sale of the Century: Russia's Wild Ride from Communism to Capitalism* (New York: Crown Business, 2000); Paul Klebnikov, *Godfather of the Kremlin: Boris Berezovsky and the Looting of Russia* (New York: Harcourt, 2000); Matthew Brzezinski, *Casino Moscow: a Tale of Greed and Adventure on Capitalism's Wildest Frontier* (New York: Free Press, 2001).

slight growth of 0.7% in 1997, after seven years of decline. It was at this point that the term "oligarch" entered the Russian political lexicon.[10] In spring 1997 t was taken up by Boris Nemtsov, a deputy prime minister who was pushing for a new round of liberal reforms, along with fellow deputy premier Anatolii Chubais. Nemtsov and Chubais wanted to cut corruption and introduce more competition into the "crony capitalism" that had been forged between the newly-emerged oligarchs and the weakened state.

The 1997 reform drive failed in the face of energetic opposition from regional governors and business oligarchs, who mobilized their supporters in the State Duma. Moreover, the macroeconomic stabilization proved illusory. The government was borrowing heavily to cover its budget deficit, and the Asian financial crisis in 1997 caused a slump in world oil prices that eroded Russia's current account surplus. That led to a run on the ruble and the dramatic devaluation and debt default in August 1998.

The demise of oligarchic capitalism was due to deep contradictions in the model, and not merely contingent factors such as Yeltsin's incompetence or the August 1998 financial crash. Two contradictions stand out. First, the oligarchs were parasitic on the Russian state. They were draining it of assets and revenues, to the point where the soaring budget deficit and profiteering from high-interest treasury bonds helped trigger the 1998 crash. Second, the oligarchs were deeply divided among themselves. They did not trust eachother, fighting bitterly over the privatization of the telecom holding company Svyazinvest in summer of 1997, and over the Yeltsin succession in 1999.[11]

The third phase (2000-05)

The oligarchs did not have a mechanism for resolving disputes among themselves. The only "mechanism" they had was appeal to Boris Yeltsin. Given that Yeltsin was physically incapacitated for most of the time, this meant they competed for the favor of the Kremlin courtiers (the "Family") who controlled access to the president. Yeltsin's second and final term as president was due end in March 2000, and the oligarchic system did not have any procedure in place for picking a successor.

Yeltsin went through a series of prime ministers in 1998-99, searching for a reliable successor who could maintain the political system that he had created. In August 1999 he appointed Vladimir Putin as Prime Minister, and after a wave of apartment house bombings the next month Putin sent federal forces back into Chechnya.

The December 1999 State Duma elections were seen as a sort of presidential "primary": it was assumed that the leader of the winning party would be well placed for a run at the presidency. The oligarchs funded rival parties which fought a bitter and dirty media campaign. The Kremlin slapped together a pro-Putin Unity party which managed to win second place after the Communists. Yeltsin pre-empted the race for the presidential succession by resigning ahead of schedule on 31 December 1999, nominating Putin as acting president. Putin proceeded to sweep the March 2000 presidential election.

[10] The word "oligarch" was first used by Aleksandr Privalov of *Ekspert* magazine, who started a regular poll of elites, publishing rankings of who were seen as the most influential political and business figures. Olga Romanova, "Novosti," *Vedomosti*, 29 January 2002.
[11] Stephen Fortescue, "Pravit li Rossie oligarchiya?" *Polis*, vol. 5, no. 8, 2002.

Putin said that his intention was to continue market reform and not to revisit Yeltsin's privatization program. It looked as if Putin wanted to strengthen the power of the state but not break the pluralistic character of the system as a whole.[12] Adding to the sense of continuity was the fact that many key figures from Yeltsin's inner circle were kept on, such as chief of staff Aleksander Voloshin and Prime Minister Mikhail Kasyanov.

But Putin proved more independent than many observes had supposed, and he moved swiftly to distance the oligarchs from the center of political power. In the summer of 2000 Putin he won back control of the two national TV stations owned by Boris Berezovsky and Vladimir Gusinsky, driving them into exile.[13] Most of the other oligarchs assumed that so long as they kept away from mass media (television in particular) it would be business as usual.

Still, some of the oligarchs envied the power of the president. In spring 2003 Mikhail Khodorkovsky, the founder of the Yukos oil company and the richest man in Russia, started signalling his interest in a political career. Rumors began circulating that Khodorkovsky intended to run for the presidency in 2008 – if not in 2004. Yukos was active in buying the loyalty of Duma deputies, and did not hesitate to use its leverage to block legislation that it disliked, such as higher oil excise taxes and revisions to the law on production sharing. In the December 2003 State Duma election, Khodorkovsky poured money into parties across the political spectrum. Yukos-linked analysts were floating the idea of introducing a parliamentary system of government, in which the government would be answerable to the State Duma (presumably oligarch controlled) rather than to the president.[14]

On the economic front, Khodorkovsky tried to strengthen his position by adopting international accounting standards and adding Westerners to the Yukos board, with a view to offering a large stake in the company to a Western oil major.[15] This would enable him to cash out some of his share holdings, valued at their peak at $15 billion. To increase Yukos's attractiveness he tried to develop new export possibilities, outside the state-owned Transneft pipeline system. He pursued an agreement with China to finance a $3 billion pipeline to carry oil from Angarsk in Siberia to Daqing in China. He also mounted an aggressive international PR campaign, funding international charities, and getting himself appointed to worthy foundation boards, such as that of the International Crisis Group. He thought that these steps would make it too risky for Putin to take him down. But his strategy backfired. The more successful he was, the greater the threat he represented to the Kremlin. In the summer of 2003 Putin gave the green light for the arrest of Khodorovsky and half-a-dozen other Yukos executives, and the dismemberment of Yukos.

This set the scene for a sweeping victory for the pro-Putin United Russia in the December 2003 State Duma election. United Russia won 37.6% of the popular vote in the party-list race that fills half the 450-seat chamber, giving them 120 seats, plus another 126 seats in single-mandate races. After the election 60 independents who won in single-seat races joined United Russia, raising their numbers to 304 – above the two-third majority required to change the constitution. The Yukos affair also led to the departure of the remaining key members of Yeltsin's "Family" from the Kremlin. Chief of Staff Voloshin resigned in November 2003 shortly after Khodorkovsky's arrest, and Putin fired premier Kasyanov one month before the March 2004 presidential election.

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[12] Natalya Astrakhanova, "Natural clan selection," *Ekspert*, no. 46, December 2001.
[13] Christian Caryl, "Twilight of the oligarchs," *Newsweek International*, 5 February 2001.
[14] "Oligarkhi-zagovorshchiki," *Stolichnaya vechenyaya gazeta*, 29 May 2003; Sovet po natsional'noi strategii, "V Rossii gotovitsya oligarkhicheskii perevorot," www.utro.ru, 26 May 2003.
[15] Lyudmila Romanova, "O strategii Khodorkovskogo," *Mirovaya energeticheskaya politika*, 31 May 2003, pp 18-21.

The oligarchs underestimated Putin's power and his political acumen. Putin had the vast resources of the Russian state at hand, a cornucopia of sticks and carrots that soon won the loyalty of virtually all the regional bosses and business leaders. The security apparatus of the Soviet state, the renamed Federal Security Service, had shrunk in size, but was still intact and eager to expand its sphere of action once its former leader became president. Putin also enjoyed huge popular legitimacy, having been directly elected in March 2000, and again in March 2004, and maintaining approval ratings above 70% in the intervening period.

The new business corporations were very powerful political actors, with considerable economic resources and direct access to the political power elite. But the headlong speed of their rise meant their popular legitimacy was fragile and social base weak.[16] Both state and society are suspicious of business, a value orientation that has deep roots in Russian culture, pre-Soviet, Soviet and post-Soviet. Big business is associated with injustice. According to a 2003 ROMIR poll, 45% consider the influence of big business on the economy is negative and 25% positive. Their influence on politics is seen as negative by 49% and positive by 17%.[17] In a FOM poll of June 2003 71% agreed with the statement that you cannot earn a lot of money without breaking the law.

As of 2005, there were some signs of a shift in public attitudes. While the "oligarchs" are reviled, that term is understood as referring to a particular group of businessmen who acquired their wealth in illegal ways. Oligarchs aside, public attitudes towards the market economy and business in general are quite positive. In one late 2004 survey 65% of respondents below pension age expressed approval of the market economy, and only 15% disapproval. Among pensioners, the corresponding figures were 34% and 42%.[18] On the other hand if asked to choose between a stronger state and developing private enterprise, the state prevailed by 82% to 12%.

BUSINESS STRATEGIES

At the end of the Yeltsin era, Russia's evolution towards what is regarded in the West as a "normal" market economy was stalled in midstream.[19] Powerful leaders had a vested interest in preserving the status quo, and there was no significant coalition of groups with a stake in further reform. The economy had been sufficiently liberalized to enable the oligarchs to enrich themselves, but no so much as to expose them to effective competition (from foreign companies, for example). This situation was inefficient and morally indefensible, but it was not unclear whether it was politically and economically stable. Could it continue indefinitely, or would it require a fresh round of market reform? In the end, Russia moved in a third direction – the return of state control.

In retrospect, we can see that oligarchic capitalism was highly unstable, since the economic fate of the individual oligarchs was too closely tied to the course of state policy. Who would be given

[16] Sergei Peregudov, "Korporativnyi capital i instituty vlasti," *Polis*, no 5, 2002; Sergei Peregudov, *Korporatsiya, obshchestvo, gosudarstvo*, (Moscow: Nauka, 2003).
[17] N.I. Gorin et al, "Obshchestvo, biznes, vlast'," *Obshchestvo i ekonomika*, no. 12, December 2003, pp. 36-63. The only "positive" element in these polls is that respondents are just as suspicious of state officials as they are of businessmen.
[18] Alexander Kolesnichenko, "No aversion to private enterprise," *Novye Izvestiya*, 4 March 2005. Survey of 15,000 Nov-Dec 2004 by Romir and the Social Projects Institute.
[19] Joel Hellman, "Winners take all. The politics of partial reform in post-communist transitions," *World Politics*, no. 50 (January 1998), pp. 203-34.

the right to acquire the remaining assets of state industry as they were put up for privatization? For how long would the government retain control over the “natural monopolies” such as the railways, Gazprom, Unified Energy System, the oil pipeline operator Transneft, Gazprom, the telecom holding Rostelecom? How could the public be persuaded to bite the bullet and accept postponed but necessary reforms of the taxation system, cuts in social benefits and increases in utility prices?

Yeltsin’s political economy was built around horizontal bargaining between a plurality of actors, and it did not provide a clear and decisive answer to any of these questions. Putin replaced Yeltsin’s system with a centralized, authoritarian hierarchy, the “power vertical.” By 2004 it was clear that the Yeltsin regime had given way to a system of what we may as well call “state capitalism”. Aleksei Zudin argues that Putin set out from the very beginning with such a goal in mind: to fundamentally weaken the oligarchs and turn them into a subordinate group, an instrument of state rule.[20] Sergei Peregudov in contrast sees more of a balance, an “iron triangle” of a bureaucratic elite, the presidential apparatus and business corporations.[21] There is no doubt that the oligarchs had the ability to veto certain policy initiatives during Putin’s first term, thanks to their influence in the State Duma.[22] But the Yukos affair destroyed this balance. Whether a more plural system will be restored during Putin’s second term, or after the presidential election in 2008, is a very open question.

What, then, is the role of business in the state capitalist system which Putin has fashioned? Albert Hirschman famously analyzed the basic political options as exit, voice and loyalty.[23] The oligarchs certainly had an exit strategy: they could always cash out and live on the French Riviera, or buy a British soccer team. But pride, greed and patriotism prevented some of them from exercising that alternative. “Voice,” meaning organized political activity in defense of their interests, was gradually squeezed out of the range of options by Putin’s systematic restoration of the “power vertical” – beginning with the TV stations, continuing with the State Duma election and ending with the abolition of elected governors.

That leaves “loyalty” as the only available strategy. It is not only that oligarchs must now be personally loyal to the Kremlin and stay out of politics. They must conduct their business in more transparent way, following Russian laws and paying Russian taxes. They are also expected to play an active role in helping the Kremlin to realize its political, economic and social agenda.[24]

The Yukos affair dramatically revealed that the tax inspectors, the courts and the security services are all willing tools of the Kremlin. The introduction in 2000 of seven federal districts headed by presidential representatives restored the president’s ability to exert direct control of the power organs in all regions of Russia. In the absence of clear property rights that can be defended in independent court system, Russian business remains very vulnerable to state pressure.

Businesses had various strategies to insulate themselves from such uncertainties. They have actively pursued vertical integration, seeking to protect themselves by controlling the entire

[20] Aleksei Zudin, “Neokorporatizm v Rossii?,” *Pro et Contra*, vol. 6. no. 4, 2001.
[21] Peregudov 2002, *op. cit*.
[22] Roland Nash, chief strategist, Renaissance Capital, “Who needs politics anyway?,” Prime Tass 17 December 2003.
[23] Albert Hirschman, *Exit, Voice and Loyalty. Responses to Decline in Firms, Organizations and States* (Cambridge, MA: Harvard University Press, 1970).
[24] Interview with Economic Development and Trade Minister German Gref by Vera Sitnina, *Vremya novostei*, 22 December 2003.

production cycle (eg. metal companies buy ports to ensure the security of their exports). They tried rooting themselves into regional bastions, buying off regional administrations, if not running for governor themselves.[25] That door was slammed shut with Putin's surprise decision to abolish elections for regional leaders in September 2004, a step ostensibly taken in response to the Beslan school crisis. In future all governors and republic presidents will be nominated by Putin, subject to approval by regional legislatures.

Then there is the international dimension. The Russian political economy was not a closed system. It was very open to international influences and opportunities. Both Putin and his oligarch rivals sought international support as part of their strategy to acquire and consolidate power. This made the balance of forces between Putin and the oligarchs inherently unstable and unpredictable. Not all the relevant variables and actors were within the Russian Federation.

At first the internationalization of business took the form of entrepreneurial activity to take advantage of the vast gulf between Russia's domestic prices and global prices by importing manufactured goods and exporting resources. That was accompanied by exploitation of the international financial system to hide revenue from Russian tax authorities through the use of shell-companies, off-shore bank accounts and transfer pricing. Some of the most detailed information about the extent of these practices has been coming out in the Yukos trial.[26] Even state-controlled institutions such as the Central Bank and Gazprom were heavily engaged in these activities in the 1990s.

Some of them also considered an exit-and-return strategy: the West could offer both political legitimation and practical support. The latter strategy was exemplified by Berezovsky and subsequently Khodorkovsky. However, the internationalization strategy had its limits. International oppoproprium was not strong enough to deter Putin from arresting Khodorkovsky and dismantling Yukos. An appeal to a Houston court against the bankrupcty of Yukos by its holding company, Menatep, did cause some Western banks to pull back from financing the purchase of its subsidiary, Yuganskneftegaz, in December 2004. But the Kremlin brazenly pushed ahead with the auction, using a phoney subsidiary to transfer the assets to state-owned Rosneft, which was in the process of merging with Gazprom.

Lobbying opportunities

On one hand, post-Soviet Russia does have a large number of social, economic and political actors (companies, labor unions, social organizations, etc.) that exist outside the state apparatus – both in law and in reality. On the other hand, the rule of law is exceptionally weak, and the state is able to exert strong influence over the conduct of most social actors.

Putin has made some efforts to institutionalize business-state relations, but the context became one of control rather than dialog. He instituted regular face-to-face meetings between the president and leading business executives, about twice a year. On 28 July 2000 Putin met with 21 leading businessmen in the Kremlin, mostly from energy companies.[27] In contrast to previous

[25] Natalya Zubarevich, "Prishel, uvidel, pobedil? Krupnyi biznes i regional'naya vlast," *Pro et Contra*, vol. 7, no. 1, 2002.
[26] A Paris-based former Yukos associate, Elena Collongues-Popova, started revealing details of the myriad offshore companies through which Yukos had evaded taxes Jeanne Whalen, "A jilted banker's view of Khodorkovsky's empire," *Wall Street Journal*, 2 January 2004.
[27] Inessa Slavutinskaya, "Liberalissimo," *Profil*, 7 August 2000.

meetings between Yeltsin and business leaders, this time it seemed to be the president laying down terms to the oligarchs, rather than the other way around. Putin cautioned the oligarchs to stay out of politics and pledged to maintain an "equidistance" from them as president, not favoring one over the other.[28] Subsequent meetings were usually low-key affairs discussing issues like trade policy and customs reform, and even these modest gatherings ground to a halt in the wake of the Yukos affair. Business leaders were fearful that Putin would give in to pressure from the nationalists in the Duma and the security bloc (siloviki) in his own administration, and embark on wholesale renationalization of the industries privatized in the 1990s.

In November 2000 Putin selected the Russian Union of Industrialists and Entrepreneurs (RSPP) as the designated interlocutor with the business community. "Putin issued a 'royal command' for all Russian business leaders to unite in the RSPP and to submit all complaints via this body, collectively, after working out a common opinion."[29] The RSPP was a rather staid, decade-old organization representing traditional state-owned factories, but in 2001 it found itself taken over by the brash new oligarchs. The RSPP remains deeply split between neoliberals and neo-statists, which inhibited their ability to give clear advice to government development plans.[30]

The Kremlin decided to spread its bets, lest the RSPP become too independent minded. They encouraged the formation of alternative groups such as Delovaya Rossiya and the United Entrepreneurs' Organizations of Russia (OPORA), which was supposed to reach out to small and medium enterprises. In December 2001 former prime minister and Putin supporter Yevgenii Primakov was appointed head of the Chamber of Commerce and Industry (TPP).[31]

Most business lobbying under Putin, as under Yeltsin, takes the form of direct approaches to government officials by business groups, either individually or by industrial sector. They lobby for tax breaks, for protective tariffs, and for government contracts. Their efforts ebb and flow depending on national and international trading conditions. Thus for example the steel industry, dominated by the Big four companies (Novolipetsk, Severstal, Magnitka, and Evrrazholding) were lobbying for state protection in 2001, but by 2004 they were born-again free traders.[32]

The legislative branch attracted a lot of attention from businessmen in the late 1990s. In the elections of 1995 and especially in 1999, many businessmen spent hefty sums to try to win a seat in the Duma. Their motives were often more individual than political. A Duma deputy is immune from prosecution unless the body votes to strip him of this privilege. Also a Duma seat would bring contacts useful for spreading their business beyond their home region

Business-connected deputies were so influential in the Duma, and in the Federation Council, where they held more than half the seats, that they were effectively substituting themselves for the role conventionally played by political parties. Leading corporations like Yukos and Gazprom were also the most politically active, with Gazprom supporting an estimated 130 candidates in the 1999 elections.[33] In the 2003 election roughly 20 percent of the candidates were directly linked to business corporations, even including the Communist nominees (24% of whose candidates were

[28] Boris Vishnevsky et al, "Equidistance in different directions," *Obshchaya gazeta*, 7-13 June 2001.
[29] Aleksei Bogaturov , "The Kasyanov cabinet is finishing its game," *Rodnaya gazeta*, 27 June 2003; Aleksei Yefimov, "The oligarchs come crawling on their knees," *Nezavisimaya gazeta*, 23 October 2003.
[30] Peregudov, 2004.
[31] *Izvestiya*, 11 December 2001.
[32] Dmitrii Butrin, "Gosplan ekonomicheskogo rosta," Gazeta.ru 26 April 2004.
[33] Sergei Kolmakov, "The role of financial-industrial groups in Russian political parties," *Russia Watch*, no. 9, January 2003 JFK School, Harvard University.

thus identified).[34] These business friendly representatives served their paymasters well, blocking new legislation on everything from the closure of tax loopholes to new production sharing legislation that would allow in more foreign investors.

State corporations

It is important to remember that not all Russian industry is owned by private businessmen. Alongside the private oligarchs there are also state oligarchs, individuals who manage state-owned companies. As of 2004 the state still held a 100% stake in some 100 companies, including the oil company Rosneft, the oil pipeline monopoly Transneft, the aircraft maker Sukhoi and the Russian Railways Corporation. It holds shares in some 4,000 other companies, including a majority stake in the savings bank Sberbank (62%), Aeroflot (51%) the electricity giant Unified Energy Systems (51%), and the natural gas monopoly Gazprom (38%).[35]

This means that many Russian business corporations occupy a grey area – they are not fully independent of the state, but not fully part of it either. Decision-making is opaque and hidden from public view, brokered in face-to-face meetings between the leaders of state corporations and top government officials.

Putin moved to ensure that the leading state corporations were headed by people loyal to him. In May 2001 he ousted the long-standing head of Gazprom, Rem Vyakhirev, and replaced him with a young and trusted economist from Putin's home-town of St. Petersburg, Aleksei Miller. Gazprom's $15 billion exports make it Russia's largest cash earner. Later in 2001 Putin removed the head of Russian Railways, Nikolai Aksenov, who was dogged with accusations of corruption. He also removed Viktor Gerashchenko, head of the Central Bank, in March 2002 and replaced him with Sergei Ignatiev, who was serving as deputy finance minister. Russia's largest company, Unified Electricity System (UES), has been headed since 1998 by Anatolii Chubais, another Petersburger whom Putin apparently trusts, and who has been left in place to oversee its privatization.

Small businesses

The oligarchs controlled a large chunk of the Russian economy, but not all of it. At the other end of the scale, small businesses have been mostly shut out from the political battle of the giants – and from economic policy making. In 2004 there were 4.7 million sole proprietors and 952,000 small companies in Russia (defined as those with turnover less than 15 million rubles or $550,000, a year and less than 100 workers). Small businesses account for 12.7% of GDP, and only 18% of the labor force: less than half the proportion in other developed economies.[36]

President Vladimir Putin oversaw the introduction of new laws on inspection, licensing and registration in 2001-02, which eased the bureaucratic burden on small firms, according to a regular survey by the Center for Economic and Financial Research, most recently conducted in spring 2004.[37] However, there are reports that the Yukos affair is being taken as a green light by

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[34] Francesca Mereu, "Business will have big voice in Duma," *Moscow Times*, 13 November 2003.
[35] Natalya Alyakrinskaya and Dmitry Dokuchev, "State = board of directors," *Moscow Times*, 9 June 2004.
[36] I. Papernaya, "Nice Guy," *Profil*, 14 February 2005, p.68-72.
[37] "Monitoring of administrative barriers to small business development in Russia," 21 December 2004, www.cefir.org.

some regional regulators to badger local businessmen.[38] And Putin himself has floated proposals to strengthen the powers of the tax authorities, by giving them the right to confiscate property and to seize assets without waiting for a court judgment.

One clear example of the ineptness of government policy in this area is the Federal Fund for Support of Small Business, whose closure was announced on 4 March 2005. The FFPMP was created in 1995 with a 25 billion ruble ($1 billion) budget to invest in small business promotion. It set up a network of regional offices, and got additional funding such as a $150 million loan from Dresdner Bank in 1997. However, it was an ineffective bureaucracy that was unable to reach small businesses. An additional complication was that it was competing with a $300 million fund of small business lending set up by the European Bank for Reconstruction and Development. A 2003 survey by the Ministry of Economic Development and Trade found that only 5% of entrepreneurs had come across the fund. The Federal Anti-Monopoly Service fought to protect the agency, which was under its jurisdiction, but after a two-year struggle the FFPMP was shut down.[39]

MACROECONOMIC CHALLENGES

Russia's heavy dependence on energy has distorted the pattern of its market economy. The energy sector has certain distinctive characteristics that profoundly shape the political economy of any country in which it plays a dominant role.[40] The energy sector typically involves a high concentration of wealth generation in a small number of production sites. It inevitably involves a strong role for the state and a small number of key business actors who control the industry's assets. Thus the question is: what form has the "resource curse" taken in Russia, and how successful will the state be in mitigating its effects?[41]

The investment problem

The disruptions caused by the Soviet collapse also hit Russia's energy industries. Oil production collapsed from 600 million tons to 300 million tons per year 1990-95 (recovering to 459 million tons in 2004), and between 1985 and 1999 not a single kilometer of new oil pipeline was built. The sector was desperately in need of new investment – and new management. But through most of the 1990s the oil sector was riven by battles for ownership between incumbent managers and outside bankers.

Russia's existing hydrocarbon extraction and transportation infrastructure was laid down in the Brezhnev era, more than 20 years ago. Investment in replacing reserves and in developing new export capacity is hampered by uncertainty over who will own what and hence benefit from these assets. Russian oil firms invested a mere $7 billion in 2000-03, while gross receipts ran at $70

[38] *Kommersant*, 1 February 2005.
[39] Dmitrii Buttrin, "Dirizhiskskaya Panama," gazeta.ru, 5 March 2005..
[40] Terry Lynn Karl, *The Paradox of Plenty. Oil Booms and Petro-states* (Berkeley, CA: University of California Press, 1997).
[41] Younkyoo Kim, *The Resource Curse in a Post-Communist Regime. Russia in Comparative Perspective* (London: Ashgate, 2003).

billion in 2003 alone.[42] Such uncertainty is even hampering investment in oil refining, which would be an obvious way to improve the value-added component of its energy sector.

Long term, there is still considerable uncertainty over the cost-effectiveness of investments in Russian energy.[43] If oil stays above $40 a barrel for 10 years, exploiting the oil and gas basins of central Siberia may be technically feasible and cost-effective. It might even be profitable to build a 3,000 mile pipeline to export these resources to China and Japan. But there are many variables in the mix. At that price, oil shale and tar sands may become competitive rival sources; and by that time the Chinese economy might have collapsed. The Russian government seems to be in no hurry to tackle these challenges, being preoccupied with short-term stability and medium-term institutional reforms.

The Dutch disease

Many economists worry that Russia will fall prey to the "Dutch disease." The influx of oil and gas revenues is driving up the value of the ruble, making Russian manufacturing and farming internationally uncompetitive. This comes at a time when Russia is moving towards joining the World Trade Organization (WTO), which will further limit its ability to defend domestic producers with tariff and non-tariff barriers. High returns on investment in the energy sector will drive up the cost of capital, putting further pressure on domestic manufacturers. More generally, oil wealth fuels corruption and complacency, leading Putin to promise "not to fall asleep under the warm blanket of petrodollars."[44]

The threat of the Dutch disease may be overrated. In Russia energy accounts for some 25% of GDP and 50-60% of federal revenues and export earnings. These are high figures, but not as high as in Saudi Arabia or even Venezuela. Services, transport and the public sector are all fairly immune to the Dutch disease, and all three sectors are underdeveloped in Russia compared to more mature market economies, leaving plenty of room for non-oil growth. Assuming that the Central Bank is competent enough to sterilize the capital inflows, the Dutch disease should be manageable. It did not prove fatal to the Dutch, after all.

In 2004 the government created a Stabilization Fund, into which are paid excess taxes from oil exports when the price exceeds $20 a barrel. By 31 January 2005 the fund had reached 740 billion rubles ($27 billion). The first 500 billion rubles are invested in foreign securities, with a view to evening out the cycle in world prices.

And in the short-term, of course, the outlook looks good. The surge in the world oil price swells the coffers of the oil producers and of the federal government. The federal budget finished 2004 with a surplus of 687 billion rubles, or 4.1% of GDP. The budget surplus means that the government is able to improve public services, pay off its international debts, and avoid financial crises. The question of how to spend the surplus has led to some bickering among government ministers. The Finance Ministry wants to use it to pay down Russia's $115 million debt, while the Health and Social Welfare Ministry wants it to plug the deficit in the Pension Fund, and help

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[42] "Russian oil: the present and the future," conference in Moscow 18-20 May 2004, RosBusinessConsulting 19 May 2004; *Moscow Times*, 20 May 2004.

[43] Leslie Dienes, "Observations on the problematic potential of Russian oil and the complexities of Siberia," *Eurasian Geography and Economics*, vol. 45, no. 4, July 2004.

[44] *Wall Street Journal*, 26 March 2004.

regions compensate citizens for the monetization of social benefits.[45] Still, the fact that despite its best efforts the government cannot seem to bring inflation below 10%, nor prevent the gradual appreciation of the ruble against the dollar, signals that Dutch disease pressures do pose a continuing challenge.

Meanwhile cash-rich energy companies have attractive price-earnings ratios and suck in foreign portfolio investors. Over the past decade each spike in world oil prices has led to a spike in new drilling, with a 3-6 month time lag, as companies drill in the marginal, high cost corners of existing fields. So output has been rising in response to the higher price level.

The ownership problem

The privatizations of the 1990s left Russia with a bizarrely diverse range of ownership structures in the energy sector.[46] While the oil industry was broken up into regionally-based private companies, Gazprom, Transneft and United Energy System, the electricity supplier, were preserved as unified entities, with a controlling packet of shares held by the state. This was less the result of a deliberate reform strategy, than it was the outcome of an asset grab by officials at different levels – oil barons at regional level, gas barons at national level.

The ownership disputes sputtered and flared throughout the 1990s, and are ongoing. On one side are the privatized oil companies, which in recent years have been cleaning up their act, moving over to international accounting standards, revealing their ownership structure, and allowing minority representatives onto the board of directors. And on the other side are the corporations in which the government still holds a majority of the shares.

Blurring the picture is the fact that even the state-controlled corporations allowed their directors to acquire personal shares, becoming millionaires and even billionaires in the process. In addition, both fully private and state corporations have relied heavily on middleman purchases and transfer pricing to hide their revenues from the tax authorities and any other prying eyes. (The 11 main oil producers use more than 200 trading companies to handle their exports.)

The subsidy problem

Some of the rents from energy exports are used to keep other domestic sectors afloat. The main vehicle for cross-subsidization is the maintenance of artificially low prices for domestic consumers of gas and electricity. (Refined oil products have generally been allowed to rise to near world-market levels). Under pressure from the government, Gazprom uses export revenues to subsidize domestic consumers, creating a mini-planned economy based on cheap energy. The biggest beneficiaries have been the energy intensive metals producers who have enjoyed an export boom thanks to electricity prices fixed at one quarter of those in Europe.

The electricity generating and transmitting monopoly, United Energy System (RAO UES), has been one of the main casualties of this policy. Electricity prices have been held down, to less than half the average world price, and the rate of increase was well below the rate of domestic inflation in the second half of the 1990s. UES claims that the selling price is below the cost of production, and it is certainly below the level needed to replace out-dated generating plants. UES has to pay

[45] Aleksei Zaiko, "Discounts from the stabilization fund," *Kompaniya*, 7 February 2005.
[46] V.A. Kryukov, "Kto v neftyanom dome khozyain?" *EKO*, November 2001.

close to market prices for many of its inputs (gas, fuel oil, coal, rail transport) but faces strict price controls over its sales to industrial and domestic consumers. A further irony is that when the economic recovery got under way in 1999 the situation of UES got worse rather than better. Given that UES was selling at below production cost, increased demand for electricity as industrial output expanded mean a widening subsidy gap for UES, and more pressure on its already exhausted physical capacity.

Unlike Gazprom, UES does not have many export earnings of its own, and it bears the main burden of the scissors between domestic and export energy prices. Political pressure prevents UES from cutting off electricity to large categories of non-payers such as communal housing services and military installations. Occasional efforts to raise electricity prices produced street demonstrations and protests from regional and municipal leaders, and full price liberalization has been postponed until the completion of Anatolii Chubais's five-year plan to reform the sector, unveiled in 2000. This has been proceeding slowly, with Chubais brokering complex bargaining between regional governors, local industrialists, and UES shareholders. But the privatization cannot really proceed until prices have been increased, since investors do not want to buy loss-making regional utilities.

After Putin brought in an obscure foreign trade official, Mikhail Fradkov, to replace Mikhail Kasyanov as Prime Minister in February 2004, the pace of liberalization slowed even more. In April 2004 Fradkov declared that the government would not allow any private oil pipelines to be built, and in June 2004 he announced a six-month freeze in the ongoing privatization of UES.

This situation has left the energy sector facing some perverse incentives. Energy companies have incentives to expand the export infrastructure (and they are doing so), but not to expand domestic production. It is easier for them to divert supplies from domestic to foreign buyers than to expand output. The persisting uncertainty over the future division of rents gives them less incentive to expand the size of the rents in the immediate term.

The foreign investor problem

Most outside observers take as axiomatic that foreign investment is a Good Thing, and a vital indicator of a country's economic success. While China pulls $50 billion foreign direct investment each year, Russia is lucky to get $5 billion, and this is considered a stinging indictment of Russia's economic reform and development prospects. Putin himself seems to agree, repeating at least rhetorically his desire to encourage foreign investment, and occasionally meeting with individual big investors.

But it is a misconception that Russia needs foreign capital. Russia is running a trade surplus of $60 billion a year, and has exported some $250 billion capital over the past decade. Russia is capital rich, not capital poor. The problem is that Russian businessmen are not investing in Russia. The prevailing levels of corruption, bureaucratic obstruction and political interference mean that the risks outweigh the potential rewards.

Russia needs foreign capital not for the cash, but for the technology and managerial expertise that comes with it. Also for the public scrutiny and exposure to global standards that comes with the technology and expertise.

Foreign investors face the same barriers that inhibit the return of Russian capital, and then some. Russia has not been very welcoming to foreign direct investment. Most FDI has gone into retailing and consumer goods such as tobacco, alcohol and candy, areas where foreign brands have a clear advantage. There has been very limited FDI in manufacturing, and only a few stand-out projects in the all-important energy sector, such as BP's $7 billion acquisition of TNK in 2003. Investors in oil, gas and metals have repeatedly run into licensing problems, and the Production Sharing Agreements allowed under the 1995 law have only been implemented in a handful of cases, notably the Sakhalin offshore oil development, that were drawn up before the new law was introduced. Even there they have been hampered by local content rules, environmental restrictions, and the like.

For the most part, foreign businesses have been rather anxious by-standers of the Putin revolution. The official government line is that: "In business, profitability and stability are far more important than a country's level of democracy. In this sense, the vertical of power in Russia plays a positive role because it is far more transparent for choosing a person with whom to negotiate investment conditions."[47] The commentator continues, apparently without irony: "Foreign businessmen long ago learned how to deal with difficulties in Russia, sometimes in a purely Russian manner."

Foreign businessmen themselves are less optimistic. According to a recent poll conducted by PBN Company for the government's Consultative Council on Foreign Investment, 71% of the foreign companies polled named corruption as the top barrier to investment, followed by administrative barriers (66%), selective application of the law (56%), and conflicting laws (51%).[48]

CONCLUSION: A PERMANENT CHANGE OF COURSE ?

Russia-watchers can never rest on their laurels. Just when things appeared to be settling down in Russia, the Yukos affair burst onto the scene, triggering a stock market slump, dire predictions of authoritarian rule, and bitter divisions over how to interpret the future course of policy in Putin's Russia.

Western perceptions of Russia are now entering their third paradigm shift. The first shift, that took place in 1992, was the conviction that Russia had shed its communist legacy and was building a normal, market economy. That paradigm collapsed with the August 1998 crash, although it still has some adherents.

The second shift was the surprising appearance of Vladimir Putin, who brought stability and order to Russian politics – while also pursuing a policy of alliance with the West and adherence to a market economy. According to this view, while Putin pursued tough, Machiavellian policies towards Chechen separatists, regional leaders and his political opponents, he wanted to press ahead with market reforms in order to turn Russia into a modern, efficient economy – the only viable basis for a leading state power in the 21st century.

Even this "market autocrat" paradigm recognized that Putin's split-personality was reflected in a division within his administration between the Petersburg liberals and the sinister siloviki. But it was also widely assumed that Putin was interested in keeping a balance between the two factions, and had the political resources and acumen to do so.

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[47] Yana Yurova, "Foreign investment in Russia hits record high," RIA Novosti, 5 March 2005.
[48] Valeria Korchagina, "Corruption tops grouch list," *Moscow Times*, 5 March 2005.

With regard to the oligarchs, Putin wanted to lay down new rules for the game, quite different from those which prevailed during the Yeltsin era. The oligarchs would have to keep out of politics, in return for which Putin would allow them to keep their business empires and would even adhere to a policy of “equidistance”, not favoring one oligarch over another.

However, the Yukos affair, with the arrest of Mikhail Khodorkovsky in October 2003 and the forced sale of the company’s main asset, Yuganskneftegaz, in December 2004, has raised profound doubts about the viability of the “market autocrat” paradigm. Some suggest that Putin never intended to coexist with the oligarchs, that he was always bent on establishing a hierarchy of power, centered in the Kremlin. First, Putin drove the oligarchs out of the media, in the summer of 2000. Then he used the presidential representatives to curb the powers of regional bosses. Finally in 2003 he pushed the oligarchs out of the State Duma, by crushing the liberal parties that they financed and which were the main conduit for their lobbying.

Some commentators argue that Yukos is an exceptional case, that Putin is merely creating a stable political environment within which market capitalism can flourish. Putin has no inclination to reverse the privatizations of the 1990s, no desire to “kill the goose that lays the golden eggs.” He seems quite happy to work with oligarchs such as Vladimir Potanin, Roman Abramovich, Mikhail Friedman, and Anatolii Chubais. So once the Khodorkovsky case is over, it will be business as usual.

Generally speaking, where you stand on stand on this issue depends on where you sit. Human rights activists belong to the first camp. Most bankers, from World Bank president James Wolfensohn on down, belong to the second.

This obviously has profound implications for the kind of analysis one makes of Russian political economy. If Russia is in the process of creating an authoritarian system run by policemen – what one might call a *custarchy* (rule by guards) – then the type of economic development strategy that one can expect will be severely circumscribed.

APPENDIX

Table 1 **Basic economic indicators**

	1998	**1999**	**2000**	**2001**	**2002**	**2003**
Real GDP growth -5.3	6.3	10.0	5.1	4.7	7.3	
Investment	-12.4	6.3	18.1	10.3	3.0	12.9
Unemployment	13.2	12.4	9.9	8.7	8.8	8.0
Budget surplus/deficit (as % of GDP)	-5.3	-0.5	3.5	3.1	0.3	1.2
Inflation	85	37	20	19	15	12
Exchange rate (R/$)	10	25	28	29	31	31
Exports ($ bn)	75	76	105	102	107	136
Imports ($ bn)	58	40	45	54	61	75
Current account ($ bn)	17	36	60	58	46	61
Foreign exchange reserves ($ bn)	12	13	28	37	48	77
Average real wages	-10	-22	18	19	17	26

(Percent annual change, unless otherwise indicated. Unemployment is based on ILO criteria – surveys, not officially registered unemployed.)
Source: Organization for Economic Cooperation and Development, *Economic Survey Russian Federation 2004* (Paris: OECD, 2004); wages from Goskomstat