

CHAPTER 5

New Competing Domestic Interests in Russia

In the last section we looked at how the Russian WTO accession process involves several contentious issues that will need to be resolved in order for Russia to become a member of the organization and how countries, in their unique relationship with Russia, will bring up a number of trade and extra-trade issues that they might use in the negotiating process. In the next section I will highlight the ways in which Russia's responses to these problems will in the future be dependent on the new competing interests that arise from the demands raised by foreign governments and the WTO but also more importantly from domestic demands created from Russia's transition into the WTO. It is argued in this research that the demands would be a significant aspect in the shaping the relationship between enterprises and the state in the WTO era. The government must be skilled at adapting the demand of the internal and external competing interests. Mere privatization is not the key. The government needs to effectively institute economic governance to avoid the pitfalls that have remnant of the government's liberalization policies of the shock-therapy period.

Multifaceted Concerns

On the eve of WTO accession, Russia signed protocols with 56 countries to give access to its goods markets protocols with 27 countries to give access to its services market. According to Tikhomirov,

These protocols give Russia to:

- Impose higher-than-current duties and other protectionist measures during a specified transition period (which could vary between 1 and 9 years);
- Introduce measures against unfair competition; and
- Set variable levels of duties for 1100 product groups (annual levels set each year, depending upon global price movements).

Perhaps most importantly, Russia retained the limit right to continue to regulate prices for important product groups, e.g., energy (natural gas and electricity). In addition, Russia retained the limit or ban altogether foreign participation in its key (strategic industries, including mining, energy, aerospace, railroads and seaports).¹⁶⁰

One must not forget that preceding the agreements, Russia also inherited a Soviet legacy, and then a significant shake-up in the distribution of ownership. Since the agreements pertained to over 1,000 industries, they have the capacity to affect those industries that would either enhance or detract from the respective industry's vested interests. These vested interests, in effect culminate in a new entrenchment of competing the interests for the federal government to contend with. This is particularly the case because of the mechanism used for the transfer of ownership as a result of Russia's shock therapy reforms, namely the Loans for Shares Program. As Broadman notes, Loans for Shares program had in the mid-1990s, "lacked transparency and raised serious concerns within Russia and abroad about the fairness and equity of this type of privatization, the resulting concentration of market (and ostensibly political) power ..."¹⁶¹ The structure of sectoral ownership is thus plagued with problems, points that we will point out later. Against this backdrop came Russia's urgency to develop and promote economic growth.

¹⁶⁰ Tikhomirov, 1.

¹⁶¹ Broadman, 84.

Moreover, it needed to balance the legitimizing efforts of promoting growth through economic governance. For instance, Nolan contends that Russia should do the following:

“A key task of the post-communist governments was to devise policies that would lead to the emergence of ‘modern industrial corporations’, often in heavy industry, which could form the basis for prosperity in other parts of the economy. This must involve a series of amalgamations to produce large, competitive multi-plant firms. In order to guide and assist this process, the governments in the former communist countries ought to have looked carefully at the corporate structure of the advanced capitalist countries.¹⁶²

Yet for Russia to develop ‘modern industrial corporations through ‘amalgamations to produce large, competitive multi-plant firms’, as Nolan suggest, Russia must also contend with the new constraints brought about by its WTO commitments. Tikhomirov points that on average, after a 3-7 year transitional period, import duties for agricultural and manufactured goods should be reduced by 3% from the current level of 11%. While Russia has retained the right to impose duties on certain industries like textiles, in some important markets – such as automobiles and aircraft – Russia has agreed to reduce duties significantly. According to the author, “within 7 years after joining WTO, import duties are to be clipped from 25% to 15% on imported new cars and from 20% to 7.5-12.5% for imported civil aircraft. Moreover, the author points out, in sectors like imported footwear, electronics, and prescription drugs would see significant cuts, while duties on Duties on imported medical equipment and computers should be waived altogether.¹⁶³

The constraints and opportunities that these rules may espouse, along with their effects on the state enterprise relationship and the composition of the vested interests should also be seen in the context of Russia’s recent economic performance. The transition process has created, in effect, the political and economic institutions for Putin to wield immense power, which relies significantly on the competing interests arising from its pursuit of economic growth as a member of the WTO and a world player in trade. In fact, according to Tsygankov, Economic Development and Trade Minister German Gref sees Russia’s recent economic performance as robust, in the respect that over the years 1999-2005, Russia’s economy almost tripled, according to, and it continues to grow

¹⁶² Nolan, 101.

¹⁶³ Tikhomirov.

at the annual rate of about 6 percent. Russia's middle class now constitutes about 25 percent of the population. Over the past five years, the average Russian saw a 26 percent annual growth in income, compared to 10 percent for the average Chinese. According to Tsygankov, Inflation is under control, and foreign direct investment grew 100 percent in the first quarter of 2006.¹⁶⁴

Energy pricing

Structural issues that are part and parcel to the state's relationship to the state and the emergence of new competing interests that are significantly related to the government's pursuit of legitimation through promotion of economic performance and stability are vast. The next few paragraphs will seek to highlight some of these competing interests arising internally and externally in further detail.

Especially nowadays with the increases in global energy prices, the energy sector is the most economically significant sector in Russia's economy. In fact, Cooper points out that

The energy sector dominates the Russian economy. Not only do oil, natural gas and electricity drive industry and provide heat to residents, but energy is also the largest Russian export and hard currency earner. The current structure of Russia's energy sector is largely a legacy of the Soviet Union.¹⁶⁵

The oil industry has already been broken up into several privatized companies. Natural gas and electricity are largely monopolies run by Gazprom and United Energy System, respectively, which are joint-stock companies with significant government ownership. The structures of these companies are now the subject of reform, but that process has, according to the author, proved controversial politically and as a consequence, slow.

In Russia domestic prices are lower than world prices; domestic prices for energy are severely regulated by the government while exports of energy products command world prices. The EU and the US have pointed out that the gap between the world price for natural gas and the Russian domestic price has been as large as six to one for electricity – five to one, and oil – four to one (World Trade organization, Draft Report of the Working party on the Accession of the Russian Federation to the World Organization,

¹⁶⁴ Andrei P. Tsygankov, "Projecting Confidence, Not Fear: Russia's Post Imperial Assertiveness," *Orbis* 50, no. 4 (Fall 2006):179.

¹⁶⁵ Cooper, 10.

WT/ACC/Spec/RUS/25/Rev.1.) The ‘dual pricing is partially a result of a policy of providing affordable heating and electricity to residential customers regardless of ability to pay and providing favorable fuels rates to enterprises and to government agencies, such as the military.

The Russian government and Russian delegates to the WTO negotiations have strongly argued that Russian energy prices are not an actionable subsidy under WTO rules because they are available to all industries. Moreover, Russia contends that its domestic energy prices reflect its comparative advantage in the energy sector.¹⁶⁶ The energy pricing issue continues to be thorny spot in relations, and while it has not been used as a bargaining chip in the June 2007 G8 talks in Germany, this does not rule out the possibility that differences among plaintiffs like the EU and the US will be used directly when and if Russia becomes a member of the WTO.

Worsening the situation regarding the energy issues, as Verduciel notes, Russia’s system for billing gas supplies relies on Gazprom’s de facto monopoly granted by the state for production and distribution. A legacy from the Soviet era, this monopoly enables a dual system to be maintained for billing, differentiating between domestic and export prices. Table 1 shows the current difference between prices billed to Russian industrial companies and world prices.”¹⁶⁷

The trading partners of Russia reckon that Russia’s domestic price for fuel as a concealed subsidy for industrial countries. Verduciel points out that the OECD has estimated that prices are, in fact, felt across many sectors, such as chemical fertilizer production, where 75 percent of the expensive is to cover the price of gas. This is why several members of the working group believe that domestic energy prices (and gas prices in particular) should be brought down closer in line with world prices. Meanwhile, Russia has contended that since domestic prices reflect Russia’s comparative advantage, they are to be applied to all different national industries and therefore, according to the Russian negotiators, should be considered as ‘non-actionable’ subsidies in accordance with WTO’s regulations in the ‘Agreement on Subsidies and Countervailing Measures.’ The debates have made Russia soften its line slightly through pricing measures yet the

¹⁶⁶ Ibid., 11.

¹⁶⁷ Verduciel, 16-7.

domestic oil prices are still far below world levels. According to the author, the government proposed a project to deregulate national gas consumption prices, and those of companies in particular, by 25 percent from 2007. Supply price liberalization for private individuals is to be spread out over several years.¹⁶⁸

Since the expropriation of Yukos, one sees a clear strategy of takeover of the energy by the state. This is confirmed by the purchase of Sibneft by Gazprom ... All observers agree that corruption is increasing in Russia. Bribes to local officials have grown much faster than oil prices, increasing tenfold in some cases. There has been social unrest surrounding plans to reform social spending. The failure to influence the Ukrainian election outcome was seen as a clear sign of weakness in the Putin presidency. The World Economic Forum's 2005 report has downgraded Russia's competitive ranking from number 70 to number 75 (out of 117 countries). It has been downgraded significantly on many important dimensions: from number 88 to 108 on protection of property rights, from number 84 to 102 on judicial independence, and from number 85 to 106 on favoritism in decisions of government officials.¹⁶⁹ Thus the clear tension that arises in the state's role can be clearly seen in the energy sector. There will be pressures put on due to the structural changes that arise in Russia's transition in the WTO, hence the role of the government to promote economic governance that is in line with competing interests such as energy will, indeed, be a touchstone of the effectiveness of the federal government to promote economic development.

Intellectual Property Rights

The TRIP agreement, an agreement designed and introduced aimed to promote predictability and order of intellectual property rights of all members. This requirement mandates that all WTO members apply fundamental principles of national treatment and most-favored-nation treatment in intellectual rights protection.¹⁷⁰ Like other sectors, competing interests from domestic firms that arise from TRIPS protocol is one but a whole host of external pressures on the government in the WTO era.

¹⁶⁸ Ibid.

¹⁶⁹ World Economic Forum, "2005 World Economic Forum, Global Competitiveness Report 2004-2005."

¹⁷⁰ Cooper, 12.

Agriculture

As for agriculture, according to Cooper, its political importance for Russia far outweighs its share of the Russian economy. According to one study, production from agriculture declined around 40% in volume in terms since 1991, a figure such higher than the decline seen in livestock production. According to Cooper

Some are scare concerned that with liberalization they have concerns about food security and unemployment and about maintaining the supply of housing, education, and other services that state farms provided to the rural communities during the Soviet period and continue to provide.¹⁷¹

The author goes on to say that a second main factor for the decline in agriculture is because of the slow pace of restructure of Russia's farms. The agricultural sector continues to harbor intact collective and state farms as joint stock companies or cooperative and operate in virtually the same inefficient manner as they did under the Soviet government.¹⁷² Thus, the initiation of further reforms resulting from the demands from the WTO will represent new concerns arising from the reverberations in the agricultural sector. Moreover, the debates that have been enshrouding Russia's Sanitary and Phytosanitary Regulations over Russia's sanitary and phytosanitary standards, that is standards and certification procedures that determine the safety of meats and other animal products, plants, and plant products, as mentioned by Cooper,¹⁷³ are but another receptor for the new competing interests that the government must govern in the wake of Russia's transition.

In China, similar issues also appear where issues including in some areas, food security, unemployment, maintaining adequate housing supplies, education are related to the dismantling of SOEs and the agricultural sector. Yet the dismantlement process in Russia, particularly in agriculture, is incomplete. Meanwhile, many domestic interests created through Russia's rapid privatization have systematic problems.

¹⁷¹ Ibid., 14.

¹⁷² Ibid.

¹⁷³ Cooper, 15.

In contrast to Russia, where the reforms attempt to improve the incentive mechanism to improve economic efficiency by decentralizing power and to give up part of the profits to microeconomic agent was undermined, in China, Lin et al. has pointed out, has this led to “economic vigour” to the country”¹⁷⁴ That is, the creation of power for decision making at the micro-management level, along with the increase in retained profit and self-disposable product, required concomitant changes in the resource allocation system and the macro-policy environment. Though on the issue, Lin has cautioned that “the reform has not been thorough enough”, this appears to be a fundamental difference between the aftermath of Russia and China’s transition process, and what types of strategies would be suitable to the respective country’s economic and political contexts. In that much of the democratic transition and privatization has already occurred, Russia does not have the institutional capacity to govern its economy exactly like China, but our analysis would like to point out several ways in which, in the context of the WTO, Russia and China share similar challenges and constraints – issues that will increasingly become important as they become more integrated into the global economic system. We highlight how the differences transition processes, created divergent relationships between political and economic actors. These differences become the focal point where power and influence of competing interests are most salient in comparing the effects of Russia and China’s divergent transitioning process in the context of the WTO.

Like in several of its industries, such as gas and natural resources, the Russian government needs to balance the demands of the agricultural sector, a sector which is spatially determined. The fact that many of Russia’s most dynamic industries are primary industries manifests another significant dimension in the Russia’s competing interests after it joins the WTO; hence, the geographic dimension should not be forgotten when analyzing its differences in terms of accession with China. Cooper notes that the “Russian federal government is under pressure from regional and local governments and from factions with the Russian parliament to protect agriculture from further erosion and to provide time and resources to permit it to become competitive.” According to the author,

The pressure has been put into high relief in light of the difference in positions in the accession negotiations between Russia and exporting countries including Australia,

¹⁷⁴ Lin et al., 238.

Canada and the US over the length of time Russia is to support its domestic agricultural sector. According to the author “Russian negotiator have also asserted that it should not be required to bind itself to dramatically lower support levels during the accession process while other in the current round of WTO negotiations, Doha Development Agenda.”¹⁷⁵ Moreover, Russia’s decision to restrict meat imports has become controversy. In fact, according to the author, On January 23, 2003, the Putin government announced it would impose a three-year quota on poultry imports effective May 1, 2003. At the same time the government announced tariff-rate quotas (TRQs) on imports of beef and pork effective April 1, 2003, and to remain in effect until 2010.¹⁷⁶

Services

Services, especially financial services (banking, insurance, and securities,), are a relatively new phenomenon in the Russian economy. Under the Soviet Union, services were government-owned and operated and were cronified to personal services (for example, lodging, hair salons, restaurants). They were not well developed because they were not a government priority. Financial services were virtually non-existent in the Soviet Union because their function as intermediaries between savers and borrowers of capital had no role in the Soviet planned economy.¹⁷⁷ Russian officials and business representative claim that their service industries must have government protection as ‘infant industries,’ because they are too immature and would be wiped out if they had to face foreign competition too soon.¹⁷⁸

The Russian banking sector is similarly underdeveloped. About 30% of the volume of Russian banking activity is conducted by two banks – Sberbank and Vneshtorgbank, both of which are owned by the CentralBank of Russia. Sberbank holds roughly 70% of the Russian savings deposits. Foreign participation in the banking sector is restricted by government laws and regulations. Foreign banks may operate in Russia on as subsidiaries and not as branches of the parent bank. Foreign banks have cited the lack of an effective deposit insurance program as a disincentive for private banks to develop.

¹⁷⁵ Cooper, 13.

¹⁷⁶ Ibid., 14.

¹⁷⁷ Ibid., 15.

¹⁷⁸ Ibid., 16.

The government in effect backs deposits of Sberbank 100%¹⁷⁹ US negotiators and negotiators from some of the other working party countries are requesting that Russia liberalize its banking sector to increase foreign participation, arguing that the foreign influence would increase, not undermine, the competitiveness of Russian banks by promoting stability and popular confidence. Furthermore, a liberalized banking sector would likely boost other sectors of the economy.”¹⁸⁰

In the face of these circumstances it is our view that in the foreseeable future China will continue its strategy of sustainable and peaceful development. Underlying such a strategy, China seems to have embraced a ‘global logic’ in its development strategy for its financial institutions by supporting efforts to “make limited use of markets as a supplement to the plan, and undertake a partial opening to benefit from the modern technology, management skills, and production practices available in the world economy.”¹⁸¹ Within the global logic framework, incrementalism and a willingness to experiment with western techniques has pervaded as well. It is our view that within these conceptual factors, the internationalization of the banking sector has become a main focal point of Chinese development policy. In fact, Wei Guo Zhang has noted, “the PRC is in the position to learn from the history of older capital markets, but the lessons learned must be adapted to the particular circumstances present in the PRC today.”¹⁸² But even if the Chinese government is hesitant about the merits of openness, deepening economic integration, according to Jeffry Frieden and Ronald Rogowski, is perhaps the only viable option for China because globalization has increased incentives for greater economic openness by raising substantially the opportunity costs of economic closure.¹⁸³

To help avoid getting left out in the dark as the financial systems of the world integrate, harmonize and synchronize with each other, China has in the wake of its WTO entry, introduced measures that would allow experienced and qualified overseas investors to have supervisory positions on the boards of many of China’s top state-owned banks. It is our view that the aggregate effects of these incremental moves toward foreign participation might provide a further push (or at institutionalize more accountability) on

¹⁷⁹ Coalition of Service Industries, “CSI Background Paper on Russian Banking Services,” (May 22, 2002).

¹⁸⁰ Cooper, 16.

¹⁸¹ Moore et al., 199.

Wei Guo Zhang, 41.

¹⁸³ Moore et al., 200.

the part of the government to make sustainable economic and legal policies that falls in line with 'normal state' behavior in an era of growing economic interdependence.

As a member of the WTO, the country saw the emergence of an internationalization in the banking industry. For instance, in a survey on the international banking, *The Economist* reckoned that:

The short answer is that the foreigners will probably not have a huge impact on state banks, whatever the early buzz. At most they can seed the Chinese banks with a few good ideas and a few good people, and hope that these take root and flourish. They can also make a fuss if they see things going badly wrong inside the banks. And that maybe far enough for them. After all, they want other things out of the relationship too.¹⁸⁴

Civil Aircraft

Russian aircraft manufacturers, as the case with the Russian defense-related industries in general, have seen demand for their production plummet after the government dramatically cut defense expenditures and other airlines from former Communist countries in Central Eastern Europe and the former Soviet Union shifted to European and U.S. manufacturers for their aircraft. The Russian government wants to protect domestic aircraft manufacturers from further erosion of business. It imposes a 20% ad valorem tariff on imported aircraft. Russia argues that its aircraft industry is operating at only 0-15% of capacity and is in great need of modernization. For it to become competitive, it needs to be protected from foreign competition and therefore must apply high tariffs to imported aircraft. The United States and EU are pressing Russia to sign on to the plurilateral WTO Civil Aircraft Agreement (which omits the signatories to eliminate tariffs on trade in civil aircraft and some related equipment. In an 1996 bilateral Memorandum of Understanding with the United States, Russia stated that it would sign the CAA but has backed off that commitment during accession negotiations. Because it is a plurilateral agreement, a WTO member is not required to sign the CAA as part of its obligations.¹⁸⁵

¹⁸⁴ "Proceed with Caution," *The Economist* (Survey of International Banking), May 20th 2006, 21.

¹⁸⁵ Cooper, 17.

Other issues

- Tariffs: The Russian government has lowered tariffs on most categories of products in the tariff schedule. Nevertheless, it maintains high tariffs on some items to protect fledgling industries from foreign competition. High tariffs on autos, for example, have been a concern of US manufactures. Tariffs and excise taxes (that vary depending on the engine displacement) can add over 70% to the delivery cost of an imported car. The Russian government also recently increased tariffs on used vehicles that are 3-7 years of age because they compete with Russian domestically produced new cars.
- Customs regulations: Some WP members have argued that implementation of federal customs regulations is inconsistent leading to confusion and inhibiting trade. Some also raised problems with the policy of restricting trade of certain goods to specific ports, making it difficult for imported products to be delivered to customers. Legislation establishing a new customs code is pending in the parliament.
- Importing licensing: The Russian government requires import licenses on certain products: pharmaceuticals, sugar (to implement a tariff-rate quota on sugar imported under Russia's Generalized System of Preferences program), precious metals and stones, and alcoholic beverages. Some WP members have expressed concern that Russia might impose additional licensing requirement that would further impede imports and are asking Russia to commit to removing import restrictions and not impose new ones that are not consistent with WTO requirements. Legislation to simplify the import licensing procedures is pending in the parliament.”
- Government procurement: WP members have requested that Russia join the plurilateral Government Procurement Agreement which commits signatories to open contracts for government purchases to bids from signatory countries.¹⁸⁶

¹⁸⁶ Ibid, 18.

In light of the aforementioned issues highlighted in this section, one should not forget the core goals of the current Russian leadership, particularly in their view of the WTO as a driver for attaining sustainable economic development. For instance, Cooper points out that:

“Putin and the current Russian political leadership have made economic growth and development their highest priority and they view Russia’s admission into the WTO as an essential part of the strategy to fulfill those goals. Putin appears to view the accession process as a way of forcing the government bureaucracy, the Duma, and Russian industry to confront the changes that are required if Russia is to attain long-term sustainable economic growth and development. While Putin’s political future probably does not depend directly on whether Russia gets into the WTO, it will likely be evaluated on the basis to what degree economic life in Russia has improved.¹⁸⁷

Hence, in terms of these dimensions, Putin must be adroit in navigating its economic governance to promote growth at a time when new competing interests arising from the WTO mandates themselves are eroding away the old relationships between the state apparatus and the enterprise, while creating new ones resulting from the WTO.

Oligarchs

This section seeks to highlight a unique feature regarding the dispersion of vested interests in Russia, which has been significantly affected by Russia’s shock therapy reform process, a process that allowed the formation of highly concentrated power with business and business-political elites, and a giant pillar of the Russian economic engine as well as a centerpiece of the state-enterprise relations. For instance Shlapentokh has described them in the following way.

Circumstances, however, are quite different for Putin. He is the ruler of an Oriental state similar to China, a state where power is easily connected with property. In this case the financial tycoons of Russia are not so much carpet barons as feudal barons, or warlords if one wants to put them in the context of China. Moreover, there are signs that he has difficulties in his attempts to create a strong state, indeed. Thus the logic of events pushes Putin to follow over the economic and political life of Russian society...Yet it is entirely possible that an

¹⁸⁷ Ibid, 24.

Oriental style Russia would once again be a strong authoritarian power: Moreover, such a Russia could easily form a military alliance with China.¹⁸⁸

In this example, it is clearly evident that the author sees oligarchs in having substantial influence on the state, and depending on Russia's external orientation, because of the federal leaderships attempts to form a strong state, he believes the author may return to an 'Oriental style Russia' that was once again be a 'strong authoritarian' power. As we will show, the political and economic relationship in China between the state apparatus and the enterprises requires Russia to take a key role in the governance of the economy, like China. This is what can be considered one of the most significant legacies of the transition process, constituting the one of the countries' main mutual uniquenesses.

According to a study conducted by Sergei Guriev and Andrei Rachinsky, which looked at owners of the top private firms in Russia, they concluded that "The only large sectors not controlled by oligarchs are natural gas, energy and manufacturer of machinery. The gas and energy sectors are dominated by federal owned monopolies Gazprom and Unified Energy Systems. Machinery production is a diverse sector that is populated by defense equipment suppliers (controlled by the federal government), oligarch firms and smaller firms controlled by non-oligarch private domestic owners."¹⁸⁹

The authors considered ten sectors where oligarchs controlled more than 20 percent of total sales. One of their findings is that except for ore and automotives, all these sectors would do well in global market: they export 20 to 90 percent of their output; actually, these sectors account for half of total Russian exports.

According to the authors,

Indeed, one of the main reasons that Russia is not yet a member of the WTO is that the WTO requires lowering import duties for cars and Russia's automotive lobby launched an aggressive (and a very successful) anti-WTO campaign. The lobbyist managed to install prohibited tariffs on imports of cars more than 7 years old and high tariffs on 3-7 year old cars.¹⁹⁰

It should be noted that these conglomerates, while large by Russian standards, constitute only 7 percent of global standards, yet some like Gazprom are among industry leader.

¹⁸⁸ Shlapentokh, 255.

¹⁸⁹ Sergei Gurviev and Andre Rachinsky, "The Role of Oligarchs in Russian Capitalism," *The Role of Oligarchs in Russian Capitalism* 1 (2005):136.

¹⁹⁰ Shlapentokh, 255.

The authors suggest that “Russia therefore does not need antitrust policies aimed at breaking up the oligarchs.”¹⁹¹

According to their study, comprising of Russia’s 22 largest domestic owners, most were relatively young: nine of them in the 30s, and 13 in their forties. Unlike those who were relatively young self-made entrepreneurs starting out in the 1980s building their initial wealth during Gorbachev’s transitional reforms when the presence of regulated and quasi-market prices created many opportunities, the elder oligarchs typically hail from the former Soviet nomenklatura, acting as managers of their respective enterprises, or working in government agencies supervising the enterprise, and after Soviet-era privatization, they converted their quasi-ownership rights into those that were real.¹⁹² Such is the case with Kakha Bendukidze consolidated a large number of privatization vouchers and then purchased controlling stake of his main industrial asset Uralmash in a voucher auction (at a fraction of its current price). In the course of 10 years, he then built a large engineering company that competes in global market, has modern corporate governance and shares listed in London.¹⁹³

According to the study, the top 10 families or ownership groups owned 60.2 percent of Russia’s stock market in June 2003. The authors point out that this percentage is much higher than any country in continental Europe, where the share of 10 largest families is below 35 percent in small countries and below 30 percent in all large countries (IN the United States and the United Kingdom, this share is single-digit percentages. In east Asian countries before the 1997 financial crisis, the highest shares of 10 largest were in Indonesia (58 percent) Philippines (52 percent), Thailand (43 percent) and Korea (17 percent) of total market capitalization in the respective countries.¹⁹⁴

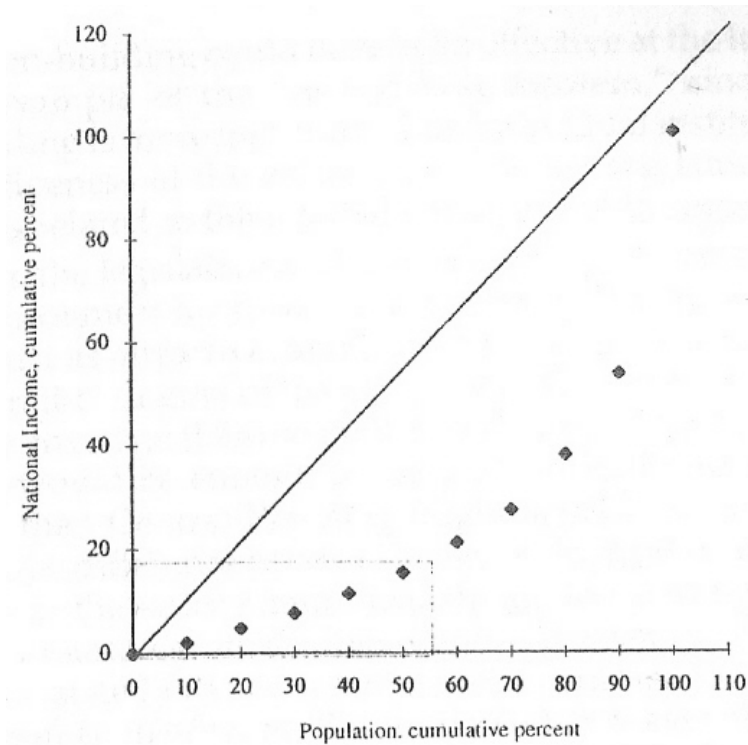
Moreover, the persistence of very rich people commanding a significant part of the nations’ wealth strengthens the contention the financial influence of oligarchs. Vorobyov and Zhukov plot 1996 Gini coefficient with 10% of the people commanding over 50% of the wealth in Russia:

¹⁹¹ Ibid., 136-7.

¹⁹² Ibid., 137

¹⁹³ Ibid.

¹⁹⁴ Ibid.



Source: Vorobyov and Zhukov (2000, p. 28); Gini's coefficient: 0.556
 Figure: Income distribution in Russia (October 1996)

Gurviev et al also note “such economies can be vulnerable to crises from a generational change in conglomerates’ leadership or from inherent inflexibility.”¹⁹⁵ At the time of retirement, the founders of family firms face a tough dilemma of either hiring a professional manager, and thus, separating ownership and control, or passing control to a less competent heir. Russian oligarchs are young so this issue is hardly relevant in any foreseeable future. They face a rather different tradeoff. Because a large Russian public deems their property rights illegitimate, the oligarchs need an exit strategy.¹⁹⁶ Indeed, expropriating foreigners is harder for the state because they are more popular than oligarchs and because of pressures from foreign governments. However, the timing of the exit is a risky gamble. Selling too early would bring too little as the assets are initially undervalued. Delaying the sale in order to restructure the company and improve

¹⁹⁵ Gurviev.

¹⁹⁶ Ibid., 140.

transparency would raise the price, but would also increase the risk of expropriation by the Russian government.¹⁹⁷

One argument that oligarch-owned firms should be less efficient is that many of these firms are conglomerates with many different lines of business. The conglomerate discount literature shows that large conglomerates should be less efficient than stand-alone firms, since they are likely to suffer from multi-layered agency problems and to redistribute capital inefficiently.¹⁹⁸

Another reason is that if the oligarchs gain and sustain their position through political favoritism, they may care less about improving firm performance.

On the other side, several arguments suggest that Russia's oligarchs might improve from performance. First, the oligarch's performance might be superior because they have successfully overcome the separation of ownership and control.¹⁹⁹ Namely, an oligarch who owns a very large majority share should have strong incentives for restructuring companies and seeking to improve the value of this asset, rather than for diverting cash flows and stripping the assets. Second, the vertical integration can mitigate the risk of hold-up problems, where in a situation of relatively few buyers and sellers, each party must be concerned that the other will attempt to renegotiate and seize a greater share of the joint surplus. Many oligarch empires have been built to overcome such hold-up problems; for example all Russian major oil companies are vertically integrated; most steelmakers own sources of coal and ore; some companies own ports, fleets of railroad cars and even railroad track.²⁰⁰

On one hand, oligarchs are large private owners who should be interested in establishment of private property rights, contract enforcement and the rule of law.²⁰¹ On the other hand, given Russia's immature political system they can use their political

¹⁹⁷ Ibid., 141.

¹⁹⁸ David Scharfstein and Jeremy Stein, "The Dark Side of Internal Capital Markets: Divisional Rent-Seeking and Inefficient Investment," *Journal Investment* (2000): 2355-6.

¹⁹⁹ Boone and Radionov, "Rent Seeking in Russia and the CIS," *Brunswick UBS* (2002).

²⁰⁰ Shlapentokh, 141.

²⁰¹ Maxim Boycko, Andrei Shleifer and Robert Vishny, *Privatizing Russia* (Cambridge, Mass: MIT Press, 1995).

influence for redistribution from other economic agents.²⁰²”Oligarchs work hard to reduce their own cost of doing business in Russia but do not lobby for other entrepreneurs to have access to an improved business environment.”²⁰³

In 2000, the oligarchs took over the Russian Union of Industrial and Entrepreneurs (RSPP), which was converted from an association of middle-size manufacturing enterprise managers into a leading lobby of big business. After the oligarchs secured control over the RSPP’s governance; they then created and led multiple taskforces, each responsible for a specific avenue of reform: tax reform, industrial policy, foreign trade, land reform, judiciary reform, railroad reform, international relations and many other. Since 2000, RSPP’s leaders have regularly met with President Putin to discuss economic policy, reform of bureaucracy and other strategic issues. They also provided ‘advice’ to the government and the parliament on legislative changes; on several occasions RSPP to Russia’s long-term economic prosperity. RSPP leaders lobby for low and transparent taxes, competent judiciary, reform of bureaucracy, reform of natural monopolies, Russia’s accession to the WTO, development of small business and even pragmatic foreign policy. Indeed, since other pro-market constituencies in Russia – like small and medium size entrepreneurs and consumers -- have failed to acquire any political weigh, RSPP has become the only effective interest to support these reforms. Some progress was achieved in administrative reform. However, RSPP was much less active in promoting banking reform and in establishing a strong competition authority. This pattern is consistent with Stigler (1971) who argues that powerful insiders try to design the rules of the game so that benefits obtained from the state are not shared with new entrants.²⁰⁴

For the time being, Putin must harness the relationships with the oligarchs, not merely for the oligarch’s significant role in Russia’s economy, and as the Yukos affair plays out, the envelope for where the state begins and where the private sector ends is being constantly pushed – even in today’s context. The entrenched state-enterprise relationship has given rise to economic governance toward giving the state the capacity to

²⁰² George Stigler, “The Theory of Economic Regulation,” *The Journal of Economic and Management Science* 2, no. 1, 3-21 in “Why the Rich May Favor Poor Protection of Property?” *Journal of Comparative Economics* 31, no. 4, *Comparative Economics*, Konstantin Sonin, 715-31.

²⁰³ Shlapentokh, 145.

²⁰⁴ *Ibid.*, 145-6.

promote comparative advantage industries ... the success of Soviet attempts, however, is up to debate as new developments will be hastened by the WTO's effects.²⁰⁵

Conclusion

For Russia, membership into the WTO would create multifaceted concerns. Concomitantly, the transition process from Soviet-style economic system into what it is today has bequeathed several significant issues related to the nature of its economic governance, namely in the relationship it has helped to foment between the state and economic agents. Perhaps most importantly, as pointed out by Tikhomirov, Russia retained the limit right to continue to regulate prices for important product groups, e.g., energy (natural gas and electricity). In addition, Russia retained the limit or ban altogether foreign participation in its key strategic industries, including mining, energy, aerospace, railroads and seaports.

Since the WTO agreements pertained to over 1,000 industries, they have the capacity to affect those industries that would either enhance or detract from the respective industry's vested interests. These vested interests, I argue, culminate in a new entrenchment of competing interests for the federal government and economic agents. This is particularly the case because of the mechanism used for the transfer of ownership as a result of Russia's shock therapy reforms, namely the Loans for Shares Program, which has been notable in its lack of transparency, thereby raising serious concerns within Russia and abroad about the fairness and equity of this type of privatization.

In light of these developments, I have analyzed several ways that new competing domestic interests have emerged. I have analyzed the issue in terms of the oil and natural gas industry, agriculture, services, tariffs, and import licensing among other sectors.

In the area of energy, since the expropriation of Yukos, one sees a clear strategy of takeover of the energy by the state. This is confirmed by the purchase of Sibneft by Gazprom. The Russian government and Russian delegates to the WTO negotiations have strongly argued that Russian energy prices are not an actionable subsidy under WTO rules because they are available to all industries. Moreover, Russia contends that its

²⁰⁵ Ibid.

domestic energy prices reflect its comparative advantage in the energy sector. Moreover, the trading partners of Russia continue to reckon that Russia's domestic price for fuel as a concealed subsidy for industrial countries.

In contrast to China, where the reforms attempted to improve the incentive mechanism to improve economic efficiency by decentralizing power and to give up part of the profits to microeconomic agent, Lin et al. have pointed out how this led to economic 'vigour.'²⁰⁶ That is, the creation of power for decision making at the micro-management level, along with the increase in retained profit and self-disposable product, required concomitant changes in the resource allocation system and the macro-policy environment. Though on the issue, Lin has cautioned that "the reform has not been thorough enough", this appears to be a fundamental difference between the aftermath of Russia and China's transition process, and what types of strategies would be suitable to the respective country's economic and political contexts. In this light, many of the relationships fostered between the state and economic relationships that are fostered operate in terms of the power and influence of unique competing interests that are created by the political and economic institutions transitioning in the context of the WTO.

We have contended that in the face of these circumstances China will continue its strategy of sustainable and peaceful development, embracing a 'global logic' in its development strategy for its financial institutions by supporting efforts to make limited use of markets as a supplement to the plan, and undertake a partial opening to benefit from the modern technology, management skills, and production practices available in the world economy. This strategy is manifest in China's policies on banking, where China has in the wake of its WTO entry, introduced measures that would allow experienced and qualified overseas investors to have supervisory positions on the boards of many of China's top state-owned banks.

The main purpose of this chapter was to highlight the divergent competing interests in Russia and China, which are part and parcel of the transition into the WTO. Today, one of the most salient features of Russia's economic landscape is the continuing influence of oligarchs in the society, brought about by the manner in which shares of

²⁰⁶ Lin et al., 238.

industries were delved out. When comparing the viability of economic governance like that of China's for Russia, one must be mindful of these divergent concerns.