

# INDUSTRIES AND SECTORS: ISSUES AND POLICIES

**ON SOME ASPECTS OF BUSINESS-STATE  
RELATIONS IN RUSSIA**

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**Abstract:** This article looks at the transition from the model of relationship between business and state, which dominated in Russia in the 1990s, to the one at the beginning of the 21st century. Russian history provides extensive evidence that business and state had always been closely connected and interdependent in this country. However, after the collapse of the Soviet Union, interdependency changed to dependency: while in the 1990s business was dominating the state, on the edge of two centuries the state took control over business. The tradition of close co-operation has been destroyed.

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## Introduction

This article looks at the transition from the model of relationship between business and state, which dominated in Russia in the 1990s, to the one at the beginning of the 21st century. In literature these models have been given the names of 'state capture' and 'business capture' accordingly, with significant attention paid to so-called oligarchs and autocratic political regimes.

Fewer papers analyze the formation of small and medium-sized businesses in post-communist Russia. Yet, as the Russian government often emphasizes the necessity to develop the SME sector, it is important to look into how business has been developed in the last 20 years. The political issues have been playing a significant role during this period and therefore they cannot be omitted from this article. The article discusses the historical background from the 18th century to the end of the Soviet era, detailed periodization and explanation of business-state relations in the post-communist period and, finally, the modern position of recent years (up to 2009). Some policy recommendations will conclude the article.

## Historical background

In the 18th and 19th centuries, the long-existing class of merchants received closer attention from the tsar's administration. This epoch is characterized by the rising number of merchants who were involved both in trade and manufacturing, whereas agriculture was mostly

controlled by noble people ('dvoriane'), as they had power over peasants ('krestnyje krestiane'), living on lands formally owned by the tsar, but which, in practice, were entirely dvoriane's estates.

Several major laws were promulgated at that time. One such law specified that all the merchants were divided into three strata (guilds) according to the size of capital (compare to the later grading of business as small, medium and large). Access into these guilds was precisely outlined. Those compiling the first cohort were tycoons of that time. Though in most cases they had no nobility, they were rather close to the government and tended to represent the tsar's interests - not only in a financial sphere, but also in providing administrative support and security (especially in remote, newly joined regions of the Empire). At the same time, tsars and their bureaucrats did not intervene into the manufacturers' own business.

At a local level merchants were regarded not only as businessmen, but also as representatives of authorities or at least arbitrators. In distant areas they were traditionally elected as town heads or members of town councils - these duties were not so popular among merchants, because they required fairly high financial expenses. The modern name for this may be 'social responsibility of business' - a notion used increasingly in today's Russia.

Noble people, owners of big estates, tended not to be particularly interested in developing manufacturing or implementing innovations in agriculture. They used to obtain sufficient profits from their land in order to live their lives in capitals; some fully engaged in politics or

military affairs, but the majority spent their time leisurely as appropriate for their social status. In most cases the same could be said about dvoriane, who owned medium-sized plots. The difference was that, more often than not, they lived on their estates or in the regional centres and served in the army or administration. However, the poorer ones, who had smaller estates and fewer peasants, had to choose another way of living. Usually after their father's death sons divided his property which, consequently, led to the inevitability of choice: either to sell their modest share in the property or to start some enterprise and make their economy more efficient (read, for example the 19<sup>th</sup> century novel "Oblomov" by I. Goncharov). The latter choice entailed obtaining permission from the government to become merchants - something that had not been allowed in previous centuries. Gradually these permissions were granted by the tsar - initially to enter the first and second guilds, followed by all of them being open to noble people.

Another period worth mentioning is the period of the New Economic Policy (1921-1928). After the First World War and the Civil War the country was devastated, and people suffered from starvation. This forced the communist government to let people organize small enterprises in agriculture and cooperatives and syndicates in manufacturing. In as little as five or six years the impact of a rising number of such enterprises pulled the Soviet economy out of disaster. As this had been achieved, communists finished their experiment and prohibited entrepreneurship for the following 60 years.

Finally, we have to look at the time of perestroika, when state enterprises were granted the permission to choose their suppliers, define production output, and be involved in foreign-economic activity. However, their output was consumed by the government through the government procurement system and usually not allowed into the open market. The prices were also frozen at a certain level, thus giving no incentive to the state enterprises to develop.

The law on cooperation allowed people to open their own enterprises and start businesses. At first, co-operators were not very successful, since they could not compete with huge state enterprises which were subsidized, included in the government procurement system and could lead foreign-economic activity. But later, when the state expenditures rapidly decreased, co-operatives gained an advantage, since they did not have to return their profits to the state; the tax rate was reduced from 65% to 35%, and businesses could attract the most talented employees by offering them two or three times

higher salaries. Almost immediately directors of state enterprises started opening their own co-operatives based on the former state enterprises; they abused their administrative influence by directing financial and material inflows from the state into their private businesses.

### **Periodization of business-state relations in post-communist Russia**

Former Minister of the Economy Yevgeny Yasin offered the following periodization of business-state relations of the last 20 years:

1. 1990-1995 Leading role of state, but business increasing in scale and influence
2. 1995-2000 Oligarchic (tycoon's) capitalism
3. 2000-2003 Period of compromise; business forced out of the mass media
4. 2003-? State capitalism: assertion of dominance by the state with the threat of expropriation (Hanson, 2005, p.482).

This table may be completed with the fifth period, starting in 2008, when the government began actively placing its representatives onto the boards of directors of major enterprises.

The early 1990s continued the tendency of the previous five years of perestroika, but the number of private enterprises rose steeply after voucher privatization. Existing business structures got more space and material resources and new ones appeared on the market. The old nomenklatura, those close to it, and young former Komsomol leaders became chiefs of new private companies. They used their administrative connections in order to obtain rent for their enterprises.

Generally speaking, two basic strategies of business behaviour were used during that period (Yakovlev, 2006, pp.1034-1035). 'Voice' strategy led to state capture. The closer a company owner was to the authorities and the lower the competition in the area, the more likely one would use this strategy. One could change the rules of the market and make them work for one's own interests. Two ways of achieving this were either to change the general rules of the game, or to tailor rules for one particular situation to secure one's private interests. Usually it was used on the federal level, where one could get subsidies, tax reductions, and access export connections. Enterprises working in such areas as heavy industry, natural resources, foreign trade, finance, and banking most likely sought rent and used federal resources.

The 'voice' strategy could well have existed on the regional level as well, if some directors of former state-owned companies got them

through the privatization. However, local authorities could not provide such financial benefits as federal ones. This led to using 'exit' strategy on the regional level (mostly in larger cities, which had sufficient infrastructure) and the formation of so-called free entrepreneurship (Yakovlev, 2006), i.e. entrepreneurs tended to keep a distance from the administration. They relied more on the market and tried to seize niches which had been unoccupied. They worked directly with consumers and did their best to offer them higher quality goods at lower prices. Rapid growth of SMEs was mostly witnessed in the trade and services areas which could provide profit in a short-term perspective, whereas manufacturing was almost ignored due to the instability in the country, huge inflation, and some other factors.

In a framework of both political and economical instability, distrust, and necessity to come to a decision under time constraints and outside pressure, business owners, regardless of the used strategy and the size of their companies, preferred to manage their enterprises themselves or at least involve their close relatives in management decisions. This resulted in enterprises being managed by non-professionals, who despite doing their best still made business by intuition, by the method of trial and error. Thus, their activities were not extremely efficient. Another important issue, which did not allow entrepreneurs to expand their businesses, or even look at the long-term perspectives, was poor property rights protection. Soviet laws could not provide adequate protection, as property rights were a new notion, and new laws had plenty of loopholes, omissions, and controversies. But by far the most important challenge was that the old security and law enforcement system did not function. In these circumstances private security organizations (so-called ChOPs [ЧОП]) were formed in abundance; they took the role of providers of such services to the entrepreneurs. In a relatively short period of time they were able to divide areas of influence and share geographical territories that each of them would control. They managed to persuade entrepreneurs (using different means of persuasion!) that it would be much safer for the latter to be controlled (or, literally, "to have a roof" - *imet' kryshu*) by such security organizations. Some of these structures were started by former police officers, and often acting policemen and other public law enforcement institutions' staff members were involved in this business. This kind of service got fairly high and stable demand from the business community who realized that with the help of these officials they could get a wider range of services: not only physical security, but

also solutions for their issues with tax payments, getting licenses and other required paperwork.

The latter resulted in the situation where, gradually, some acting staff members of state law enforcement structures (i.e. police, Federal Security Service, Department of control over economic crimes, Prosecutors' offices etc.) got the leading positions in this 'security market', as in most cases they had easier access to information, power, and resources, essential in outbidding the competitors. Keeping their state status, they still got money, or other bonuses, from those entrepreneurs, whom they *kryshevali* - controlled and secured. Subsequently the tendency of dividing the areas of influence could be seen even among these very structures. For example, street patrolling police might have controlled small enterprises, like shops, stalls, and markets. District police could control medium-sized enterprises, such as restaurants or small manufacturers. Larger factories and enterprises in general, were mostly controlled by the policemen of higher levels (i.e. regional and federal) or those with the Federal Security Service. Intervening into the area of influence of higher, or just another, level was strictly suppressed.

At the end of the 1990s this created the environment where property rights not protected by law still had some level of guarantee, and this could help entrepreneurs to grow their business. The same processes framed the behaviour of big businesses; the only difference was the positions of *kryshevateli* in the hierarchy of power. If a tycoon had contacts, or patrons, on the federal level, usually the whole package of services was provided to him. In all probability, that is how the one-stop-shop solution started functioning in Russia. Yet, this unhealthy environment of suspicion, distrust, and unsteady property and contractual rights did not provide entrepreneurs with incentives to invest long-term in Russia, but rather take capital offshore, or just invest into the estate property abroad, as soon as they could.

### President Putin's era

The situation drastically changed after Vladimir Putin came to power in 2000. Though on the surface no changes were seen, the relationship between power and business had taken a new meaning. Gradually one could see that it was not business who got services from government or state structures, but that the government entirely controlled business. So, by the summer of 2004, dominance of the state over business had become evident.

Yet, entrepreneurs continued paying for services provided by individual officials

(usually they are called bribes, but one could argue that the more accurate and less negative notion of payment for services could still be used), and indeed they received what they paid for. However, as the government gathered all the information on what was happening in the business, directions of financial flows and means of tax evasion, they could control entrepreneurs more easily.

The second step, which allowed the government to gain even stricter control over business, was the implementation of a significant amount of laws, amendments to them, orders, instructions, and government comments. This excessive system of regulations inevitably led to entrepreneurs breaking at least some law, or rule, even if an entrepreneur tried to follow all the legal procedures. The most notorious means to manipulate businesses was to apply tax laws retrospectively. The largest resonance was created by the 'YUKOS' case. Not commenting on the political and possibly personal motives in starting this pursuit of Russia's largest private company, one should admit that this case played a significant role in suppressing the business community. The latter kept their silence for all those long years of the trial, and the government received wide public support and *carte blanche* for their actions. This is probably one of the best examples of the negative attitude towards entrepreneurs among Russians (see e.g. Mickiewicz, 2008/2009).

Yakovlev gives a very good example of the importance of the social attitude towards private property and its security in Russia. He quotes his friend, a banker: 'Do you see my watch? It remains mine only so long as everybody around me agrees (or forced to agree - ID) that it really belongs to me. Should my neighbours think differently, I wouldn't have been able to sleep soundly anymore' (Yakovlev, 2004). As private property rights are the cornerstone of entrepreneurship, his words are especially important in understanding the environment in which Russian business is functioning.

Thus, the best strategy for business owners in these circumstances would possibly be to remain silent, try to follow all the directives from the government and find some senior officials who could patronize their enterprises. In some cases these officials were officially invited to join the boards of directors, or served as consultants. As a response, entrepreneurs established three groups to defend their interests and promote their ideas to the government. As in the earlier period when there were three guilds in Russia which embraced merchants on the basis of their capitals, three associations have been set up: RSP (The Russian Union of Industrialists and Entrepreneurs) (for large

enterprises), Delovaya Rossiya (for large and medium-sized enterprises) and Opora Rossii (for SME). However, these organizations do not have enough influence and tend to step back from politics and come up with their fairly moderate ideas and suggestions only when the authorities call upon them. Hence, both 'voice' and 'exit' strategies seem to be inapplicable in the current environment in Russia.

### **Present-day situation**

Today the tendency of the aforementioned period develops, though officially the authorities declare that the rule of law and equal attitude to all business people are of utmost importance. Businesses continue taking capital out of the country or at least investing it in more trustworthy assets, e.g. estate property. At the same time, understanding that the government entirely controls business causes businesses to be more active in taking loans abroad. They know that in case of disaster, the government will pay all their obligations, as it is not interested in losing Russian assets. Though the majority of companies are still managed by their owners, as it was in the 1990s, more professional managers (including expatriates) are managing Russian companies. This tendency will only become stronger, as the business people of the first entrepreneurship wave become older.

The 2008 financial crisis changed the relationship between the state and business. At least it precipitated action by the government which started sending their representatives to the boards of directors of private companies and initiated mild nationalization of big enterprises. The list of companies which had government officials involved in their structures comprises of such companies as: Gazprom, Transneft (oil), United Aircraft corporation, Russian Railways, Rosselkhozbank, The First Channel (TV), Aeroflot, Oceanpribor and many others.

Finally, the government declared its will to engage the business community in solving the problems of the country. They even published the list of one hundred people (mostly successful managers and entrepreneurs) who are considered to be a reserve for different governmental positions. Yet, there is a long way to go to the proper interdependency of the state and business.

### **Conclusion**

As one can see from Russian history, business and state had always been interdependent and a huge influence on each other which is obviously not only the case in

Russia. As business used to provide certain services, which due to different reasons could not be provided by the state, the state regarded business as its partner in a variety of projects (either providing security of distant borders, judging or the resurrection of the economy after the crisis). People from the noble class or from the bureaucracy actively entered business, and entrepreneurs tended to do their best to ease the life of the surrounding society. However, after 70 years of Communism and the eventual collapse of the Soviet Union, the balance in these relations was destroyed. Interdependency has given way to dependency. If in the 1990s, strictly speaking, business was dominating the state, then on the edge of the centuries the state has taken control over business. The pendulum has swung in the opposite direction.

Some recommendations might still be given to restore natural interdependency: 1. Big businesses should protect their right to function further in the future and gain the security of not being charged or prosecuted for the past operations by a substantial fixed one-off payment to the treasury such as sponsorship or tax contribution. etc.; 2. The limited number of key areas where the state will play a significant role and keep control should be defined; 3. Less control should be imposed onto SME; 4. Finally, business people should be more actively engaged in the process of governing the state (for instance, Medvedev's 'Golden hundred' seems to have been a rather reasonable solution to the challenge of the current dependency-based situation).

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