

**ECONOMIC SURVEY OF THE RUSSIAN FEDERATION 2006:**  
**EXPANDING STATE OWNERSHIP IN THE RUSSIAN FEDERATION**

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***The expansion of state ownership is disturbing***

The state's evolving economic role is not limited to the kind of renewed activism described above. Perhaps the most disturbing recent policy trend has been the on-going drive to expand the direct role of the state in "strategic" sectors such as power-generation equipment, aviation, oil and finance. Increasingly, policy seems to have been focused not on market reforms but on tightening the state's grip on the "commanding heights" of the economy. This bodes ill for Russia's growth prospects: a large body of research confirms that privately owned companies generally perform better than state-owned firms or those in mixed ownership, especially in sectors characterised by robust competition, and Russia is highly unlikely to prove an exception to this rule.<sup>1</sup> Indeed, the Russian state's track record when it comes to owning and operating businesses is very poor, not least because the contradictions and delays that afflict government decision-making processes in most spheres of policy also come to affect the corporate decision-making of the companies it controls.

The legal and political onslaught against the oil company Yukos has, of course, been the most visible and controversial sign of the shift towards greater state control. This is not the place for a detailed analysis of the Yukos case,<sup>2</sup> but no assessment of Russian economic performance over the recent past can overlook the damage wrought by the affair. To the extent that at least one apparent aim of the campaign against Yukos was to engineer a change in ownership, the attack on the company increased uncertainty about the security of property rights and thus created further disincentives to long-term investment.<sup>3</sup> Moreover, the case highlighted larger institutional weaknesses that are deep-rooted and affect even companies that face no risk of expropriation: the rule of law is still weak, and the scope for arbitrary official behaviour is great. Indeed, high-level pressure on Yukos appeared for a time to signal to the bureaucracy that it should adopt a more aggressive stance *vis-à-vis* business. While no other company found itself under the kind of pressure brought to bear on Yukos, late 2003 and 2004 saw many businesses under mounting official pressure: oil and telecoms companies were threatened with the loss of their licences, attempts were made to revive investigations into past privatisation deals and corporate restructurings, and the tax inspectorate became increasingly aggressive, in many cases reopening accounts for past years and revising its interpretation of particular regulations.

Nevertheless, although the short-term costs were substantial, the Yukos case need not do lasting harm to Russian performance. The government has been working to re-establish a degree of trust between business and the state. Legislation reducing the statute of limitations applied to privatisation deals from ten years to three should help make property rights more secure, and the government continues to work on measures to reduce the scope for arbitrary or abusive action by the tax inspectorate. However, progress has been slow, particularly with respect to tax administration, and there appears to be considerable resistance within the state administration to measures that might curb tax inspectors' powers or freedom of action.

Of far greater concern than the immediate impact of the Yukos affair on Russian growth is the broader trend towards greater state ownership and control that it exemplifies. There is no sign that this is being reversed. The expropriation of Yukos subsidiary Yuganskneftegaz in a court-ordered auction to settle tax debts in December 2004 was merely the most visible instance of a broader trend towards asset acquisition by the state itself and/or state-controlled companies, particularly Rosneft and Gazprom (Table 1.5).<sup>4</sup> While individual acquisitions have often been explained as "one-off" events dictated by the specific circumstances of a particular company or sector, the trend is now unmistakable and the overall scale of the expansion has been remarkable. According to one recent estimate, the state-owned share of Russia's equity market capitalisation rose from just 20% in mid-2003 to 30% in early 2006.<sup>5</sup> In 2003, state-controlled companies accounted for about 16.0% of crude production. By end-2005, that figure had reached 33.5%. On the assumption that just half of Yukos's remaining production assets end up in state ownership, it will approach 40%.<sup>6</sup> In many cases, moreover, state companies engaged in mergers and acquisitions (M&A) activity appear to be pursuing their own ends, even where these contravene government policy, and they are able use political, legal and regulatory pressure to enhance their bargaining power.

**Table 1.5. Major state acquisitions, 2004-06**

Company	Sector	Date	Mechanism
Guta Bank	Banking	August 2004	State-owned bank Vneshtorgbank purchases 85.8% stake with central bank support.
Mosenergo	Electric power	Summer-Autumn 2004	Gazprom raises its stake above "blocking" (25%+1) level.
Promstroibank St Petersburg	Banking	September 2004	Vneshtorgbank purchases a blocking (25%+1 share) stake.
Atomstroiekспорт	Nuclear construction	October 2004	Gazprom-controlled Gazprombank purchases 54% stake.
RAO UES	Electric power	Autumn 2004	Gazprom raises its stake to 10.5%
Tuapse oil refinery	Oil refining	December 2004	Rosneft purchases 40% from minority shareholders to take full control of the refinery.
Yuganskneftegaz	Oil and gas	December 2004	Rosneft purchases 76.8% stake from the firm OOO "Baikalfinansgrupp", the winner of a state-organised auction of Yuganskneftegaz shares to settle tax debts.
Tambeyneftegaz	Oil and gas	May 2005	Gazprombank purchases a 25% stake from Novatek.
Northgas	Oil and gas	June 2005	Gazprom regains control of independent gas producer Northgas, taking over a 51% stake following litigation.
<i>Izvestiya</i> (daily newspaper), <i>Chas pik</i> (weekly newspaper)	Media	June-September 2005	Gazprom-Media purchases control.
Gazprom	Oil and gas	July 2005	State-owned Rosneftegaz purchases 10.7% of Gazprom to raise state's direct stake in Gazprom above 50%.
Selkupneftegaz	Oil and gas	July 2005	Rosneft purchases 34% stake from independent gas producer Novatek.
Sibneft	Oil and gas	October 2005	State-owned gas monopoly OAO Gazprom buys 69.66% stake for \$13.1bn.
Verkhnechonskneftegaz	Oil and gas	October 2005	Rosneft purchases 25.9% stake from Interros Holding.
AvtoVAZ	Autos	October 2005	State arms export concern Rosoboronekспорт takes control over 62% and installs new management.
OMZ	Machine-building	November 2005	Gazprom-controlled Gazprombank purchases a 75% stake.
Ulan Ude Aviation Plant, Moscow Helicopter Plant, Kazan Helicopter Plant, Kamov Holding, Rosvertol, Moscow Machine-building Plant "Vpered", OAO "SMPP"	Aviation	2005	State-owned defence company Oboronprom takes control of these enterprises in the course of forming a single, state-controlled helicopter holding via the consolidation of shares already held by the state, purchase of additional shares and share swaps.
Power Machines ( <i>Silovye mashiny</i> )	Machine-building	December 2005	Electricity monopoly RAO UES purchases 22.4% stake, raising its stake above 25%, and acquires voting rights to another 30.4% until end-2007.
Udmurtneft	Oil	June 2006	Rosneft acquires a 51% stake from Sinopec after the latter buys 96.7% from TNK-BP for an estimated \$3.5bn.
Sibneftegaz	Gas	June 2006	Gazprombank purchases a 51% stake from Itera.
Novatek	Gas	June-July 2006	Gazprom purchases a 19.9% stake for a sum reportedly exceeding \$ 2bn.
VSMPO-Avisma	Titanium	September 2006	State arms export concern Rosoboronekспорт purchases 41% stake for an undisclosed sum.

Note: The table excludes acquisition of foreign assets by state-owned companies.

Source: OECD from various sources.

While a great many factors seem to have contributed to the expansion of state ownership in recent years, the explanation would appear to stem in part from the combination of highly concentrated ownership and a weak state. Russia's industrial structure is heavily tilted towards capital-intensive sectors with relatively high barriers to entry and exit, and a high degree of asset specificity – particularly resource-extraction sectors. Given such an industrial structure, Russia would probably have a fairly high concentration of ownership of industrial assets in any circumstances, but this concentration is even greater as a result of the flawed privatisation processes of the 1990s. The state thus finds itself faced with the need to govern an economy dominated by a small number of relatively large companies. Yet both the legal order in Russia and the state's administrative and regulatory capacities were and are weak. As Chaudhry (1993) and others have observed, a weak state may find it extremely difficult to manage relations with (and conflicts among) large, powerful private companies. It will be tempted to rely on direct control rather than contract, regulation and taxation. In the case of Russia, these incentives are probably all the greater precisely because, whatever its other weaknesses, the Russian state possesses very substantial coercive capacities, capacities that are arguably out of all proportion to any of its other capabilities. Nor is nationalisation the only purpose for which they are used: it is often a matter of private companies "voluntarily" undertaking social projects or infrastructure investment at the behest of the authorities,<sup>7</sup> or seeking informal approval of mergers, acquisitions and other major transactions in which the state is not a party at all. In some respects, such informal interference in commerce is worse than more formal interventions, as it involves less accountability and less transparency.

Ironically, the same institutional weaknesses that generate incentives to rely on direct control also undermine the state's ability to manage state-owned companies well. In weak institutional environments, the creation of large state companies is likely to be associated with high levels of opacity, corruption and rent-seeking by insiders, who will be tempted to run the companies for their own benefit and will face strong incentives to resist increased transparency and accountability. At issue, then, is not merely the question of state versus private ownership in general but the capacity of the state to efficiently manage large companies in technically complex sectors. The country's existing large state-owned companies are hardly models of good corporate governance,<sup>8</sup> and their performance suggests that expanded state ownership will result in poorer performance by the companies affected. The state tends to interfere in the day-to-day operations of the companies it owns (including those with substantial private shareholdings), often in a manner that confuses the state's ownership functions with its other functions, such as regulation or industrial policy. The boards of state-owned companies are often dominated by state representatives who have little competence in business-related matters, making effective oversight of management even more difficult, while the fact that state representatives on company boards are given voting instructions by the state contradicts their legal duty to act in the interests of all shareholders. Finally, it is important to recognise that the state's interference in company affairs frequently serves to distort markets and to create perverse incentives even for private companies operating in sectors dominated by state concerns.

To judge from public statements and official programmes, the authorities are aware of the risks which come with greater state involvement in business: Russia remains committed, in principle, at least, to a private property-based economy, and leading officials have explicitly rejected "state capitalism" as a model for Russia. Moreover, the growth of the state sector has coincided with efforts to improve the investment climate and with further progress in reducing the "bureaucratic burden" on small and medium enterprises, in particular. Yet the gap between rhetoric and action remains. State actions often contradict declared reform goals, and there does appear to be a constituency favouring a rather more *étatiste* and interventionist model.<sup>9</sup> While such an approach might have its attractions, it would not help over the long term. Russia certainly needs a strong state commitment to, and involvement in, its long-term economic strategy, but this involvement should not take the form of a "hands-on" approach relying on direct control over assets and intervention in markets.

## NOTES

1. Boardman and Vining (1995); on the Russian case, see Tompson (2002).
2. For a close look at the affair, see Tompson (2005).
3. Some senior officials continue to insist that the affair was simply a tax case. However, it is difficult to make sense of the authorities' handling of the case in such terms. Often, the state took steps that *reduced* the budget's potential gains from the case, and other aggressive tax "optimisers" in the sector were treated relatively well by the authorities. The recent discount of the tax liabilities of former Yukos subsidiary Yuganskneftegaz is a telling example in this context.
4. Table 1.5 covers acquisitions in finance and industry in 2004–05. It does not cover print and broadcast media, where a major expansion in direct and indirect state ownership took place in 2001–03.
5. Weafer and DePoy (2006). This refers only to the equity holdings of the state, as opposed to the value of the companies its controls, which would probably be much higher. However, the figure is influenced in part by the fact that a large portion of the state's shares are in oil and gas companies, the value of which rose sharply during the period in question.
6. These comparisons are based on 2003 production data; obviously, differences in the rate of production growth in 2004–05 have altered somewhat the relative shares of different companies in total output.
7. This is sometimes presented as a form of "corporate social responsibility".
8. OECD (2005b) finds that Russian state companies often perform poorly with respect to transparency and disclosure, particularly in respect of related-party transactions and on-going event disclosure.
9. Disturbingly, the authorities seem as inclined to intervene in cases of "market success" (such as the oil industry) as they are to address instances of "market failure".

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