Analysis

Business-State Relations in Russia

By Robert Orttung, Washington

Summary

Currently the Russian state exercises considerable power over Russian business, often acting in a predatory fashion. The state is expanding its holdings in the lucrative energy sector as well as other strategic sectors, such as aircraft and automobile manufacturing. Unstable property rights give the bureaucrats powerful levers over business owners. At the same time, the ability of the Russian state to control the business community is severely limited by the extensive corruption in the country and the unreformed banking sector. Business plays an important role in center-periphery relations, binding regions together, and in Russia's foreign policy, helping Russia pursue Kremlin-defined state interests abroad. However, the expansion of the state into the business sphere is reducing Russia's ability to compete globally.

Different industries-different relations

The nature of state-business relations in Russia depends on which industry one is examining. In the energy sector, the Russian state is very powerful and can control the actions of the key corporations working in this field. In other areas, such as forestry, the state is very weak and has little influence over what happens on the ground.

In recent years, President Vladimir Putin and his administration have focused much of their attention on the energy sector. Energy makes up a major share of Russia's economy: Oil and gas accounted for about 20 percent of Russia's GDP for 2001, according to Masaaki Kuboniwa, Shinichiro Tabata, and Nataliya Ustinova, who recalculated official Russian data to give a more accurate assessment of energy's importance to the economy. Russia's overall economy will remain highly dependent on resource extraction for many years to come. Oil and gas exports now account for 55 percent of Russia's exports, according to the World Bank's 2004 report on the Russian economy. Russia's economy is thus highly vulnerable to changes in natural resource prices on the world market.

Even before Putin began his efforts to strengthen the Russian state, it had extensive control over the energy sector. The Constitution and federal law give ownership of Russia's resources to the state. Since oil can only be extracted under license, bureaucrats have extensive control over companies. The state also has monopoly power over Russia's oil and gas pipelines.

The Russian state recently bought a majority share in natural gas monopolist Gazprom, which essentially functions as a rent-redistribution mechanism benefiting numerous inside players. Much needed reforms are not likely to happen any time soon.

In the oil sector, there were two business-state models in recent years: oil-insider controlled companies (Surgutneftegaz and Lukoil) and financier-controlled and managed companies (Yukos and Sibneft). With the destruction of Yukos and the transfer of its assets to the state-owned Rosneft and the sale of Sibneft to Gazprom, financier-controlled companies are now gone, leaving only the oil-insider controlled companies. In addition to its natural gas monopoly, the state now controls approximately 30 percent of Russia's oil sector.

While the Russian state has taken over key energy assets, it remains unclear if it will be able to manage these assets effectively. As private companies, Yukos and Sibneft focused on immediate output since they were trying to increase share-holder value, leading to increased output for Russia. If Russia wants to maintain or expand its oil output, it needs to make extensive investments to develop new oil fields.

During 2005 the growth of Russian oil output slowed due to a lack of investment caused by a variety of political, regulatory, and geological obstacles. Moreover, Gazprom CEO Aleksei Miller announced on October 9 that the company would develop the massive Shtokman gas field in the Barents Sea without foreign partners and relying on its own resources. While Russian leaders suggest that the country can develop its energy resources on its own, critical observers doubt whether Russia currently has sufficient financial reserves for these projects or access to the necessary technology. Whether foreigners will be allowed in, and whether they would want to come, remains an open question.

Beyond energy: State expansion in other sectors

The Russian state has not limited itself to reorganizing the energy sector. Recent moves placed it at the head of aircraft manufacturing and automobile production, sectors of the economy that the Kremlin deems strategic.

Putin created the United Aircraft company in February 2006. The Kremlin claimed that forcing all of Russia's aircraft companies into one structure would help it compete on the world market. Critics argued that the giant new company really represented a sinecure for the personal benefit of high-level bureaucrats. Others pointed out that combining the firms at a time when there is already a shortage of funds in the defense sector would prevent them from innovating and therefore cause them to fall further behind in the world market.

Additionally, at the end of 2005, the state monopolist arms exporter Rosoboronexport took over the AvtoVAZ factory, Russia's largest automobile manufacturer, which produces approximately one-third of Russia's cars. The newly-installed state managers hope that they will be able to turn around fortunes at the ailing automobile maker by merging it into a larger state-owned automobile holding company. The logic behind why Rosoboronexport took over the car plant is unclear since the arms dealer is a highly bureaucratic organization with no experience in car manufacturing. AvtoVAZ is having serious trouble competing with the growing flood of foreign imports on the Russian market. Its low quality product currently only appeal to Russia's most impoverished consumers.

Despite the optimistic hopes of the new state managers, the results of state control have not been promising so far. This year Russia dropped nine places to 62 of 125 countries analyzed in the World Economic Forum's Global Competitiveness Report, released on September 26.

Conflicts of interest

As the Russian state grabs more assets from the private sector, it will face a growing number of conflicts of interest. Currently, for example, high level bureaucrats serve as board members for Russia's largest corporations. Kremlin Chief of Staff Dmitry Medvedev chairs the board of Gazprom, while Deputy Chief of Staff Igor Sechin heads the board of Rosneft. In a September meeting with foreign Russia watchers, Putin argued that Sechin had no problem dealing in a fair way with a variety of oil companies even though he sat on the board of one of them. Outside observers suspect that Rosneft's state-owned status and well-placed connections naturally give it an advantage over Russia's other oil companies.

Property rights remain unstable

The destruction of Yukos, once one of Russia's largest and most transparent companies, shows that there are a number of problems in Russia's broader institutional environment: property rights remain insecure and there are many powerful groups in Russia that have a strong interest in blocking any reforms that would put them on firmer footing. Under current conditions, the state can take action against any company it wanted to target. Putin's academic work shows that he is determined that the Russian government should have a "decisive voice" over decisions about energy and natural resources.

The shaky nature of Russian property rights give the state expansive power over business in the country. The Russian state's strength vis-à-vis big business is unusual for a middle-income country—or indeed for any country. Russia differs from post-war Japan and Italy because most businesses in Russia began with shady deals and because big businesses are associated with the oil and gas sector, which means that they must rely on state licenses, according to Philip Hanson and Elizabeth Teague. As a result, the Russian state holds considerable leverage over its companies because it can threaten them at any time with legal action or the removal of their licenses.

Since businesses acquired most of their property in a largely lawless environment, owners have no security that they will be able to hold onto their acquisitions. Property rights depend entirely on the whims of state officials. Moreover, as state officials are replaced, their successors may decide to transfer current property to new owners. Thus, even apparently legitimate businesses exist under a cloud of uncertainty about their future activities. Accordingly, the wealthiest magnates of the Putin era seek protection for their business by trying to draw as close to the Kremlin leadership as possible.

Corruption—the limits of state strength

The extensive corruption pervading the Russian economy limits the capacity of the Russia state. Data from Transparency International, the World Bank, and Freedom House show that corruption seemed to fall in the early years of Putin's tenure, but is now rising. In many spheres of the economy there is essentially no coherent state due to the prevalence of corrupt officials. In the forestry sector, for example, small businesses illegally cut down Russian trees, while paying off the inspectors who are supposed to stop them. They then export the logs to countries like China through corrupt customs points. The state has effectively lost control of this business because its agents are more interested in their personal enrichment than doing their job.

One major consequence of the extensive corruption and inefficiency within the energy sector is that

Russian policy makers are not using the income generated in this field to diversify the economy. A truly developmental state, with an eye to ensuring Russia's long-term prosperity, would work to transform current income into investments in new technologies that would support a knowledge-based economy of the future, guaranteeing jobs outside of the natural resource sector.

Banking—a black hole for business

Not only is the economy not being diversified, but energy wealth is deforming much of the rest of the economy. For example, Anastasia Gnezditskaia argues that the size of the mineral economy has had a large and negative impact on Russia's banking sector. Oil companies own some of the best capitalized banks in Russia, but force them to operate using nontransparent methods, for example by not disclosing who owns the bank. Banks with oil money do not engage in retail banking or lend money to enterprises as western banks typically do. These banks are extremely opaque because they do a large share of lending to their shareholders, owners, and affiliated structures. Moreover, there is little regulatory scrutiny of these banks.

Banks facilitate business development in many countries, but Russia's unreformed banking sector has not played that role. The sector is dominated by huge state-owned banks such as Sberbank and a wide variety of small private banks. There are currently about 1,200 banks operating in Russia, most of them extremely small, according to the Center for Economic Research.

Many of the banks are involved in money laundering and other criminal practices. Andrei Kozlov, Russia's top bank regulator, had been working to shut down these questionable banks, but his assassination in September will put that effort on hold for the time being. Putin set up an interdepartmental working group under the aegis of the General Procurator's office in the wake of his murder, but it is unlikely to have much success fighting bank sector crime, given the violent means at the disposal of the launderers.

Before his death, Kozlov had managed to shut down 90 of the 1,200 banks, including 33 in the summer of 2006. Optimistic observers suggest that Russia is slowly growing a core of legally functioning banks that will ultimately provide the foundation for an effective sector. Since many Russian salaries are now directly deposited in banks, ordinary people are starting to use the banks more often and the banks are beginning to offer a wider range of services.

Big companies have power in the regions

While big business has to kowtow to the Kremlin, it is often much more powerful than the average regional governor. As a result, corporate giants are often in a position to dictate terms to the regional elite. However, in regions where several large companies are active, these companies have to compete to secure the loyalties of the regional elite.

The interests of big business do not always coincide with those of the Kremlin. Where big business wants a strong governor to help protect its operations, its interests may differ from those of the federal government, which seeks to subordinate the regional elite within its vertical power hierarchy.

However, in closed regions like Tatarstan and Bashkortostan, where local elites protect their own interests by blocking outsiders from operating within their jurisdictions, big business allies with the federal government in seeking new business opportunities. In these cases, business works closely with the federal government against regional interests. In this sense, big business in Russia serves the function of helping to band the regions together into a cohesive whole. When Putin came to power, ensuring such unity was one of his main goals.

Corporate foreign policy

Russia long has used companies like Gazprom and LUKoil to flex its muscles in the former Soviet republics and the Baltic states. Most prominently, Gazprom cut off gas supplies to Ukraine in a dispute on January 1, 2006. Similarly since July Russia has used threats about future oil deliveries to Mazeikiu refinery in an effort to force Lithuania to sell this former Yukos plant to LUKoil, rather than the Polish concern PKN Orlen, Lithuania's preferred buyer.

Now Russia is seeking to exercise its influence in different ways. The state-owned foreign trade bank Vneshtorgbank recently purchased a 5 percent share in the European Aeronautic Defense and Space Corporation (EADS), seeking to gain a voice in managing the corporation. When EADS announced that Russia would not obtain a seat on the company's board of directors, Russia suspended an order for Airbus planes, which an EADS subsidiary produces. Both EADS, France and Germany expressed clear displeasure at the prospect of Russia gaining leverage over the company. In addition to making civilian aircraft, EADS is also a major European defense producer.

While Russia's leaders hope to use Russian business as a way of exerting power on the international stage, their current policies are unlikely to develop

Russian business in an effective manner. Further state control and the absence of secure property rights will undermine future business activity and make Russian corporations less competitive internationally. Thus, Russia's current efforts to manipulate the state-business relationship in favor of the state may ultimately work to undermine state interests by weakening the business community's ability to compete in a global market.

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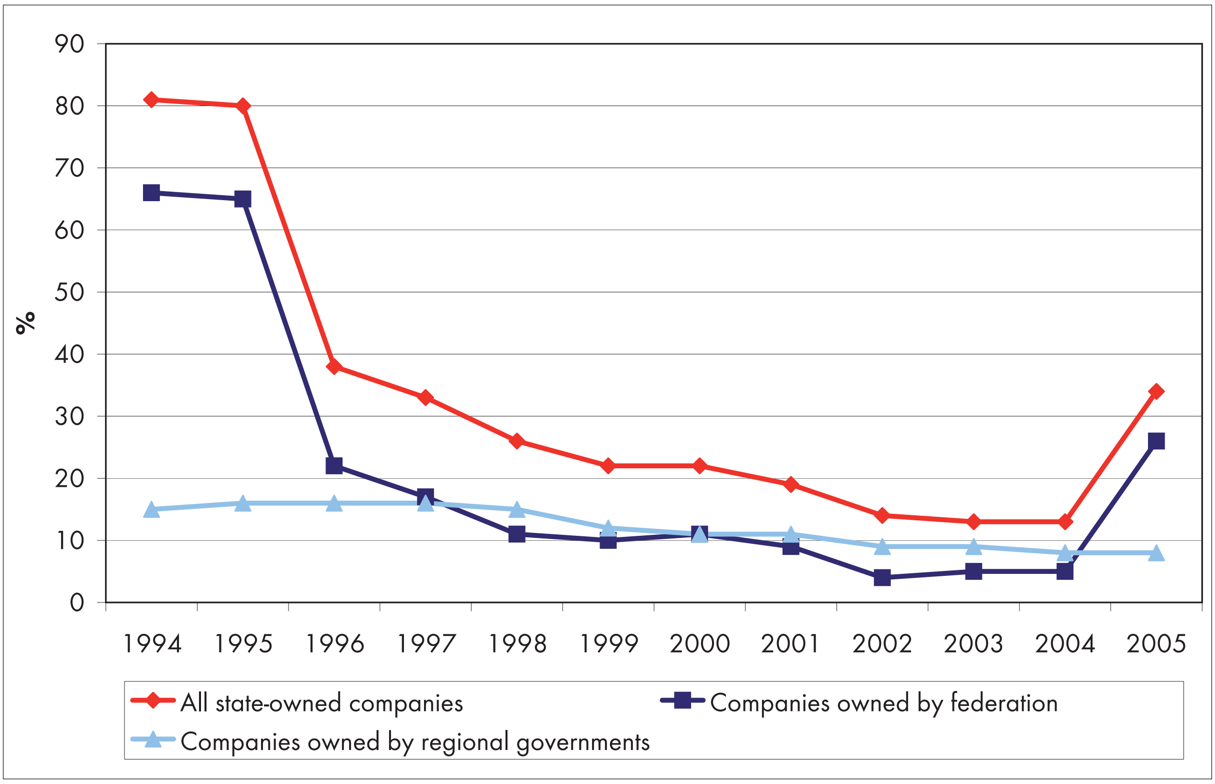
Further reading:
- Andreas Wenger, Jeronim Perovic, and Robert W. Orttung, *Russian Business Power: The role of Russian business in foreign and security relations*, London: Routledge, 2006.
- Shinichiro Tabata, *Dependent on Oil and Gas: Russia's Integration into the World Economy*, Sapporo: Slavic Research Center, Hokkaido University, 2006.
- Philip Hanson and Elizabeth Teague, "Big Business and the State in Russia," *Europe-Asia Studies* 57:5, July 2005.
- Anastasia Gnezditskaia, "'Unidentified Shareholders': the Impact of Oil Companies on the Banking Sector in Russia," *Europe-Asia Studies* 57:3, May 2005.

Diagram

The State's Share in Oil Production 1994–2005

(in % of total oil production)



Source: Research Centre for East European Studies, Bremen