Charity Registration Number: 208223

Russia and Eurasia 2013/04

How the Soviet Inheritance Holds Back Russia's Development

Andrew Wood

Chatham House

July 2013

The views expressed in this document are the sole responsibility of the author(s) and do not necessarily reflect the view of Chatham House, its staff, associates or Council. Chatham House is independent and owes no allegiance to any government or to any political body. It does not take institutional positions on policy issues. This document is issued on the understanding that if any extract is used, the author(s)/ speaker(s) and Chatham House should be credited, preferably with the date of the publication or details of the event. Where this document refers to or reports statements made by speakers at an event every effort has been made to provide a fair representation of their views and opinions, but the ultimate responsibility for accuracy lies with this document's author(s). The published text of speeches and presentations may differ from delivery.

INTRODUCTION

Russia's problems are by no means entirely the making of its post-Communist leaders. Relatively few of them can be pinned at the door of the West either, as current Russian leaders are wont to do. In discussions of Russia's economic prospects, observers tend to neglect one important constraint: the country's dependence on its economic inheritance from the Soviet Union. Russia's economy recovered its dynamism after the financial crisis of 1998 thanks in large part to a sustained leap in energy prices, but also to its consequent ability to exploit its wider Soviet economic inheritance. Moving on from that now will prove increasingly problematic, however. Failure to do so will be dangerous.

This paper covers five specific Soviet legacies and two broader ones which Russia has had bequeathed and which hold it back. It was not inevitable that they should do so but mismanagement, greed and over-ambition have ensured that they do.

THE ENERGY SECTOR

Much has been written about the role of Russia's oil and gas in its development. The facts can be simply stated as follows:

- An inflated Russian state budget is dependent on (a) the price of oil remaining high and (b) oil and gas production and exports increasing;
- Whatever the price, maintaining production, let alone increasing it, will require substantial new long-term investments as Soviet-inherited assets decline;
- The world market for gas, and potentially for oil, has altered profoundly, and not necessarily to Russia's advantage; and
- Russia's oil and gas companies have not yet shown how they will change to meet these challenges and nor has the Russian state.

There was boastful talk during the last decade of Russia's decisive oil and gas power. One could as easily speak now of a once aspiring hegemon becoming the market's prisoner. The Russian state has become increasingly dependent on its oil and gas sector, and on its natural resources more widely. It is therefore at risk from changeable prices. The necessary development of new fields will be expensive and will take time; and investor trust will need to be developed.

Russia's coal sector is not in the same bind as the oil and gas one, and is less subject to politically directed expenditure. Changes in the energy market affect it too, but the pace of technological progress is currently less for coal than it is for oil or gas. Nuclear energy is managed secretively, and its prospects and current state are the harder to judge for that. It has been singled out (along with space, civil aviation and pharmaceuticals) by the Russian government as a priority area for the development and diversification of the economy, as well as for export earnings. Rosatom's CEO announced in June 2013 that his corporation had secured a rise of 60 per cent in export contracts over the previous two years.² The government's Energy Strategy to 2030, published in 2009, included ambitious plans for the development of new nuclear plants, in part to replace domestic gas consumption in the power industry, thus liberating more gas for export.³ The evidence to date would seem to indicate, however, that the nuclear industry is largely built upon the Soviet inheritance rather than on new products or ideas. In any event, Russia's domestic nuclear capacity, according to official statistics, has been increasing only very slowly.

-

¹ See, for instance, Thane Gustafson, *Wheel of Fortune: The Battle for Oil and Power in Russia* (Harvard University Press, 2012) or *Scenarios for the Russian Federation*, World Economic Forum, January 2013. http://www3.weforum.org/docs/WEF_Scenarios_RussianFederation_Report_2013.pdf.

^{2 &#}x27;Rosatom Bucking Nuclear Trend to the Tune of \$66.5Bln', *Moscow Times*, 20 June 2013. http://www.themoscowtimes.com/business/article/rosatom-bucking-nuclear-trend-to-the-tune-of-665bln/482015.html. 3 *Energy Strategy of Russia up to the Period 2030*, 13 November 2009, http://www.energystrategy.ru/projects/docs/ES-2030_%28Eng%29.pdf.

INFRASTRUCTURE

Ports, roads, railways and other transport networks take time to decay, which is why governments hungry for money neglect capital investment. The same goes for housing, water management, health and education, for example. Russia is no exception in this. Much of its infrastructure, moreover, was built to serve a different economy where spending was subject to government fiat and political – especially military – interests, and where the borders were different too. The need for comprehensive renewal has become increasingly evident – and so has its cost.

In terms of infrastructure investment today, who would pay for what, who would answer for the results, and how priorities would be established are all unclear. What is clear, however, is that a lot has been spent on, for instance, roads and the railways without significant result. The Russian network is little changed. As Vladislav Inozemtsev has recently pointed out, railways in Russia, despite their unprecedented ineffectiveness, are one of the main recipients of state subsidies.⁴ Vladimir Yakunin, the Chairman of Russian Railways, has been subjected to criticism but has so far at least been able to rely on Vladimir Putin to retain his position. The president told the St Petersburg Economic Forum on 21 June 2013 that the Russian government had decided to spend 450 billion roubles (\$13.6 billion) on a variety of transport projects, notably a high-speed railway between Moscow and Kazan, an expansion of the Trans-Siberian railway, and a multi-lane outer ring road around Moscow. The National Welfare Fund would make a substantial contribution to these projects and other domestic investments.⁵ It is not clear if this is in addition to the 20 trillion roubles (\$630 billion) by 2020 apparently earlier earmarked for the construction and repair of roads, ports and airports – with regional governments remaining responsible for local roads – or to the further 20 trillion roubles apparently already envisaged for putting the railway system in order.

Despite regular promises of remedial action, Russia's housing stock, health system and education are also in difficulty with their principal foundation – the Soviet inheritance – on life support. The regime's predilection for huge projects that use up vast amounts of money and overrun on costs do not produce the benefits claimed.

THE GOVERNMENT MACHINE

Rehabilitating, reorienting and building up Russia's infrastructure will require money, a consistent long-term strategy with clear priorities, a set of coordinated and accountable executors, and the understanding of the Russian public. In so far as foreign investment may be required, that too would have to be managed appropriately. The record to date suggests that none of these can be relied upon. The budget is under strain, and the competition for spending on social purposes, including from the military, looks set to remain considerable. According to World Bank figures, expenditure on the Russian civil service has grown to be five times as much in 2010 as it was in 2002, and there has been an increase of 44 per cent in the overall numbers employed, a rise concentrated at the federal level.⁶ There is room for discussion about who should be considered a civil servant, but the trend is undeniable. No one appears to argue that the result has been increased efficiency or coordination.

ELECTRICITY GENERATION

The last consistent effort to manage strategic reform of Russia's infrastructure was the hard-fought attempt to set up a market-oriented power sector in place of the state-wide – and crumbling – state corporation that used to manage it, RAO-UES. That effort needed the powerful, committed and able Anatoly Chubais to drive it through, against determined opposition. Results have been mixed, with particular interests (Gazprom and Rusal, for instance) seizing control of particular generating companies, and the initial hopes of foreign investors on the whole being disappointed. E.ON, Enel

⁴ Vladislav Inozemtsev, Vozdukkh protiv relsa (Air versus rail), Vedomosti, 11 June 2013, p. 6.

⁵ St Petersburg International Economic Forum, plenary session, 21 June 2013, http://eng.kremlin.ru/news/5626.

⁶ Scenarios for the Russian Federation.

and Fortum each got control of one or two generating companies, but subsequent policies, including on price controls, have weakened incentives for investing in upgraded capacity. The experience suggests that even articulate sectoral planning may not be enough. The Soviet tradition of top-down planning informed by hope lives on but is confronted by reality, and repeated promises of action to remedy failings in the infrastructure have failed to create steady improvement.

THE MILITARY

Putin and, it would appear, Dmitry Medvedev are committed to greatly increased spending on defence, with yet another 20 trillion roubles earmarked from the budget, this time to be spent on new military hardware in 2012–20 for modernizing the Russian armed forces. The President maintains that the technological benefits from this will profitably work their way through to the civilian economy.

There is certainly a case for updating the capabilities of the Russian military. It is questionable whether the reforms begun under the now-disgraced former defence minister, Anatoliy Serdyukov, which cut across the interests of senior officers, will be completed under his successor Sergei Shoigu. The scale of re-equipment ought to be based on the proposed future shape of the armed forces. There has also been a dispute as to how much should be imported and how much should be made under licence. There is a substantial lobby for Russian manufacture, whether or not its products are up to contemporary standards, with Putin's favour for military vehicle producer Uralvagonzavod, which makes tanks the Ministry of Defence would rather not have as an example.

The defence sector is a particular instance of the problems facing the Soviet-bequeathed manufacturing sector as a whole, heightened by the neglect it has suffered over decades. It needed to shrink after its excessive build-up in Soviet times, but did so in an unplanned way that left it with a considerable number of enterprises that somehow survived neglect but were in effect bankrupt. The idea that Russian arms exports should continue to be a potent factor for growth retains its hold on the political imagination. But the fact is that the overseas market for Russian arms is under pressure as their sophistication and quality declines. Arms exports are not shown in the trade data but, according to one source, income from them rose by 12 per cent to \$15.2 billion last year. However, the level of dissatisfaction publicly expressed by some customers is indicative of underlying problems. The record also shows that past sales were not in the end fully paid for by some of Russia's clients: Venezuela has a significant balance to settle.

The twin problems of obsolesence and the avoidance of creative destruction are compounded for the defence sector by an obsession with secrecy and by pervasive corruption. Greater direction from the top is the favoured but ineffective impulse of the senior levels of the Russian administration. As is often the case with governmental structures set up under a highly personalized system, the result is not central control but chaotic competition beneath the apparent arbiter. The Ministry of Defence has complained for years about procuring what it wants from its suppliers at a cost that it can afford. Placing defence giant Rosoboronexport under Sergey Chemezov's direction in an effort to improve its performance has not significantly reduced the range of bankrupt firms under its shelter. Deputy Prime Minister Dmitry Rogozin's responsibilities for defence procurement will add to the confusion as to who is really in charge of what. The establishment of his Foundation for Advanced Research – modelled, it is claimed, on a US analogue – is surely unreal in its ambitions. Merging individual enterprises to make larger ones operating in the same sort of field will not be enough to conjure invention out of an ageing and probably by now apathetic cadre of experts.

The defence sector depends for its effectiveness, as do other sectors of the Russian economy, on having a flexible array of enterprises able to supply it with a changing range of components – a theme addressed below.

_

^{7 &#}x27;Russian Defence Ministry Signs \$23Bln in Arms Deals,' *RIA Novosti*, 24 June 2013. http://en.rian.ru/military_news/20130624/181841423/Russian-Defense-Ministry-Signs-23-Bln-in-Arms-Deals.html. 8 Meeting of the Commission for Military Technology Cooperation with Foreign Countries, 3 April 2013. http://eng.kremlin.ru/transcripts/5209.

INSTITUTIONAL CHANGE

No analysis of the prospects for Russia and its future prosperity omits to say that the outlook is bleak without institutional change. The rule of law, transparency and accountability are all favourite prescriptions. Their exact meaning is debatable, but the sentiment is clear. Bringing them about is another matter. What law? The thicket of contradictory and imprecise law surviving from Soviet days and further complicated since is an obstacle to consistent obedience and a trap for the unwary. So it must be a higher concept of justice that is to rule. Is there a Russian sense of this that differs from the norm? Transparency to whom? Accountability to whom? Where do the regions fit in?

The prospects for Russia beginning to move in the direction of institutional change that would make its ruling group genuinely accountable to the country look remote at present. Popular trust in the rulers and those who are charged with implementing their purposes is minimal. Yet fear of change is powerful too. To that extent questions as to the meaning of benign institutional change are academic. But it is also the case that there is a certain dynamic that underlies the need for such an evolution, and that doubts as to the future inhibit investment. The sense that the ground may shift under their feet is part of the reason for the defensive, even reactionary, attitudes of those in the ruling group, and for their fear lest economic difficulties provoke social unrest.

THE WIDER SOVIET INHERITANCE

Russia emerged from the break-up of the Soviet Union as the command economy collapsed with too many enterprises (for want of a better word) already in place. Refitting them to a new order of things has been problematic.

The story that has taken hold, namely that the transformations of the 1990s were forced through by the theft of state assets by ruthless bandits, is emotionally satisfying but misleading. It has encouraged a widespread belief at home and abroad that wealth in Russia can only have been stolen, and can never be legitimate. The underlying assumption that the emerging private sector was and is unjust was nurtured by the Duma majority during Boris Yeltsin's presidency, at least until the government headed by Prime Minister Yevgeny Primakov found itself having to deal with the 1998 crisis and its aftermath. It has been kept alive since Putin came to power in 2000.

The point is not that what happened in the 1990s was clear, clean or orderly, but that something like it had in any case become inevitable. The rot set in under Soviet rule, when the impending collapse of the command economy entailed the impending collapse of state ownership. Property was becoming ownerless, and the planning system that had regulated the interaction between enterprises in the place of market-driven prices was becoming redundant. Those in charge of existing assets did their best under Mikhail Gorbachev to assume control of them, with varying success. Their legitimacy was no clearer than those who took over under Yeltsin. The disintegration of the USSR completed the destruction of the previous system in 1991–92. It is not surprising that replacing it was so difficult.

Enterprises that either retained a strong link with the state, like Gazprom, or that were quietly transformed into independent bodies from existing state institutions, such as Lukoil, Surgutneftegaz or Severstal, were more easily accepted than enterprises apparently conjured out of nothing by prominent oligarchs through banks that mushroomed or through voucher privatization. The oligarchs were personified by the 'loans for shares' deal, and the boasts of some of their new executives, to say nothing of their mutual quarrelling. It is arguable that the 'oligarchs' who became magnets for hatred were no worse than their more discreet colleagues who morphed from state backgrounds. In the absence of anything resembling a stock market, or of understanding of its possible role in either spreading ownership or facilitating structural changes, and given the disappearance of Soviet-era personal savings that accompanied the whole process, it was probably inevitable that a poorly explained and messily implemented change should have left a scar that time has not healed. Putin has found it convenient from time to time to irritate that scar when speaking of the first generation of 'oligarchs'.

The initial hope was that market forces would over time improve the efficiency of Russian enterprises, including by ensuring that inefficient proprietors would find themselves driven out by competitors. That process has been partial, at best, and vitiated by violence and a corrupted judiciary. There have been improvements in corporate governance, and in the banking system. In some sectors where there was little or no Soviet inheritance to begin with, some competitive firms have developed, such as Yandex and Kaspersky Lab in IT, X5 in retailing or Vimpelcom and others in mobile telephony. But most of the mechanisms that allow companies in Western countries to conduct accepted and effective market operations are at best weak in Russia. These include widespread share ownership; independent funds managing, for instance, insurance, pensions or mortgage interests; a developed or even dominant cast of managers reporting to autonomous boards; respect for minority shareholdings; a fully independent banking system; and a free and investigative press. These weaknesses, along with the flaws of the Russian legal system and the predatory instincts of the bureaucracy, have compromised what might otherwise have been a more effective process of renewal and restructuring, including necessary adaptation through the creative destruction of the inefficient, let alone the unviable.

The legacy of the Soviet penchant for large-scale enterprises, and for housing and other necessary social services to be set up in dependence on them, has further inhibited the economy's development. Even if the planning for these Soviet-era complexes had been perfect, there would have been difficulties in adjusting them to changes in demand for their products. Labour mobility is a general problem and one that particularly affects the so-called mono-towns, which are dependent on a single employer. Such towns run into the hundreds. Even cities less drastically dependent on a particular employer have the analogous problem of hosting a large enterprise with a substantial labour force attached to it that has had difficulty in adjusting to new requirements. The pressures on enterprises producing, for instance, combine harvesters in Rostov-on-Don or turbines in Perm illustrate the point.

No country has a perfectly functioning market economy, and such a thing may not even exist in its theoretically pure form. Russian governments have not been alone in preferring to put off difficult decisions as long as they can, including during the 2008–09 crisis. Putin has not been alone in putting the most optimistic gloss he can on his country's prospects. Russia's natural resources bonanza, coupled with its success during Putin's first two terms in bringing enough of its Soviet inheritance back into production, fuelled impressive growth rates until 2008–09. But there was a penalty: structural reforms that might have begun to address the underlying problems in the way of sustained future diversified growth were set to one side. They are harder to face now, while the need to do so is becoming clearer.

The talk of privatizations now is ambivalent, but does not seem to imply much more than state companies raising investment funds through the sale of minority shareholdings. The new draft privatization plan for 2014–16 would, unlike the previous plan, leave the state with majority stakes in Rosneft, Rusgidro, Transneft, Zarubezhneft, RZhD and VTB, and golden shares in the likes of Alrosa, Rostelekom and Aeroflot, but would still sell off Inter RAO and Sovkomflot completely – in principle. Big enterprises remain dominant, start-ups difficult, and long-term fixed capital investment disappointing. The record does not support the idea that the mega-projects that the government wishes to pursue will generate wider opportunities. The recent decline in the officially recorded number of small and medium-sized enterprises (SMEs) in Russia may prove to have been caused by a retreat into the grey economy by some of them, but even so there is no sign of the strengthening of the SME sector that would be needed to underpin growing and urgently needed flexibility in the Russian economy.

WHAT NEXT?

The underlying theme of all the above is the question of how far Russia can deal with the obsolesence of a great part of its Soviet inheritance. The answer until 2008 – when that inheritance was already growing thin – was that the energy and natural resources dividends were such as to build domestic demand and that this would allow for incremental change in the economy, diversifying it and modernizing it. That did not happen over a broad enough range to be a self-sustaining process, but there was enough wealth generated to raise popular expectations – and to

fuel establishment fears of what might happen as and when these were disappointed. Long-term progress towards change depends on a degree of trust between rulers and ruled. This is now greatly eroded and it is hard to see how it will be restored.

Putin's pre-electoral promises were an attempt to address this problem. Since his return to the Kremlin, however, the accent has been on preserving the status quo, the cultivation of the conservative and state-dependent vote, and the repression of perceived enemies. He has criticized his government for not making progress on implementing his promises, but paid Medvedev scant respect. Putin's proposals lack effective content. He appears to ignore the extensive efforts made by various institutions and groupings during Medvedev's presidency to address the diversification and modernization issues, including the group Putin himself called into being to revise the '2020 Strategy'. The thrust of Putin's approach so far remains to see the state and its favoured agents as the most effective instrument in managing and developing Russia's economy. His acknowledgment in June of forthcoming strains on the budget was of a piece with that philosophy. So was what he said to the St Petersburg Economic Forum a few days later.

The fear of change and the deep-rooted belief that Russia must be managed from the top down are also constituent parts of Russia's Soviet inheritance. The present administration seems paralysed in its fear of the social and political consequences of economic reform. Perhaps Putin and the ruling group around him understand that any attempt to work for effective changes would entail political shifts, and they simply hope that somehow continued reliance on rents from natural resources will be enough to see them through until the economy in some way diversifies itself. Certainly, nothing has been done to prepare Russia and the Russian people for the sort of shake-up that would enable them to move beyond their Soviet inheritance. On the contrary, the debate that at least began during the Medvedev presidential term has been suppressed. The present outlook suggests muddling down, not muddling through to the success that Russia could have under braver and more disinterested rule.

ABOUT THE AUTHOR

Andrew Wood is an Associate Fellow of the Russia and Eurasia Programme at Chatham House and author of the Chatham House Report *Putin Again: Implications for Russia and the West* (with Philip Hanson, James Nixey and Lilia Shevtsova), *Change or Decay: Russia's Dilemma and the West's Response* (with Lilia Shevtsova) and a 2011 paper for Chatham House on *Russia's Business Diplomacy*. He is a consultant to a number of companies with an interest in Russia. He was British ambassador to Russia from 1995 to 2000.

⁹ Darya Korsunskaya and Douglas Busvine 'Russia can't raise state spending forever - Putin', Reuters, 13 June 2013, http://www.reuters.com/article/2013/06/13/russia-budget-idUSL5N0EP18T20130613.