

# Does Russia take Internal Challenges to its Security Seriously Enough? The Case of Economic

Written by Justa Hopma

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## Does Russia take Internal Challenges to its Security Seriously Enough? The Case of Economic Instability

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JUSTA HOPMA, AUG 27 2008

Economics hold an important place in Western liberal democracies, if not the most important place. However, a society's well being entails more than economic prosperity. After the collapse of the Soviet Union Russia was nearly bankrupt, but experienced an economic revival over the following decade. An average GDP growth rate of 7% was maintained over the period 2001-2003[1]. However, this growth was mainly attributable to easy profit after the devaluation of the ruble, temporary high world market prices for oil and an import substitution effect. The Russian economy therefore proved highly susceptible to external influences and still no easy prediction about future performance can be made. President Putin's economic policy is as yet successful but statistical analysis alone cannot provide a satisfactory answer to the question of whether economic security is being taken seriously enough. Issues of WTO accession, widespread internal corruption and the question of sustainability of growth loom over the prospects for economic stability. In order to construct a comprehensive view of the economic climate in Russia, it is necessary to look beyond growth rates and other data. The simple question of 'which policy steps does the Russian government take and why' results in a much more complete view of Russian economic stability. However, a Western understanding of the ultimate meaning of economic stability may differ from a Russian policy maker's point of view. Vladimir Putin conducts a successful economic policy and takes internal challenges to economic stability seriously, even though certain key economic issues are not prioritized. The Russian President realizes that liberalization and cooperation with the West and Asia are a 'sine qua non': an essential condition, *not* for eventual integration in the world economy but for a return to Russian *derzhavnost*.

Numerous factors affect economic stability in Russia, including sustainability of growth: Will Russia be able to maintain and fortify the foundations of its economic revival? ; Business climate: the Russian government needs to develop the legal system when it concerns taxation and property rights. It also needs to create encouraging conditions for both foreign and domestic investment. The first is necessary as a catalyst for growth and the second to prevent capital outflow. In all these areas corruption is pervasive, which poses a major threat to stability as it affects both the state's actual ability for successful revival and people's confidence in the state.

In addressing these problems I will focus on the Russian energy sector and the Energy Charter Treaty (ECT) in particular. These issues reflect Russia's struggle with liberalization, necessary for increasing revenues and sustaining growth. The Russian government's handling of ECT negotiations also shows similarities with WTO accession talks and is indicative of a remaining sense of Russian exclusivism.

Next I will discuss the business environment and focus on property rights and state ownership. The former because it is the main disincentive for foreign investors and the latter because it explains Russia's economic identity i.e. the way the Russian government understands relations between business and the state. I will look at the issue of corruption throughout the entire discussion as it arguably poses the biggest threat to Russian economic stability.

Before discussing the issues above, I will first analyse government discourse in order to determine whether economic challenges are recognized by the Russian government itself and form an issue at all.

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## Government Discourse

Over the course of 2001-2006 official Russian government documents repeatedly claim the economy to be a priority issue. After strengthening the Russian state, 'stable economic development is a prerequisite for all other national interests'.<sup>[2]</sup> In 2003 Putin specifically states that 'over the next decade Russians must at least double our country's gross domestic product' and 'only economic growth can provide a genuinely reliable foundation for long-term solutions to social problems'.<sup>[3]</sup> In 2004 he says: 'We must be ahead of other countries in our growth rate, in the quality of our goods and services and level of our education, science and culture. This is a question of our economic survival'.<sup>[4]</sup>

Taxation issues were recognized as early as 2000 and were seen as a very serious problem, hence the topic was mentioned in all subsequent annual speeches. Throughout all annual speeches the government expressed its will to introduce a single income tax rate, weaken the tax burden, fight tax avoidance and simplify the collection system. The President stressed the importance of a stable tax policy and underlined the stimulating effect of a sound taxation system upon growth and competitiveness in the business arena.<sup>[5]</sup>

Apart from economic growth and taxation, the Russian government repeatedly addresses two other key issues: gas and oil regulations and the business environment in Russia as such. During the opening address of the 2006 G8 summit, the Russian minister of Industry and Energy pointed out that 'market approaches are necessary to answer the challenges of energy security' and 'market-driven price formations' should be realized.<sup>[6]</sup> Putin also explained that 'Russians must understand that the gas industry should function in normal market conditions and gas must have a real price which does not considerably differ from foreign prices'<sup>[7]</sup>. In addition to market regulation, the government committed itself in both its foreign policy and national security concept to the creation of a friendly business environment: 'Russia shall actively work to attract foreign investments' and 'a key task is to create favorable conditions for the international integration of the Russian economy'.<sup>[8]</sup> In 2006 however, the minister of Natural Resources Yuri Trutnev, articulated a dissenting voice in stating that 'Russia will further confine cooperation with foreign investors in developing oil and gas fields.'<sup>[9]</sup> Has the Russian stance concerning the nature of its business environment changed or were earlier statements mere wordplay? Official discourse over 2006 reflects increased skepticism and more severe regulations towards foreign investment.<sup>[10]</sup>

Overall, the Russian government seems to take challenges to its economic security seriously. Not only in words, the Putin administration has backed up its rhetoric with actions. During 2000-2002 the government has pursued tax reforms that resulted in a unified social tax, flat tax instead of a proportionate rates and a general decrease in the number of taxes. On the government's side, collected tax used to be divided over three funds, but is now assembled in one fund: the treasury.<sup>[11]</sup> A tax reduction for fixed investment was also implemented in 2002, which resulted in some recovery of the investment climate. These tax reforms not only simplified the system, but also increased total revenue and formed a disincentive for tax evasion. Apparently, a flat tax encourages people to report their possessions more accurately as opposed to when a proportionate rate is applied. Besides, the simplification of the system annulled several legal options for tax evasion and made tax avoidance more costly in comparison to compliance due to overall lower rates.<sup>[12]</sup>

Additionally, a stabilization fund was created: budget surpluses are collected, which function as a buffer for oscillations in the country's balance of payments. The aim is to decrease Russia's economic vulnerability to external influences.<sup>[13]</sup> Furthermore, minimum wages were raised in stages over the course of 2000-2006.<sup>[14]</sup>

Thus, the government addressed both the sustainability of economic growth and the quality of the economic climate. It has enforced the rule of law and strengthened the state on a durable basis. All these measures contribute to economic stability and prove a commitment to it. Despite these actions however, problems remain mainly in the energy and business sector.

## The Energy Sector

Both the Russian gas and oil sectors cause controversy on almost a daily basis. The discussion below is limited to

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the gas sector, since this area touches upon more topics relevant to the essay question and a discussion of the situation in the Caspian Basin is beyond the essay's word limit.

The gas sector accounts for Russia's greatest source of export earnings[15] but the sector is in a critical state. Over the past decade management focused on profit maximization and not on the development of new gas fields. The leading company, state-controlled Gazprom, maintains a dual pricing policy in which households are distinguished from industrial and foreign consumers. European consumers for example, pay six times as much as domestic ones.[16]

The Energy Charter Treaty is an initiative aimed at the integration of European and Russian energy systems that could correct these distortions. Its main provisions deal with the elimination of commercial obstacles and the protection of investment.[17] Both parties have a direct interest: Europe seeks new gas suppliers due to a growing need for energy while its energy resources are in decline. Russia needs a secure export market; Europe pays, in contradiction to former Soviet countries such as the Ukraine that lets its debt amount to billions of dollars[18]. The agreement however could be significant in a broader sense: 'the commercial relationship may well change into a long-term strategic partnership', according to John Faull.[19] Irrespective of these prospects, Russia maintains that the Charter is unfavorable to Russian interests and demands amendments to the Transit Protocol in particular. It would also like to see the nuclear energy issue included, as future EU expansion may harm Russian nuclear energy markets.[20] As of October 2006 the Treaty is not ratified, which makes one wonder 'Does Russia really need Europe?'. In the end, Russia could look East for new markets. China's energy consumption continues to expand and President Putin has already mentioned plans for creating an 'energy bridge' to China, Japan and the Koreans.[21] On a larger scale, this standpoint calls into question Russia's motivation behind economic development.

Bobo Lo provides a good explanation of Russia's new, more assertive approach in economic relationships.[22] The current government recognizes the catalyst working of certain economic challenges, such as the operation of market prices or WTO accession. At the same time the government maintains a 'national priority' approach, in which such powerful change may not be desirable. Two key issues are behind this problem: firstly, there is no consensus in the Russian government on whether reforms have to be fast, accompanied by sacrifices, or slow. Secondly, there is no clear understanding of what economic integration means for Russia or what its purpose is. From a historical point of view, Russia always enjoyed great autonomy and now continues to perceive itself as a stand-alone power.[23] Exclusivist behaviour however, is not well received in relation to ECT ratification and WTO accession. 'It appears that Russia wants national treatment for the establishment of its companies abroad, but seems unprepared to extend the same privilege to foreign firms looking for operations in Russia'.[24] Likewise, Russia expects the WTO to make concessions in its accession requirements.[25] Contemporary events however may require Russia to change its view on the world, and itself.

## The Business Climate

Other challenges to economic stability are represented in Russian business culture and include the following: the protection of (intellectual) property rights, restrictions on Production Sharing Agreements, enforcement of legislation, revocations of earlier decrees, a weak banking system.[26]

According to McCauley, a sound legal system distinguishes prosperous capitalist countries from failing ones.[27] Property rights are not well established in Russia, which opens up opportunities for widespread corruption that results in a loss of 125bn pounds a year.[28] The government has formed an anti-bureaucracy commission[29], adopted several measures to eliminate ineffective regulation and continues to attempt and reform its licensing system. However, reorganization is slow and encounters fierce opposition because people's incomes are at stake. In addition, the dual pricing strategy as described above provides government officials with an easy chance to make money: on paper gas could be sold to Moscow oblast, whereas in reality it is sold to Georgia. Current penalties are not severe enough to deter these practices and even if they would, legal enforcement is still developing and prone to corruption.[30]

Production Sharing Agreements are a favourite method for investment in natural resources, because they share the

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high risks. Initial PSA legislation facilitated investment, but a 2003 amendment restricted future possibilities for the PSA method.[31] Such changes in legislation directly harm ongoing projects and also aggravate the sense of uncertainty in the business climate at large. Foreign direct investment (FDI) in Russia received a boost in 2003 after the TNK/BP [32] merger. The link-up formed the largest multinational company in Russia. It reflected an improvement in the business climate, since the government allowed a foreign company a 50% share in ownership. Then the YUKOS affair unfolded: a legal and political campaign by the state against one of the world's largest oil companies. The state persecuted the company and its shareholders for actions it previously approved of and charged the firm with tax evasion.[33] In 2006 YUKOS was declared bankrupt; unsurprisingly, the attack set off the positive effect on the business climate of the TNK/BP merger and caused yet more uncertainty.

Historically, Russia has been a country of political instability. This inspired mistrust in government and hence the banking sector, as they were integrated. Currently, the banking system is weak because it is obscure, ineffective and has limited capacity; during 2004 the sector experienced a period of liquidity shortage in which people couldn't possess over their money.[34] International Accounting Standards are not applied and rules of corporate governance i.e. business ethics, are not adhered to. The lack of regulations causes intransparency and encourages capital outflow which contributes to the deterioration of the business climate and hence Russia's ability to sustain growth.[35]

Another illustrative shift in ownership occurred in 2005 when Russia's most valuable oil and gas companies, state-controlled Gazprom and state-owned Rosneft were merged. In doing so, the state secured control over the Russian gas market: the merger increased the government's stake in Gazprom from 38% to 51%.[36] Normally, mergers occur to increase efficiency, but Gazprom is not known for its effectiveness: over 2004 staff costs increased by 30%, while its net revenue only increased by 24,2%.[37] Privately owned companies demonstrate larger profits.[38] Therefore, large state presence in the gas market reduces competition and total revenue of the sector as a whole.

Why does the Russian government maintain such close relationships between business and the state? Several government officials are known to be on the boards of major companies. Despite the President's affirmation of these officials' non-interference with business, they merely *represent* the interest of the state,[39] it seems to be a consolidation of Putin's *power vertical* : a line of power that ultimately leads back to the president himself.[40] Nonetheless, this 'incestuous relationship between business and the state' is seen to be the main obstacle to a normal market economy as perceived by Western businessmen and scholars.[41] A possible explanation is that in the 1990's, Russia saw a small number of people reap the benefits of privatization, which in retrospect was seen as stealing from the state. National resources were exhausted in order to increase private wealth.[42] As such, Russia's first encounter with capitalism proved a struggle. By controlling the majority of the nation's most valuable resources, the Russian government can prevent this from happening. Alternatively, the Putin Administration might just not believe that market economics as practiced in the West, are the way forward for Russia. If so, Russian business culture is and will evolve differently from Western business culture.

## Conclusion

As demonstrated in the first part of this essay, Russia takes its internal security seriously in word and deed but challenges to economic stability remain. Issues however are not always addressed congruent with Western economic logic and not always dealt with as quickly would be expected of 'priority issues'. The state actions concerning ownership and control outlined in part two illustrate that Vladimir Putin and his government have not embraced liberal market economics as a goal *per se*, but merely as a means to an end. Economic integration in the true sense of the word is therefore not a priority. Russia experiences a period of revival and redefinition; the country is in search of a new identity. Must Russia decide on its new identity now in order to progress, or can it ignore external pressure and pursue its goals at its own pace? Economic potential in form of natural resources never lost its 'great power' and precisely these resources provide a new Russia with a *chance* to shape itself in the image of its great predecessor. However, the country has a long way to go and further research on the nature of the relation between business and the Russian state would be useful. Further study could inform whether there is an ideal business-state relationship in post-soviet countries, or whether various successful models that guarantee economic progress exist.

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*Written by: Justa Hopma  
Written at: Aberystwyth University  
Date written: 2006*