THE BUSINESS SECTOR IN POST-SOVIET RUSSIA

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Introduction

Twenty years after the Soviet collapse, business state relations in Russia are still very much a work in progress. After a decade of dissolution in the 1990s, the Russian state has revived under a centralized, authoritarian system of rule, one in which most democratic elements (such as free media and competitive elections) have been purged from the system. However many observers argue that the political regime is weakly institutionalized, and its architecture rests on the personality of the "national leader" Vladimir Putin, raising questions about its long-term viability.

In the space of a decade Russia managed to transform itself from a state-owned, centrally-planned system into a predominantly capitalist economy. The main locomotive of the economy is the export of energy and metals, sectors in which the state continues to play a decisive role. Formally, the bulk of the economy lies in the hands of capitalist owners who are profit-seekers responding to the laws of supply and demand and not state orders. The broad (albeit inefficient) Soviet social welfare state was allowed to collapse, and the new privately-owned businesses divested themselves of most of the social obligations which had been carried by the old state corporations. So in broad terms Russia seems to have abandoned the quest for a unique development model that had become its national mission during the Soviet era, and had made a strategic choice to embrace the logic of globalization and integrate with the international economy

However, it is difficult to come up with a simple formula to characterize the Russian economy. It is not a liberal market economy along Anglo-Saxon lines, despite the fact that the government accepts that capitalism is the most effective engine of growth, and pays lip-service to many of the tenets of neoliberalism.[1] Nor however is Russia a social market economy along German lines. Labor unions are weak; the state is only minimally responsive and accountable to the electorate; and there is no institutionalized bargaining between the state and representatives of labor and capital. It is tempting to categorize Russia as another case of "crony capitalism," since key decisions are made by a small network of individuals with no transparent institutional basis for their relationships.[2] State institutions and the corporate sector in Russia are more formally institutionalized than is normally the case in classic "crony capitalism" models such as South Korea under President Park Chung-hee, the Philippines under Ferdinand Marcos, or Suharto's Indonesia.

Russia can certainly be characterized as a 'petrostate', since more than half its export earnings and government revenue stem from oil and gas. It confirms the covering law of the "oil curse" – that no country has become a democracy if it had discovered oil before democratic elections took place.[3] However, Russia has some important features that distinguish it from most other

[1] Peter Hall and David Soskice (eds.), *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford University Press, 2001).
[2] Gulnaz Sharafutdinova, *Political Consequences of Crony Capitalism inside Russia* (Notre Dame University Press, 2011). Peter Hall and David Soskice (eds.), *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford University Press, 2001).
[3] Carlos Boix, *Democracy and Redistribution* (Cambridge University Press, 2003).

petrostates, such as Venezuela or Saudi Arabia. It still has a fairly robust industrial base accounting for 17% of employment in 2009. [4] It has a more diverse range of resources than most petro-states – not only oil but also natural gas, and a broad range of metals.[5] Finally, in all the other petrostates the oil industry is controlled by a single state-owned corporation. But in Russia, while the gas industry was privatized as a single corporate entity, Gazprom, the oil sector was broken up into a dozen competing corporations. This adds an element of pluralism, or at least complexity, not seen in other petrostates.

The political and economic context.

The Russian economy has gone through wrenching changes over the past two decades. In the 1990s a series of political crises (the struggle for power between President Boris 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 2000, the crises seem to have receded. Vladimir Putin quickly established himself as a strong and popular president, and was fortunate enough to preside over an economy that was growing at around 7% a year (thanks largely to a booming world oil price) until the 2008 global economic crash.

In current dollar prices, GDP went from $200 billion in 1999 to $1.23 trillion in 2009. Russia moved up from being the 20th largest economy in the world to the twelfth.[6] Russia's real Gross National Income per capita (in constant 2000 dollar equivalents of purchasing power parity, or PPP) rose from $5,964 in 1998 to $14,330 in 2007.[7] 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 (especially in ethnic republics 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. 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

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4 Federal State Statistics Service www.gks.ru

5 Russia is the world's largest producer of nickel, second largest for aluminum, third largest for cobalt, fourth largest producer of steel and diamonds, fifth largest coal producer, and sixth place for copper and gold.

6 World Bank, *Growth with Moderation and Uncertainty: Russian Economic Report 23*, Washington, DC: orld Bank, November 2010.

7 World Bank, *Russian Economic Report*, 15, Washington, DC: World Bank, November 2007, p. 15.

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 this energy-led development model faces several important challenges which, if not resolved, will severely hamper Russia's future economic development. All around the world oil-based economies tend to see lower levels of economic development outside the energy sector, and higher levels of political corruption. President Dmitry Medvedev, who took office in 2008, has pledged to tackle these problems and push through a broad and deep modernization of the Russian economic system. But his first two years in office were absorbed with damage control from the 2008 global financial crisis, and as of 2010 he had little to show for his efforts.

THE EVOLUTION OF STATE-BUSINESS TIES

In the 1990s a weakened Russian state embraced the tenets of market liberalism and opened the doors to a rapid transformation of the country's economic system. This quickly generated a sui generis capitalist economy, one based mainly on the export of Russia's natural resources to world markets. In the 2000s, under President Vladimir Putin the Russian state recovered its vim and vigor, and Putin had set the terms for a new relationship with the leaders of the business community.

Within a decade a few dozen aggressive and astute entrepreneurs had managed to forge successful business corporations that in the 2000s would become prominent players on the global economic stage. In little over a decade Russia went from being a country where entrepreneurship was a crime, to one which had produced dozens of individuals with a net worth of more than one billion dollars. By 2004 there were 36 billionaires, the third highest number in the world.[8] Their number peaked at 101 in 2008, but the global crash in the fall of that year shrank their number to 49, rebounding to 77 in 2010.[9] The combined wealth of the top ten alone stood at $139 billion, down from $221 billion in 2008.

In a World Bank study of industrial concentration as of 2001, 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.[10] 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 previously.

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 was ultimately sentenced to an eight-year jail term.[11] 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, most observers assumed that the system of oligarchic capitalism had stabilized: few foresaw Putin's crackdown.

[8] "Rising tide," *Forbes*, 15 March 2004. *Forbes* counted zero Russian billionaires in 2000 and 17 in 2003.
[9] *Finans*, 16 February 2010, http://www.finansmag.ru/94502/
[10] 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.
[11] Natalya Byanova and Andrei Litvinov, "Russian pogrom against the oligarchs," *Gazeta,* 24 December 2003.

So business at the highest level can be seen as a product of two powerful forces: a new-born, rapidly expanding capitalist elite facing off against a reviving state apparatus with very deep historical roots. It would not be easy for these two blocs to find a modus vivendi which would satisfy their respective interests and objectives. And in the meantime society at large, including the small business sector, tended to get shut out of the collective decision making process.

The first phase (1992-94)

The first period of chaotic liberalization and voucher privatization launched in1992 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.[12] 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 responsibilities 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.

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.[13]

Alarmingly, businesses started using criminal groups and not the courts to enforce contracts and secure their property rights.[14] This criminalization of Russian business was a highly volatile process that opened the door to a later counter-offensive by state security organs. 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 disapproval.

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).

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[12] Anders Aslund, *How Russia Became a Market Economy* (Washington, DC: Brookings Institution, 1995).
[13] 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).
[14] Federico Varese, *The Russian Mafia* (New York: Oxford University Press, 2002).

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.[15]

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.[16] 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 12% in 1997. GDP even recorded 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.[17] 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 physical incapacity 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 each other, fighting bitterly over the privatization of the telecom holding company Svyazinvest in summer of 1997, and over the Yeltsin succession in 1999.

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[15] 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).

[16] Stephen Fortescue, *Russia's Oil Barons and Metal Magnates* (London: Palgrave Macmillan, 2007).

[17] 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.

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.[18] 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).

The third phase (2000-05)

A new deal with the oligarchs

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 June 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.

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.[19] 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. 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 signaling 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

[18] Joel Hellman, "Winners take all. The politics of partial reform in post-communist transitions," *World Politics*, no. 50 (January 1998), pp. 203-34.
[19] Natalya Astrakhanova, "Natural clan selection," *Ekspert*, no. 46, December 2001.

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.[20]

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.[21] 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. 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 ended up with 304 deputies in the 450-seat chamber, 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.

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 Yukos affair dramatically confirmed 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 was very vulnerable to state pressure.

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.[22] Both state and society were suspicious of business, a value orientation that has deep roots in Russian culture, pre-Soviet,

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[20] "Oligarkhi-zagovorshchiki," *Stolichnaya vechenyaya gazeta*, 29 May 2003; Sovet po natsional'noi strategii, "V Rossii gotovitsya oligarkhicheskii perevorot," www.utro.ru, 26 May 2003.
[21] Lyudmila Romanova, "O strategii Khodorkovskogo," *Mirovaya energeticheskaya politika*, 31 May 2003, pp. 18-21.
[22] Sergei Peregudov, "Korporativnyi capital i instituty vlasti," *Polis*, no 5, 2002; Sergei Peregudov, *Korporatsiya, obshchestvo, gosudarstvo*, (Moscow: Nauka, 2003).

Soviet and post-Soviet. Big business was associated with injustice. According to a 2003 ROMIR poll, 45% considered the influence of big business on the economy as negative and only 25% positive. Their influence on politics was seen as negative by 49% and positive by 17%.[23]

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 may as well be called "state capitalism." Aleksei Zudin argued 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.[24] Sergei Peregudov in contrast saw more of a balance, an "iron triangle" of a bureaucratic elite, the presidential apparatus and business corporations.[25] 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.[26] But the Yukos affair destroyed this balance.

Economic policy in Putin's first term

The main challenge was the need to reform the "natural monopolies" – the railways, Gazprom, and the UES electricity giant – which were still under state control. In 2001 Putin replaced the long-standing head of Gazprom, Rem Vyakhirev, with a young economist from St. Petersburg, Aleksei Miller. Gazprom's $15 billion annual exports made it Russia's largest cash earner and the second largest employer after UES. It had more than its share of scandal, with new revelations surfacing in 2001 about dubious international transactions through its subsidiary Itera. Nevertheless, Putin rejected suggestions that Gazprom be reformed.

Putin tried to move ahead with reform of UES, but he retreated in the face of stiff resistance and the sheer complexity of the task. UES was Russia's largest employer, with revenues of $16 billion. It provided another $7-10 billion in subsidies to domestic customers through artificially low prices. Former privatization chief Anatolii Chubais had been appointed to head UES in 1998, and Putin kept him on. Chubais prepared a plan to privatize the company by breaking it up into regional energy companies while create a national electricity market. The government agreed to this reform in November 2001, and the bills passed first reading in the State Duma in October 2002. But it then ran into opposition from regional governors and rival oligarchs, supported by Chubais's opponents inside the government. Only Putin's firm support for Chubais and the latter's relentless energy kept the proposal alive.

UES could only be privatized if the new companies had a chance of making a profit. This meant that utility prices would have to be raised and customers in arrears would have to be cut off. Efforts to introduce such measures triggered public unrest, especially in energy-deficient regions such as the Russian Far East. In January 2003 the Federal Energy Commission said a ceiling of 14 percent for utility rate increases for 2003, but regional energy commissions rose rates by double that amount, causing public unrest. In a bizarre twist, even the pro-government One Russia party organized protests against utility tariff increases in April 2003. Actual implementation of the plan was postponed until after the 2003-04 election cycle The rise in utility

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23 N.I. Gorin et al, "Obshchestvo, biznes, vlast'," *Obshchestvo i ekonomika*, no. 12, December 2003, pp. 36-63. In these polls is that respondents are just as suspicious of state officials as they are of businessmen.
24 Aleksei Zudin, "Neokorporatizm v Rossii?," *Pro et Contra*, vol. 6. no. 4, 2001.
25 Peregudov 2002, *op. cit*.
26 Roland Nash, chief strategist, Renaissance Capital, "Who needs politics anyway?," Prime Tass 17 December 2003.

prices was still not enough to close the gap between actual production costs and what consumers were being asked to pay. This meant the regional branches of UES fell even further behind in their long-overdue investment program. In the end, it was not until July 2008 that UES was finally broken up into a dozen private regional energy companies, and even further prices were due to be phased in by 2012.

As with the natural monopolies, the reform of the bank sector proceeded at a snail's pace. In 2002 the conservative head of the Central Bank, Viktor Gerashchenko, was replaced. But there was no progress in restructuring or improving regulation of the commercial banks, which had been devastated by the 1998 crash. The foreign trade Vneshtorgbank was not privatized as promised. In 2002 the 12 percent ceiling on foreign ownership in banks was abolished, and a law on mortgage collateral adopted. Seventy percent of deposits were still lodged at the state-owned Sberbank. A long-overdue law introducing deposit insurance for private banks was passed in November 2003. Steps to tighten bank regulation in preparation for deposit insurance triggered a run on several banks in April 2004. Even the leading Alfa Bank was besieged by panicky depositors, in a worrying echo of earlier bank crises.

The fourth phase (2005-10)

Lobbying opportunities

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 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

[27] Inessa Slavutinskaya, "Liberalissimo," *Profil*, 7 August 2000.
[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.

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, took 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 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.

Corporate governance

Leaving aside the exceptional case of Yukos, corporate governance throughout Russia's newly-minted private sector leaves much to be desired. By 2004 only a dozen of the leading firms had adopted international accounting standards, and traded their shares on the stock exchange. There is a vast sector of state-owned defense and other plants, which continue to receive subsidies and which account for perhaps a quarter of industrial output. Nearly half of Russian companies routinely report that they are running at a loss. Many of them only survive thanks to state subsidies (such as toleration of tax and utility arrears); many are probably under-reporting income in order to evade taxation.

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[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.
[34] Francesca Mereu, "Business will have big voice in Duma," *Moscow Times*, 13 November 2003.

Stock ownership in Russian firms is extremely concentrated, posing an endemic problem for minority shareholders. And in many cases, actual control is not related to formal stock ownership. More legal reforms are needed. Prime Minister Mikhail Fradkov complained that "many companies, including large ones, do not disclose their real owners, do not disclose an exhaustive list of affiliated firms and people, and continue to act, not always legally, through offshore zones."[35]

In 1998 a new bankruptcy law was introduced, intended to make it easier to sue debtors. (Under the 1992 law, debts had to exceed assets.) The new law was used by unscrupulous businessmen holding modest unpaid bills to tie up major companies in bankruptcy proceedings in obscure regional courts. Sometimes the goal was blackmail, other times entrepreneurs used the procedure to seize ownership of companies they coveted. Regional governors also used bankruptcy to repel outsider owners and evade federal taxes. In dozens of cases rival court decisions were resolved through pitched battles among private (and public) security agencies. Eventually in 2002 an amendment to the law closed most of the loopholes.

The Russian government still holds a large stake in a broad range of Russian industries. Periodically the state sold off its stake in select industries, and these sales were often reminiscent of the corrupt loans-for-shares auctions of the 1990s. A case in point was the auction of Russia's sixth largest oil company, Slavneft, in December 2002. Rival bids were blocked, including one from a Chinese oil company, and the auction was rigged to ensure victory for the $1.86 billion bid from TNK and Sibneft. (Sibneft's owner Roman Abramovich was seen as close to Premier Kasyanov.)

For much of the 1990s, the government did not try to exercise any systematic influence over the privatized companies in which it held shares. Putin made a coordinated effort to regain control over these companies by having trusted aides appointed to their boards, in some cases as chief executive. In the wake of the Yukos affair Putin moved to tighten Kremlin control still further. In the summer of 2004 two deputy heads of the presidential staff were appointed to chair the board of directors of Transneft oil pipeline and Rosneft oil companies, while other presidential staffers joined the boards of Aeroflot and Russian Railways

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 2007 there were 2.6 million sole proprietors with 5.6 million workers and 1.4 million small companies with 11.4 million workers. Small businesses account for some 15% of GDP and 30% of the labor force: roughly 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 survey by the Center for Economic and Financial Research.[37]

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[35] Interfax, 4 June 2004.

[36] Small business defined as those with turnover less than 400 million rubles or $13 mn a year and less than 100 workers. *Maloe I srednee predprinimatel';stvo v Rossii – 2009g.,* Federal State Statistics Service. http://www.gks.ru/bgd/regl/b09_47/Main.htm

[37] "Monitoring of administrative barriers to small business development in Russia," 21 December 2004, www.cefir.org.

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.[38]

The problem of corruption

Medvedev, a former corporate lawyer who had literally written the textbook on civil law, seemed serious about tackling Russia's endemic problem of corruption. In part the new legislation he proposed was required under a United Nations convention against corruption that Russia had signed and ratified in 2006. One of the measures was a bill requiring civil servants to declare their income and assets.[39] In an August 2008 speech to small businessmen Medvedev appealed to officials "not to turn business into a nightmare."[40] The timing was interesting, because the previous month Putin had scolded Igor Zyuzin, chief executive of the Mechel coal and steel group, for missing a meeting with him, citing illness. Putin threatened to find him a doctor.

Businessmen are the most directly affected by corruption. Interior Minister Rashid Nurgaliev estimated that 70 percent of entrepreneurs were giving corrupt officials 50 percent of their undeclared incomes, costing the government 40 billion rubles ($2 billion) a year in lost taxes.[41] The ordinary public is aware of the problem, but may not have that many routine encounters with bribe-taking officials. In a 2006 poll 43 percent said that corruption did not affect their family directly.[42] Another 2008 survey only 23 percent of respondents say they have given bribes to state employees in the fields of health-care, education, or military service within the past two years.[43] A 2008 Gallup poll found 74 percent of Russians thought that corruption was widespread in the government; and 37 percent thought it was worse than five years previously. [44]

Both state and society held conflicted positions with regard to corruption. Russians complained about officials on the take – but in the meantime they carried on paying bribes. Not all businessmen welcomed Medvedev's campaign – some feared that it would increase risk and

[38] Dmitrii Buttrin, "Dirizhiskskaya Panama," gazeta.ru, 5 March 2005.
[39] Olga Pavlikova, Anastasiya Novikova, "National anti-corruption plan," Gazeta.ru, 26 June 2008.
[40] Anna Barakhova, "Measures to suppress corruption," *Kommersant*, 1 August 2008.
[41] Francisca Mereu, "Crisis could take a bite out of corruption," *Moscow Times*, I November 2008.
42 Elena *Corruption Levels in the Russian Federation: Research Data for 2006*. Center for Anti-Corruption Research and Initiatives, Transparency International-Russia. November 2006.

[43] Madina Shavlokhova, "The corruption storm grows stronger," Gazeta.ru, 30 June 2008.
[44] Cynthia English and Neli Esipova, "Perceptions of corruption high in Russia," gallup.com, 5 February 2009. 66 percent thought it was worse than in Soviet times.

cause bureaucrats to drive up their rates.[45] The Kremlin in turn was aware that a serious anti-corruption campaign could undermine elite unity and lead to factional bloodletting. Putin and Medvedev talked tough on corruption, but rarely followed through with the arrest of senior wrongdoers. There were some 3,700 corruption-related criminal cases opened in Russia during 2008 – not that impressive a number, given there are more than one million businesses in Russia. Also, the most senior officials arraigned were two first deputy governors in Orel.[46] One year into the campaign, Justice Minister Aleksandr Konovalov admitted "there was still no 'fundamental shift' against corruption in the country."[47]

The court and prosecution system could not be relied upon to tackle corruption. On the contrary, they were part of the problem. According to a May 2008 poll, 52 percent of respondents thought that judges were influenced by bribes or pressure from above in most cases. [48] In May 2008 Yelena Valyavina, first deputy chairwoman of the Supreme Arbitration Court, publically accused a Kremlin official of threatening to dismiss her unless she changed her position on a case involving the Federal Property Fund's shares in Tolyattiazot, the nation's largest ammonia producer.[49]

Dealing with the global economic crisis

Within months of becoming president, Medvedev found himself facing the biggest global economic crisis in 75 years. Would the ambiguous tandem leadership be able to make the tough decisions needed to cope with the crisis? Would Putin's relatively liberal, open economy approach survive the challenge of a deep recession?

At first, in the summer of 2008 the Kremlin was in denial, arguing that the government's hard currency reserves would insulate the Russian financial system from the wave of U.S. bank failures. That confidence proved short-lived. The Russian economy was hit hard by a double whammy of falling oil prices and excessive borrowing by the oligarchs, greedy to expand their acquisitions overseas. The oil price plunged from a peak of $147 in July 2008 to $40 by year's end. That in turn caused the ruble to fall 40 percent against the dollar, while the stock market plunged 72 percent in 2008 – the largest drop of any country. In the first half of 2009 GDP and real wages were falling at an annual rate of 9 percent – and industrial production by an astonishing 17 percent. The budget came under tremendous strain, with official projections for 2009 showing revenues falling 40 percent and a deficit rising to 8 percent of GDP. (The 2009 budget had assumed an oil price of $95.) The government spent down $200 billion of its $600 billion reserves, but did prevent any major bank failures and managed to stabilize the ruble by May 2009. The focus on crisis-containment meant that ambitious plans for Russia's long-term development were put on hold. In March 2009 Putin disbanded the cabinet department responsible for the four national projects launched in 2006 (in farming, health care, education and housing), on which the government had spent $10 billion in 2008.[50]

Medvedev himself admitted that the crisis posed a serious challenge for the Russian elite, who had grown up in eight years of rising economic prosperity. It also exposed the fact that the

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[45] Francisca Mereu, "Everyone pays, few want to stop," *Moscow Times*, 20 June 2008.
[46] RIA Novosti, 24 February 2009.
[47] Roland Oliphant, "Tilting at the windmills of corruption," Russia Profile, 28 May 2009.
[48] Alena Ledenova, "Medvedev's crackdown on corruption in courts," RIA 29 May 2008.
[49] Natalya Krainova, "Judge tells of Kremlin threat," *Moscow Times*, 14 May 2008.
[50] Anatoly Medetsky, "National projects moved to back seat," *Moscow Times*, 10 March 2009.

Russian economy had failed to diversify and was still heavily dependent on commodity exports.[51] In effect, the Kremlin's strategy amounted to holding on until the crisis receded, and commodity export prices started to recover. [52] One can identify two broad strands in the policy advice offered in response to the crisis. A dwindling band of liberals favored maintaining the open economy, export-driven course laid down during the Putin years. They faced off against a chorus of neotraditionalists who wanted to see protectionist barriers, price controls, and the nationalization of bankrupt plants. The acerbic Andrei Piontkowsky described this as a struggle between nationalist kleptocrats and globalist kleptocrats.[53]

The crisis was exposing deep rifts within the ruling elite as they struggled for a share of the shrinking pie and tried to blame each other for the nation's plight.[54] All of the major elite groups were weakened by the economic crisis: the siloviki, the liberals, the oligarchs, the political parties, and the Kremlin. The siloviki saw the state budget shrink, while the oligarchs saw their fortunes evaporate. The liberals found their faith in the market shown to be naïve. The political class as a whole found themselves swamped by forces beyond their control, and beyond their understanding. Each of these groups saw a decline in their political or economic resources in absolute terms, but it was hard to predict how the crisis would affect their relative power. The various factions of the elite were all too aware of their collective vulnerability, which meant that they had a strong incentive to keep their feuding within limits – and under wraps.

The policy coordination between Medvedev and Putin left something to be desired. At the G20 summit in Washington in November 2008, Medvedev and the other participants agreed not to erect protectionist trade barriers against each other. Then, just a few days later, Putin announced the introduction of higher customs duties on the import of used cars in order to protect the domestic auto industry. On 10 June 2009 Putin announced that Russia would be withdrawing its individual bid to join the World Trade Organization, and would instead be pursuing a joint bid as part of a customs union with Kazakhstan and Belarus. WTO officials were taken aback, explaining that there is no provision for collective membership applications. Russia had been negotiating entry for 16 years, and had agreed 95 percent of the provisions, though talks had been suspended after the August 2008 Georgian war. Just one month later, Medvedev seemed to reverse Putin's announcement, telling reporters at the G8 summit that "One can, having agreed some general standards within the customs union troika, join separately – which is my view is simpler and more realistic."[55] This switch was not a sign of rivalry in the tandem leadership, but of incompetence and lack of coordination in the policy-making process.[56]

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[51] Interview with Azera Musaliev, "Elites and elites," *Kommersant*, 4 June 2009.
[52] Aleksei Mikhailov, "Waiting for a miracle," Gazeta.ru, 6 July 2009.
[53] Andrei Piontkowsky, "Moscow's power divide," *Transitions Online*, 18 August 2008
[54] Vladimir Milov, "Putina can be replaced," Gazeta.ru, 9 February 2009.
[55] Speaking at the G8 summit, BBC Monitoring, "Medvedev on 'good personal contact' with Obama," Vesti TV, 10 July 2009.
[56] "A correction for Putin," Gazeta.ru, 13 July 2009.