Policy Choices of the Post-Soviet States Regarding Foreign Direct Investment in the Key Sectors of their Economies: the Experience of Kazakhstan, Russia, and Ukraine

by Olga Kesarchuk

A thesis submitted in conformity with the requirements for the degree of doctor in Political Science

Department of Political Science

University of Toronto

© Copyright by Olga Kesarchuk 2015
Policy Choices of the Post-Soviet States Regarding Foreign Direct Investment in the Key Sectors of their Economies: the Experience of Kazakhstan, Russia, and Ukraine

Olga Kesarchuk

Doctoral Degree in Political Science

Political Science Department
University of Toronto
2015

Abstract

Why did some post-Soviet states open up their key economic sectors to Foreign Direct Investment (FDI) while others did not? This dissertation argues that the levels of FDI were a result of conscious policy choices rather than ability or inability of the post-Soviet states to create positive investment climate. It explains why Kazakhstan, Russia, and Ukraine made different policy choices regarding FDI into their oil and gas, and metallurgy and mining sectors despite similar sectoral composition of their economies and common past as part of the Soviet Union. I argue that these policy choices were political. The state officials made their policy choices under the influence of two main factors.

The first factor was whether or not they believed they could develop a sector exclusively through the use of national resources, with the help of domestic state and private actors. The state
of the sector's development during the Soviet era heavily influenced this perception. After the collapse of the USSR, all sectors across all republics needed capital and technologies to maintain production, yet needed them to a different extent. The second factor influencing FDI policy choices was the strategy of power maintenance that political regimes chose and, more specifically, the different political roles they ascribed to different sectors. Sectors with their assets became highly material forms of power that were used by the regimes toward attainment of these three goals.
Acknowledgements

The best part about producing this thesis has been meeting all the wonderful people through affiliation with the Department of Political Science and the wider University of Toronto community. This is a good opportunity to thank all of them for all their friendship and support.

In the first turn, I would like to thank my supervisor, Professor Antoinette Handley. I do not think I will ever be able to thank her enough for all support, encouragement, patience, and feedback I have received from her. I would also like to thank my committee members, Professors Peter Solomon and Professor Edward Schatz for all the support and guidance they have given me over the years. Professor Lucan Way provided valuable feedback on the earlier draft of this work. I would also like to thank Professors Paul Kingston and Peter Rutland for giving me a lot of suggestions on polishing the text of this dissertation in the future.

Daniella Levy-Pinto, Sude Beltan, and Kate Korycki provided that daily encouragement you need in order to get through the program that lasts nearly a decade. Thank you for sharing all the joys and disappointments and providing a shoulder to lean on. You have been fantastic friends!

I would also like to say “thank you” to all my wonderful colleagues and friends from the Political Science Department: Suzanne Hindmarch, Kristin Cavoukian, Zack Taylor, Sanjay Jeram, Isabelle Cote, Victor Gomez, Erica Petkov, Yi-Chun Chien, Svetlana Inkina, Elinor Bray-Collins, Melissa Levin, Safiyyah Ally, Ozlem Aslan, Begum Ozun, Dragana Bodruzic, Alexandre Pelletier, Mihaela Mihai, Karlo Basta, Heather Bastedo, Ann Staver, Anna Gradek, Filiz Tutku Aydin, Ethel Tungohan, Noaman Ali, Seung Hyok Lee, Olga Klymenko, Emily Scott, Igor Shoikhebrod, Jessica Soedirgo, Essyn Emurla, Kara Santokie, Patrycia Greve, Isrela Stein, Lilian Abou-Tabickh, Vuk Radmilovic, Wayne Chu, Ethel Tunghohan, Pauline Beange. Vojin and Irina Majstorovic, Aneta and Stephen Gilles, Luba Shmygol, Constantin Necrasov, Visnja Soronda, Miki Milinovic, Oksana Polyuga, Vlad Surducki, Jelena Stojkovic, Vid Stambolovic, Ljubica Stambolovic, Srdjana Filipovic have been wonderful and supportive friends.
I owe a lot of thanks to many wonderful people who have helped me during my fieldwork. In the first turn, I would like to thank all my interviewees to finding time in their busy schedules to meet with me and share their views on the political and economic situation in their countries. I would also like to thank Dmytro Boyarchuk and Vladimir Dubrovskiy for hosting me at CASE Ukraine in Kyiv. I owe a lot to Vladimir Dubrovskiy for helping me understand the essence of business-state relations in Ukraine. I would also like to thank Sergey Guriev and Natalya Volchkova for hosting me at the New Economic School during my fieldwork in Moscow and also to the wonderful staff of the Higher School of Economics. I owe a special thanks to my friend Daniyar Serikov for all support he provided me with during my fieldwork in Kazakhstan. Professors Solomon and Professor Schatz have generously shared their personal and institutional contacts to facilitate my fieldwork in Russia and Kazakhstan.

I would like to thank the Petro Jacyk Program for the Study of Ukraine at the Centre for European, Russian, and Eurasian Studies at the University of Toronto for providing me with financial support to pursue my interest in Ukrainian Studies. I have also benefitted greatly from the Ukrainian Studies Scholarships at the University of Toronto.

Last but not least, I would like to thank my family for their love and encouragement: to my parents, Lidiya and Oleksandr Kesarchuk, my sister Tetyana, Vasya, Andriy, Sasha, Maryna, and to my Serbian family Nada, Gordan, Milena, and Andreja. My husband Nikola Milicic has provided invaluable support throughout my studies at the University of Toronto: he has been by my side during the madness of comprehensive exam preparation, he has been a keen listerner to all my fieldwork stories, and he has supported me during all those long years of producing the draft. He knows my dissertation inside out even without reading it.

Finally, I would like to thank my “big boys” Sasha and Stefan for enriching my life outside the university. They have taught me who Optimus Prime is and also ensured that I read beyond the boring academic literature by introducing me to Dr. Seuss and Eric Carle books, wonderful stories about Curious George, the well-behaved monsters, and the Octonauts. I want to read even more of these books with you after this project is completed. Lublu vas, myli moji.
# Table of Contents

Abstract ............................................................................................................................................................. ii

Acknowledgements ........................................................................................................................................ iv

Table of Contents ........................................................................................................................................ vi

List of Abbreviations ................................................................................................................................... xii

List of Tables .................................................................................................................................................. xiii

List of Figures ................................................................................................................................................ xiv

Chapter 1. Introduction ................................................................................................................................. 1

1. Practical Importance of the Study ........................................................................................................... 2

2. What Were the Choices? .......................................................................................................................... 3

3. How Did the Post-Soviet States Make These Choices? .......................................................................... 6

4. Research Method and Design ............................................................................................................... 7

5. Case Selection ........................................................................................................................................ 12

5.1. Regimes ............................................................................................................................................... 14

5.2. Sectors ............................................................................................................................................... 15

Chapter 2. Theoretical Underpinnings of This Study ................................................................................ 18

1. International-Domestic Interaction ......................................................................................................... 18

2. The Centrality of the State ..................................................................................................................... 19

3. How Does a State Make Its Decisions Regarding FDI? ..................................................................... 22

4. This Dissertation’s Approach ............................................................................................................... 24

5. The Role of Business .............................................................................................................................. 25

6. The Role of Foreign Investors .............................................................................................................. 27

7. The State-Regime Interaction ............................................................................................................... 29

8. How I View the Regime and the State ................................................................................................... 34
8.1. How the Regime Influences the State ................................................................. 35
8.2. How the State Influences the Durability of the Regime ......................................... 42
9. Dependent Variable ................................................................................................. 43
10. The Independent Variables ..................................................................................... 47
11. The Structure of the Dissertation ............................................................................ 49

Chapter 3. Economic Development of the Republics during the Soviet Era .................. 50
1. Introducing the Republics ........................................................................................... 50
  1.1. The RSFSR ........................................................................................................... 50
  1.2. Kazakh SSR ......................................................................................................... 51
  1.3. Ukrainian SSR .................................................................................................... 52
2. Soviet Management of the Economy: General Characteristics ................................. 54
3. Soviet Oil and Gas Industries ....................................................................................... 57
  3.1. Soviet Oil ............................................................................................................... 57
  3.2. Soviet Gas ............................................................................................................. 60
  3.3. Problems with Oil and Gas Production in the USSR ............................................. 61
  3.4. Seeking Solutions ................................................................................................. 65
  3.5. Oil and Gas in Soviet Kazakhstan ....................................................................... 66
  3.6. Oil and Gas in Soviet Ukraine ............................................................................. 68
4. Soviet Metallurgy and Mining Sectors ........................................................................ 70
  4.1. Metallurgy and Mining in the RSFSR ................................................................. 71
  4.2. Metallurgy and Mining in Ukraine ..................................................................... 71
  4.3. Metallurgy and Mining in Kazakhstan ............................................................... 72
  4.4. “Natural” Challenges of Development ............................................................... 73
  4.5. Institutional Inefficiencies ................................................................................... 74
  4.6. Extensive, Not Intensive Development ............................................................... 76
5. Conclusion .................................................................................................................. 79
Chapter 5. Russia Under Putin: Establishing Control Over Domestic and Foreign Investors.... 141

1. Main Political and Economic Challenges During Putin’s Presidency................................. 142
2. Redefining Relations with Big Business .............................................................................. 144
3. Essence and Implications of Statism for Russia ................................................................. 148
4. Policy Regarding FDI during Putin’s Presidency............................................................... 154
5. The Relationship between Putin’s Regime, Business, and Foreign Investors in Oil and Gas
   Sectors........................................................................................................................................ 160
   5.1. Political Importance of Oil and Gas For Putin’s Regime .................................................. 160
   5.2. Private Companies and the Regime.................................................................................... 162
6. Policy Regarding FDI in Oil and Gas .................................................................................. 165
7. The Relationship between Putin’s Regime and Domestic Business in Metallurgy and Mining
   Sectors........................................................................................................................................ 173
8. Policy regarding FDI in Metallurgy and Mining................................................................. 180
9. Conclusion................................................................................................................................... 184

Chapter 6. Kazakhstan: Using FDI to Consolidate the Nazarbaev Regime ......................... 186

1. Main Challenges before Nazarbaev’s Regime................................................................. 187
2. Nazarbaev’s Response to These Challenges.................................................................... 189
3. The Nature of the Regime................................................................................................. 190
4. Regime’s Relationship with the State............................................................................... 192
5. FDI Comes to Kazakhstan............................................................................................... 196
6. Why Foreigners.................................................................................................................. 197
   6.1. Source of Revenue and a Tool for Improving Economic Performance......................... 199
   6.2. Strategy of Legitimization............................................................................................... 200
   6.3. Solidifying Power within Kazakhstan........................................................................... 201
   6.4. Personal Interest ........................................................................................................... 202
7. Origin and Role of Domestic Business ............................................................................. 204
8. Strengthening the State...................................................................................................... 208
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>DCK</td>
<td>Democratic Choice of Kazakhstan</td>
</tr>
<tr>
<td>FDI</td>
<td>Foreign Direct Investment</td>
</tr>
<tr>
<td>FIG</td>
<td>Financial Industrial Group</td>
</tr>
<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
</tr>
<tr>
<td>HI</td>
<td>Historical Institutionalism</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>IPO</td>
<td>Initial Public Offering</td>
</tr>
<tr>
<td>JSC</td>
<td>Joint Stock Company</td>
</tr>
<tr>
<td>JV</td>
<td>Joint Venture</td>
</tr>
<tr>
<td>KazSSR</td>
<td>Kazakh Soviet Socialist Republic</td>
</tr>
<tr>
<td>KMA</td>
<td>Kursk Magnetic Anomaly</td>
</tr>
<tr>
<td>NGDU</td>
<td>(Russian) <em>Neftegazodonyvaushchee upravlenie</em>: oil and gas extracting managing unit</td>
</tr>
<tr>
<td>OECD</td>
<td>Organization for Economic Cooperation and Development</td>
</tr>
<tr>
<td>PSA</td>
<td>Production Sharing Agreement</td>
</tr>
<tr>
<td>RSFSR</td>
<td>Russian Soviet Federative Socialist Republic</td>
</tr>
<tr>
<td>RUIE</td>
<td>Russian Union of Industrialists and Entrepreneurs</td>
</tr>
<tr>
<td>UkrSSR</td>
<td>Ukrainian Soviet Socialist Republic</td>
</tr>
<tr>
<td>UNCTAD</td>
<td>United Nations Conference on Trade and Development</td>
</tr>
<tr>
<td>USSR</td>
<td>Union of Soviet Socialist Republics</td>
</tr>
<tr>
<td>VIC</td>
<td>Vertically Integrated Unit</td>
</tr>
</tbody>
</table>
List of Tables

<table>
<thead>
<tr>
<th>Table</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Industrial Profile of the Studied Republics</td>
<td>p.13</td>
</tr>
<tr>
<td>2</td>
<td>Political Regimes in the Post-Soviet States Covered in This Work</td>
<td>15</td>
</tr>
<tr>
<td>3</td>
<td>The Summary of State Force and State Power under Different Regimes</td>
<td>38</td>
</tr>
<tr>
<td>4</td>
<td>An Overview of the Main Developments in the Key Sectors of the Studied Post-Soviet States</td>
<td>45</td>
</tr>
<tr>
<td>5</td>
<td>USSR Crude Oil Production, 1965-1980 (thousand metric tons)</td>
<td>59</td>
</tr>
<tr>
<td>6</td>
<td>Production in the Metallurgy Sector, Selected Outputs (in million tons)</td>
<td>70</td>
</tr>
<tr>
<td>7</td>
<td>Results of loans for shares auctions</td>
<td>87</td>
</tr>
<tr>
<td>8</td>
<td>Foreign Direct Investment By Selected Sectors (FDI and other forms)</td>
<td>159</td>
</tr>
<tr>
<td>9</td>
<td>Russia’s Sectoral Distribution of FDI Stock, 2005 and 2010 (US million)</td>
<td>159</td>
</tr>
<tr>
<td>10</td>
<td>FDI Stock by Sector (as of June 2011, in USD millions). Data for selected sectors of Kazakhstan’s Economy</td>
<td>197</td>
</tr>
<tr>
<td>11</td>
<td>Balance Reserves of Major Commodities, Kazakhstan</td>
<td>226</td>
</tr>
<tr>
<td>12</td>
<td>Ukraine and Its Presidents</td>
<td>236</td>
</tr>
<tr>
<td>13</td>
<td>Oil and Gas: Summary</td>
<td>284</td>
</tr>
<tr>
<td>14</td>
<td>Metallurgy and Mining: Summary</td>
<td>285</td>
</tr>
</tbody>
</table>
# List of Figures

<table>
<thead>
<tr>
<th>Figure</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Figure 1</td>
<td>FDI Inflows into Kazakhstan, the Russian Federation, and Ukraine as Percentage of GDP</td>
<td>p.8</td>
</tr>
<tr>
<td>Figure 2</td>
<td>FDI Stock as Percentage of GDP, 1990-2013</td>
<td>p.9</td>
</tr>
<tr>
<td>Figure 3</td>
<td>Level of Sector’s Development as a Key Factor Influencing Policy Choices</td>
<td>p.10</td>
</tr>
<tr>
<td>Figure 4</td>
<td>The Political Role of the Sector as a Key Factor Influencing Policy Choices</td>
<td>p.11</td>
</tr>
<tr>
<td>Figure 5</td>
<td>FDI Into Ukraine by Studied Sectors (stock at the beginning of the year, in USD millions)</td>
<td>p.254</td>
</tr>
</tbody>
</table>
Chapter 1. Introduction

After the break-up of the USSR, states that emerged on its former territory faced a number of challenges in solidifying their newly acquired statehood. Restructuring the ailing command economy that had been a key cause of the USSR’s collapse was one of the most difficult tasks on the agenda. Having functioned as one economic entity for nearly seventy years, the newly independent states (NIS) that emerged out of the Soviet republics had to make use of whatever pieces of Soviet economy were located on their territory. Since the central government in Moscow had formerly made the most important decisions regarding the entire country, the majority of Soviet republics had very limited experience in policy-making and had to learn to make policies from scratch.

The neo-liberal economic doctrine advocated by Western advisors and formally embraced by the majority of the post-Soviet states\(^1\) (unofficially known as the “Washington consensus”) offered a convenient shortcut to one set of policies available to the post-Soviet states. The economists from the IMF, the World Bank, and the US Treasury considered the adoption of any kind of restrictive policies toward Foreign Direct Investment (FDI) “foolish.”\(^2\)

According to the neo-liberal doctrine, the opening of economies to FDI was an essential part of transition for the sake of benefits FDI was associated with, such as capital inflows, technology transfer, and advanced management practices. The post-Soviet states needed all of these benefits to put their economies back on track. Yet, a decade later the literature documents the failure of the majority of post-Soviet states to attract FDI on a large scale. A poor investment climate due to corruption, policy inconsistency, low quality of laws and their weak enforcement has been blamed for this failure. What this perspective overlooks is that, as a conscious policy choice, some states explicitly decided not to pursue FDI. Far from being a policy failure, then, lack of FDI may represent a certain “policy success.” Instead of focusing on why so many post-Soviet states were unable to attract FDI, my dissertation aims to explain these very policy choices –

---

\(^1\) Throughout this dissertation, I use two main terms to refer to regions that share specific characteristics. The first is the post-Soviet states, which are the states that emerged out of the former Soviet Union. The second term is the post-communist states, which includes the post-Soviet states and the former Soviet satellites that have now successfully undergone transition to capitalism and market economy and joined the European Union (for example, Hungary, Poland, the Czech Republic).

whether or not to energetically solicit FDI. This in turn invites a follow up question: if states indeed make choices, what determines who gets to develop key economic sectors? My dissertation focuses on why some states prefer to develop their strategic sectors by inviting foreign investors in while others “reserve” these sectors for domestic private and state actors.

Based on a study of Kazakhstan, Russia, and Ukraine, I argue that state officials made their policy choices regarding FDI under the influence of two main factors. The first is whether or not they believed they could develop a sector independently, with the help of domestic state or private actors, which was conditioned by the level of development a sector had achieved during the Soviet times (for initial choices) and during the post-communist era. The second factor is the strategy for maintaining the regime in power that political elites chose, in particular, the role they ascribed to key economic sectors in maintaining themselves in power. Put another way, my first explanatory variable is a historic-economic one: what choices were possible (or most feasible) given the state of the sector at the beginning of independence and afterwards. The second variable is more explicitly political: it concerns how a regime maintains its power and how it uses the resources of the state toward this purpose. Economic sectors with their physical assets and specific role in the economy were an important resource for the power holders, who ascribed these sectors specific roles in maintaining their power.

1. Practical Importance of the Study

Privatization of former state assets became a key stage in transition from communism to capitalism. Inviting foreign investors in could provide competent owners and skillful managers for the struggling post-Soviet plants and factories. The availability of substantial physical assets inherited from the Soviet era could potentially ignite foreign investors’ interest in the post-Soviet economies. Since there was an opportunity to attract FDI during the course of privatization, why some states chose to pursue it and others did not is a question of both practical and theoretical significance.

This dissertation speaks to some of the pertinent issues on the agenda of the post-communist elites after gaining independence. The study has practical significance as it answers two important questions: 1) what choices, if any, the post-Soviet states enjoyed about attracting capital into their economies, including in the form of FDI, and 2) how the states actually made
these choices in the post-Soviet context. The first question is based on the assumption that at least some post-communist elites were interested in fostering development of their national economies and looked for optimal strategies of integration into the global economy. There were however also other contexts where interest of the political regime in sustaining its power and personal interests of political elites (usually about self-enrichment) trumped all others. Both contexts are important to understand.

2. What Were the Choices?

The neoliberal literature presents the question of “policy choice” as easy – it simply assumes that choice does not effectively exist because policies are determined structurally and externally. This literature believes that globalization and the resulting capital mobility drives all states to compete for capital, both foreign and domestic. For example, Jan Drahokoupil argues that after some policy divergence, the Czech Republic, Poland, Hungary, and Slovakia converged on foreign-investment friendly policies and became “competition” states a decade after communism collapsed. Initial differences in domestic politics prevented them from converging sooner, yet the fact that policies converged at the end makes them “transnationally constituted.”

States are said to be driven by an “investment imperative” to actively facilitate investment into their domestic economies and maintain their power in such a way. Whether they are forced to open up or they do so voluntarily, countries are believed to benefit from opening up because FDI results in technology transfer, improvement of management techniques, widened market access, and increased competition. Because not all countries have realized the benefits of opening up, some works within this set of literature call for the urgent setting of new rules in order to “reinforce a worldwide trend toward liberalization of policies on FDI” and to lock in this liberalization. Optimism about FDI in this literature and among the majority of Western officials and advisors at the time was overwhelming. In 1995, US

---

3 Jan Drahokoupil, Globalization and the State in Central and Eastern Europe: the politics of foreign direct investment (New York: Routledge, 2009) 1-3.
Ambassador Donald Blinken referred to private foreign investment as “a new Marshall Plan to help Central and Eastern Europe.”

The literature on the post-Soviet region has commonly argued that states were unable to attract FDI due to numerous domestic problems caused by the political and economic transition. Some authors have suggested viewing inflows of FDI as a measure of transition’s progress. Usually, the failure of the post-Soviet states to attract FDI is contrasted with the success of Central European states. This literature focuses on foreign investors’ motivations for FDI and obstacles to FDI in the potential host-countries. It often prescribes to governments what they should do in order to create an investment climate that would allow attracting and retaining foreign investment. That is why I refer to this set of literature as the “do-all-you-can” literature. While its works offer a variety of useful data on FDI, they give little practical guidance on what the post-Soviet states could do to foster their development. Its authors assume that all countries have uniform goals, namely to attract FDI, and prescribe a uniform set of means to achieve them, such as the elimination of corruption or simplification of procedures regulating FDI entry.

Not all literature has taken neoliberal policy convergence as a given. For example, the literature informed by the history of East Asian development considers not only whether there are foreigners interested in making an investment but also whether the potential host country actually has an interest in accepting this investment. It awards host states a choice and looks at policies regarding FDI as a reflection of a state’s broader developmental strategies. For example, scholars have referred to China’s post-1978 “open door” policy of establishing joint ventures with foreigners as a “dramatic shift” away from a previously inward-oriented development strategy. Singapore relied on FDI in fostering economic growth since the early 1960s. In

---

6 Quoted in Drahokoupil 2.
7 See, for example, Michael Bradshaw, “Foreign Direct Investment and Economic Transformation in Central and Eastern Europe,” in Foreign direct investment and regional development in East Central Europe and the former Soviet Union: a collection of essays in memory of Professor Francis ‘Frank’ Carter, ed. Frank Carter and David Turnock (Burlington, VT: Ashgate, 2004).
8 Even though the “do-all-you-can” literature views FDI mainly from the perspective of foreign investors, it acknowledges that foreign investors themselves may be driven by larger structural forces.
9 For a work that studies FDI from the perspective of foreign investors, see, for example: Saul Estrin, Foreign direct investment in Central and Eastern Europe: multinationals in transition, ed. Kirsty Hughes, Sarah Todd and Royal Institute of International Affairs (Washington: Pinter/Royal Institute of International Affairs, 1997) or Paul Fischer, Foreign direct investment in Russia: a strategy for industrial recovery (New York: St. Martin's Press, 2000) 344.
contrast, South Korea, another East Asian “economic miracle,” heavily restricted FDI from 1962 to 1983 in order to protect domestic firms. The literature on East Asia thus recognizes that even when some states converge on a broad goal (development), they may diverge over the means of achieving it (specific policies).

If we accept that states make choices about whether and how they should integrate into the global economy, it should not be surprising that not all states open up their economies to FDI. The extent to which a country needs (from an economic point of view) an external infusion of capital is one of the key factors determining this choice. Robert Solow was one of the first authors to establish the centrality of capital – in particular new capital that comes with likely technological innovations – to growth. Yet capital can come in different forms. Not all sources of capital are equal. States often “pick and choose” which kind of capital is invited into their country based on its origin, form of investment, and the needs of a sector. They may try to attract global financial capital in the form of credit or portfolio investment. States may also choose to focus on establishing domestic banks and capital markets in order to find capital from within. Sometimes governments may decide to invite FDI. The extensive industrialization and development of physical infrastructure that occurred during the Soviet era put the post-Soviet states in a unique position to choose among different sources of capital, each with their benefits and shortcomings and their own forms of control and power.

In this dissertation, I rely on the OECD’s definition of FDI as a source of capital that “reflects the objective of obtaining a lasting interest by a resident entity in one economy (“direct investor”) in an entity resident in an economy other than that of an investor (“direct investment enterprise”).” According to this definition, there should be “a long-term relationship between the direct investor and the enterprise and a significant degree of influence on the management of the enterprise.” The actual degree of control a foreigner receives with an investment is not always

---

proportionate to a formal ownership share and can vary widely depending on the peculiarities of a particular country and a particular sector.

From a narrow economic perspective, attracting capital in the form of FDI offers a number of advantages. Some studies have shown that a dollar of FDI to developing economies translates into an additional dollar of domestic investment. By contrast, bank loans and bond funds do not generate the same level of add-on investment because FDI often comes in the form of greenfield projects. Capital inflows in the form of FDI are also relatively stable and easy to service. FDI is also likely to give an investor the biggest stake in the success of the project compared to other forms of investment. FDI can bring in technology and advanced skills and management techniques and therefore increase competitiveness of the host countries’ economies. However, the literature acknowledges that whether or not these benefits from FDI materialize often depends on the specific policies of the host country’s government and the characteristics of its economy. For example, prior development of domestic financial markets shapes the effect of FDI on a host country’s economy. FDI also clearly has its downsides. For example, it may “crowd out” domestic enterprises that do not have the ability to compete with MNCs and may reduce the incentives to develop technologies available within a country.

3. How Did the Post-Soviet States Make These Choices?

The second question of practical importance is how the post-Soviet states navigated among these choices and what were the driving forces behind the choice of these policies, i.e., whose interests the chosen policies aimed to serve – broader public or narrow private ones. The distinction between the state and the regime (discussed in detail in the next chapter) I make allows me to offer insights into how policies were chosen. In brief, this work treats the state as an owner of resources and a source of unique powers. The state itself is a form of public good that is operated by the political regime. The political regime can make the state work in the wider,

public interest and therefore strengthen state power or it can use it to serve narrower, private interests.

All policy choices are ultimately political. In democratic countries, formal institutions and actors such as a vibrant civil society and vigilant mass media can prevent or restrain political elites from pursuing choices focused exclusively on maintaining their own power. In non-democratic settings, such as the post-Soviet states, the political leadership has faced considerably fewer restraints. The population at large has been excluded from the policy-making process. At the same time, the regimes have had some ability to mobilize public pre-dispositions in favor of or against FDI to fit their own needs. Even if FDI may offer opportunities for fostering long-term growth, the elites may decide against attracting it based on their political (i.e., power maintenance) and personal (i.e., self-enrichment) interests. While most often fostering economic development requires a competent and dedicated political leadership, sometimes (much more rarely) it can be a by-product of rent-seeking elites struggling to maintain their power. We need to understand better under what conditions the private interests of regime representatives go against or coincide with public interests. By focusing on the specific policy choices that their political leadership made about FDI and understanding how the private interests of regime officials interacted with the broader public interest, this dissertation makes the first step toward understanding the long-term developmental trajectories of the post-communist states. Although the study provides some insights into implications of these choices based on whether they aimed at bringing public or private goods, a more detailed discussion of broader policy outcomes, such as development or underdevelopment, would require a separate study.

4. Research Method and Design

My dissertation is a small-N study that compares policies regarding FDI that three post-Soviet countries pursued in two key economic sectors (oil/gas and metallurgy/mining respectively). The study seeks to explain the different choices regarding whether or not to seek FDI that post-Soviet states made. As we can see below, Kazakhstan attracted the largest percentage of FDI as a share of its GDP throughout the independence era, even if the pattern of FDI entry was uneven across time. Ukraine generally received little FDI, with the exception of a
spike in 2005. For Russia, FDI measured as the share of GDP has generally been low (see Figure 1). Figure 2, which presents FDI stock as percentage of GDP, tells a very similar story.

Figure 1. FDI Inflows into Kazakhstan, the Russian Federation, and Ukraine as Percentage of GDP

Source: World Bank
It is possible that differences in investment climate influenced this variation, which would be consistent with the neoliberal argument. Once states learned how to improve their investment climate, they would ultimately converge on open policies. However, the variation could have also resulted from states making distinct and varied choices regarding the desirability of foreign capital, demonstrating that domestic politics “matters.” In this dissertation, I focus on the latter explanation and analyze whether and in which ways domestic politics “matters.”

Ultimately, I argue that policy choices regarding FDI reflect answers that political regimes gave to two key questions. The first question was whether these states required foreign capital to develop or maintain production in their key economic sectors when they gained independence. The answer to this question requires a close examination of Soviet developmental legacies. The level of development that a sector achieved during the Soviet era made the post-Soviet regimes more or less predisposed toward FDI after gaining independence. As Stern wrote in 1993, “[t]he perception of whether foreign investment is needed is a key issue.” 19 The Soviet-era development did not determine the choices unilaterally, however.

The second question that political regimes asked was how they could use the resources they inherited from the Soviet era to maintain their political power. I argue that the regimes treated economic sectors as a resource to this end, a form of “starting capital” that could determine their political survival, which influenced the policy choices the regimes made regarding the sectors. The interaction of political considerations and structural factors (the state of the sector) determined the policy choices regarding FDI that the post-Soviet pursued regarding FDI.
I use historical institutionalism (HI) as the main approach for my research. However, I also draw on the state-society literature in order to go beyond the study of institutions and discuss the power relations that formed between the regime, domestic business, and foreign investors.

Qualitative, inductive analysis is best fit to answer my research question. To this end, I conducted extensive empirical research, including a total of six months of fieldwork in Kazakhstan, Russia, and Ukraine that consisted of semi-structured interviews with policy makers, domestic and foreign business elites, and policy experts relying on the method of “structured, focused comparison” in collecting empirical data:

The method is “structured” in that the researcher writes general questions that reflect the research objective and that these questions are asked of each case under study to guide and standardize data collection,
thereby making systematic comparison and cumulation of the findings of the cases possible. The method is “focused” in that it deals only with certain aspects of the historical cases examined.20

As much as possible, I relied on process tracing in order to uncover causal mechanisms behind policy choices and potential intervening variables through examining primary and secondary sources (primarily interviews with participants of the process and experts, various newspaper articles, and memoirs) that described how a certain policy choice was made.

5. Case Selection

The countries that were chosen as cases for this study present a variation on the dependent variable – policy choices regarding FDI, where in the course of transition Kazakhstan emerged as a leader in attracting it whereas Ukraine and Russia have lagged behind. These differences invite the question why this might be the case. The three countries provide a fruitful ground for search for potential answers.

All three cases I study emerged as independent states in the aftermath of the dissolution of the Soviet Union. It is not true to say that in 1991, Kazakhstan, Russia, and Ukraine were identical units simply because all of them had been part of the USSR but they were similar in that all had been subjected to command economy for nearly seven decades. All three needed (and pledged) to undergo significant political and economic transformation. All three had undergone impressive industrialization during the Soviet era.

While designing my research project, I wanted to focus on key (“strategic”) sectors of the economy that could be of potential interest to foreign investors and where the regimes would be more likely to think hard about whether or not they wanted to attract FDI into a sector that is important for their economy and therefore political power too. That is why I focused on oil/gas and metallurgy/mining. Russia, Ukraine, and Kazakhstan had both sectors as substantial part of their economies.

20 George and Bennett 67.
Table 1. Industrial Profile of the Studied Republics

<table>
<thead>
<tr>
<th></th>
<th>Fuel and energy, % of industrial production, 1992</th>
<th>Metallurgy, % of industrial production, 1992</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kazakhstan</td>
<td>12.4</td>
<td>14.8</td>
</tr>
<tr>
<td>Russia</td>
<td>27.1</td>
<td>18.3</td>
</tr>
<tr>
<td>Ukraine</td>
<td>20.7</td>
<td>23.6</td>
</tr>
</tbody>
</table>


There were also important differences. As figures 1 and 2 demonstrate, Kazakhstan started to get ahead of Russia and Ukraine in terms of FDI it attracted from the very beginning of transition. This is very important as it suggests that the amount of FDI attracted may not be a matter of institutions, as Oksan Bayulgen argues. According to Bayulgen, it is the consolidated democracies and consolidated authoritarian regimes that are able to provide the best possible conditions for FDI.21 However, even though Nazarbaev was more skillful in maintaining his power and neutralizing his opponents than Yeltsin, as we now know, back in 1991-1992 Russia and Kazakhstan may have not looked that differently in terms of their institutions. Kazakhstan was not a consolidated authoritarian regime at the time yet, which allows me to test Oksan Bayulgen’s argument on a different set of cases. While I do not have a consolidated democracy among my cases, one of my cases (Ukraine) has had a period of unconsolidated democratic rule: during Victor Yushchenko’s presidency (2005-2010). It thus presents a good test case for examining how the state and the regime shape each other.

By studying variation in policies toward the same economic sector in different post-Soviet states, my research design allows me to challenge the literature that treats the nature of economic sectors as the main factor determining policies and their outcomes.22 I discuss the sectorial literature in more detail below. Also, despite similarities in industrial profiles Ukraine clearly lagged behind Russia and Kazakhstan in terms of oil and gas production. Instead, metallurgy (especially ferrous metallurgy) was one of the “signature” sectors of the republic and was therefore more likely to be key for economy of independent Ukraine. Including Ukraine into

---

21 Bayulgen 2010.
22 In particular, D. Michael Shafer’s perspective.
this study allows me to examine in which ways the structure of the economy and the nature of a sector influence policy choices that political regimes make.

5.1. Regimes

Politicians in power are formally responsible for setting goals and formulating policies to attain these goals. That is why my main unit of analysis is the political regime in charge of particular state structures. I place policy choices in a broader perspective where political elites (independently or under the influence of other actors) chose policies based on a set of considerations. The exact motives behind their particular policy choices were established during empirical research. My analysis is dynamic as it looks at how externally and internally induced factors determined the strength of regimes (defined as ability to hold on to power) and necessitated different power maintenance strategies. These strengths and vulnerabilities of political regimes in their turn shaped the relationships that formed around key economic sectors.

All of the political regimes that I consider in my dissertation had significant tasks on their agenda, such as nation-building, launching political reforms (some vigorously or half-heartedly began democratization), and transforming their economies. The weakening of state institutions associated with the dissolution of the Soviet Union made the task of meeting these challenges even more difficult. At the same time, political regimes had (and were perceived as having) different sources of vulnerabilities, which determined what role they assigned to key sectors of their economies.

The life span of a regime does not necessarily coincide with the term of a particular politician as president or with their overall presidency (if a politician stayed in power for more than one term). Even though Kazakhstan has had the same president – Nursultan Nazarbaev – since independence, effectively it has had two kinds of political regimes – the weaker Nazarbaev in the 1990s seeking political support from abroad, and the stronger Nazarbaev speaking to both foreigners and domestic business with increased confidence, mostly but not exclusively due to energy prices that began increasing steadily in the early 2000s. I analyse two political regimes in Russia (Yeltsin’s and Putin’s), each with their distinct strengths and vulnerabilities. Given that Putin de facto appointed Dmitri Medvedev as president in 2008 and succeeded him after
Medvedev’s term expired in 2012, I treat Medvedev’s presidency as part of Putin’s regime. My discussion of Ukraine is focused on three regimes based on presidencies. These regimes shared some similarities in terms of power maintenance strategies yet I still differentiate among presidencies to highlight both changes and continuities. I do not look at Leonid Kravchuk’s (1991-1994) and Petro Poroshenko’s presidencies (2014-now). Kravchuk did hardly anything in the economic sphere during his tenure as Ukraine’s first president and was voted out of office after less than three years of presidency. The presidency of Poroshenko did not take a clear shape in how important policy choices would be made by the time the full draft of this dissertation was written.

Table 2. Political Regimes in the Post-Soviet States Covered in This Work

<table>
<thead>
<tr>
<th>Kazakhstan</th>
<th>Russia</th>
<th>Ukraine</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Victor Yanukovych (2010-2014)</td>
</tr>
</tbody>
</table>

5.2. Sectors

By studying variation in policies toward the same economic sector in different post-Soviet states, my dissertation challenges the literature that treats the nature of economic sectors as the main factor determining policies and their outcomes. D. Michael Shafer’s work exemplifies this approach. Shafer argues that a state’s capacity for economic restructuring “depends on the attributes of the leading sector through which it is tied to the international economy.”

My research shows that the nature of the economic sector is indeed important. Initially, all the sectors I study required large capital investments but they could then function without larger investments for some time when the USSR collapsed. Both oil/gas and metallurgy/mining

---

23 Some of the other authors who have made a sectoral argument are Richard Auty, Alan Gelb, and Terry Lynn Karl.
are characterized by capital intensity, the importance of economies of scale, production inflexibility, and asset/factor inflexibility.\textsuperscript{25} As Shafer notes, these characteristics shape the ability of sectors to represent themselves collectively and influence the sectors’ interaction with the state.\textsuperscript{26} However, if the nature of the sector is the sole determining factor, then we should have seen the same type of relations between business and the regime emerge across all cases that share that particular sector. However, empirically this is not the case. For Shafer, the nature of the sector has an overwhelming explanatory power, which makes sector-based theory excessively rigid. This theory is especially ill-suited for analyzing economies undergoing major transformations. After all, countries can organize production within the same sector quite differently.\textsuperscript{27} We should look not only at a sector’s capital intensity, which Shafer considers to be a constitutive part of the “nature of the sector,” but also at how much capital investment the sector had received in the past.

Political regimes and foreign investors may pursue different goals vis-à-vis different sectors. In some sectors, such as oil and gas, foreign investors may be willing to take on bigger risks than in other sectors due to expectation of larger profits. For its part, the political regime may be less likely to pursue open-door policies for this kind of sector than for other industries, such as retail or services, for a variety of reasons (revenue control, the sector being the backbone of the economy, “pride” of the country etc.). However, although natural resources are usually considered “strategic” for any economy, the degree of importance given to a sector varies depending on a number of factors, among them the sector’s size, the structure of economy, political considerations, and the leadership’s vision for a country’s short- and long-term development.

The structure of the economy influences FDI policy choices. What you have and what you do not (in terms of economic sectors) determines the ownership patterns you favor in different economic sectors and also how you behave as a political regime. For example, Jones Luong and Weinthal argue that post-Soviet states with alternative sources of export revenues tended to adopt restrictive policies regarding FDI in energy sectors whereas states without such

\textsuperscript{25} Shafer 10.
\textsuperscript{26} Shafer 12.
\textsuperscript{27} Peter Evans, “State Structures, Government-Business Relations, and Economic Transformation,” in Business and the state in developing countries 75n.
sources were more likely to pursue open policies.\textsuperscript{28} In this work, I also examine the structure of economy to determine if the availability of oil and gas, for example, pushed Russia and Kazakhstan in any particular direction regarding their metallurgy and mining sectors. What is clear, however, is that the presence or absence of a sector, even if tied to the ability of this sector to provide alternative revenues (as in Jones Luong’s and Weinthal’s analysis) provides only part of the answer. First, the level of development of a sector cannot be ignored. Secondly, state revenue can come from many sources, not only through exports. The state can access capital internally (for example, through taxation) and externally (for example, multilateral loans and foreign aid). Domestic business can also over time provide this capital.

In this dissertation, I examine whether each political regime faced different incentives vis-à-vis two different sectors of their national economies – that is, whether it treated some sectors as more important than others. I use the term “key sector” broadly as a sector that has economic, political, social, or geopolitical importance. In short, a key sector is a sector state officials pay close attention to. In the cases I selected, first, oil and gas and, second, metallurgy and mining were such sectors. What happens in a key sector affects the power of the regime itself: this sector is also more likely than other sectors to serve as the nursery for domestic big business. This speaks to the interlocking nature of economic and political incentives that drive policy choices.

Chapter 2. Theoretical Underpinnings of This Study

If convergence on a single set of neoliberal policies (namely, openness to FDI) is to be expected, why do we witness different levels of FDI in post-Soviet states? Even if we accept the premise that investment climate is the key explanation, we still lack a convincing explanation: all of these states were undergoing profound changes of their political and economic systems in the 1990s, which would have negatively affected their ability to offer an optimal environment for foreign investment. At the same time, the levels of attracted FDI differ. What explains this variation? Who is the main actor determining an “FDI success” or an “FDI failure”? How do power relationships play themselves out in this context? The literature on post-communism has not yet provided convincing answers to these questions.

1. International-Domestic Interaction

Whether or not post-Soviet states have a choice regarding the nature of their integration into the global economy has not only practical but also theoretical significance. Authors who take globalization as a given treat it as “a series of constraints that economic openness places on the viability and effectiveness of particular national policies.” For some, states can either trust the over-powerful benevolent forces of globalization or perish as economic entities. For others who are more critical of globalization, national governments can no longer mitigate its effects within their countries’ borders. Whether globalization is viewed as positive or negative, it heavily constrains the role of national governments. As Susan Strange puts it, “the impersonal forces of world markets … are now more powerful than the states to whom ultimate political authority over society and economy is supposed to belong.” The role of states is limited, in this view, to providing rule of law, most basic regulation, and minimal social safety nets. It is argued that “national capitalisms” are currently being eroded as all economies are becoming more and more like liberal market economies.

---

2 Graham 1-2.
little room for the post-Soviet (and other) states to decide their developmental trajectories. According to this view, we are witnessing (or are about to witness) the retreat of the state.⁵

In this dissertation, I challenge this view by arguing that, for better or worse, national governments continue to play an important role regarding their national economies. Throughout the post-Soviet region, states that were expected to focus on attracting FDI due to capital shortages, outdated technologies, and the need for more effective management techniques, clearly did not do so. Political regimes pursue different goals when deciding whether or not to open their economy to FDI. They may look at whether an open economy will help them advance their own goals, such as maintaining their power. In formulating these goals, political elites may respond to specialized, narrow interests (domestic business, organized labor, or specific interest groups) or aim to advance the interests of the entire society.⁶ Policy choices vary due to a number of reasons that need to be empirically identified and explored.

There is no evidence that post-Soviet states have been converging on the neoliberal model of openness to FDI. Over time, some post-Soviet states have become more open (for example, Russia in the oil sector), but this openness remains heavily shaped by the desire to control foreign investors’ activity in the key sectors of Russia’s economy and limit the scope of foreign presence as much as possible.

2. The Centrality of the State

If domestic politics plays a role in whether or not a country opens up to FDI, who makes these choices? The literature on policy-making regarding FDI has focused on the relationship between the state, business, and foreign investors. It considers the investment climate to be a derivative of these relations. While the majority of authors ascribe some influence over policy choices to all three actors, different authors emphasize different actors. This is particularly evident in the case of state-society literature due to its tendency to bring different actors “back

in," arguably after a long period of unjustified scholarly neglect. The literature also differs in terms of exactly how much agency it ascribes to the actor it privileges in this relationship.

My dissertation analyzes the policy choices of the post-Soviet states regarding FDI by studying the push and pull of relations between the political regime that operates the state structures, domestic business, and foreign investors. Since the formulation of policies is the official prerogative of the state and given that post-Soviet domestic business largely received its initial wealth from the state, the state emerges as a natural place to start my analysis. I do not, however, make an apriori assumption that the state unilaterally shapes the policy-making process: other actors also influence it to a different extent.

After approximately two decades of economic stagnation during the Soviet era, the transitional economies needed capital to foster economic growth. The state, domestic business, and foreign investors could each potentially provide this capital. Under conditions of capital scarcity, the actor that offers this essential economic input is likely to have significant power over others. Therefore, the study of policy-making regarding FDI can tell us about how these power considerations play themselves out in different contexts.

A number of authors have written about the post-Soviet political regimes and challenges these regimes have been facing in democratization. In contrast, the literature on the post-Soviet states is less developed. Early works on the region almost immediately dismissed the state as an actor. This neglect of the state by the literature was not surprising given that the neo-liberally inclined transitologists expected the state to “wither away.” The all-pervasive Soviet state, they argued, had a dismal record of running the economy. They also assumed that the state was “already there,” shaped by Soviet legacies. Some argued that the post-Soviet state became “over-

---

7 See, for example, Bringing the State Back In, ed. Peter B. Evans, et al (New York: Cambridge University Press, 1985).
8 Here, I mean potentially interested foreign investors investigating the prospects of making such an investment or those foreign investors who have made their investment.
9 For discussion, see Business and the State in Developing Countries 65.
10 There are more potential actors than these three. See, for example, Stalling’s definition of foreign capital: Manufacturing miracles: paths of industrialization in Latin America and East Asia 59. But if we think of capital being associated with a lasting interest, these three actors are the main ones.
endowed with state structures” during communism.\(^{12}\) In some cases, the literature confused state-building with nation-building. It was only in the late 1990s that scholars began to recognize the on-going importance of a powerful state (i.e., a state with high institutional capacity to formulate coherent goals and achieve them) in political and economic transition. The literature finally acknowledged that the former Soviet state required re-organization rather than demolition in order to manage the transformation. Within a decade, the state was “taken out” and “brought back in” to the literature on the region.\(^{13}\) As my research shows, even though the post-Soviet state fell out of the focus of scholars of post-Soviet transition, it remained a central figure in the actual political and economic processes that were taking place.\(^{14}\)

Venelin Ganev makes the strongest case for “bringing the state back in[to]” the post-Soviet literature.\(^{15}\) I rely heavily on his work in understanding the role of the state under post-communism. Ganev highlights the distinctiveness of the post-communist state building process by reversing Charles Tilly’s view of state building as an elite-driven project. Tilly argues that Western European elites agreed to certain constraints in exchange for the right to extract resources from the population. Ganev argues that, in contrast to Western Europe, in the post-communist region the main bulk of resources was initially located in the hands of the state, which turned the state into a target for predation by elites and undermined state building.\(^{16}\)

The end of communism may have not made a uniform impact on the state and its relations with society, however. Gerald Easter, who makes an argument similar to Ganev’s, differentiates between contractual (with tamed coercion) and predatory (untamed coercion and fewer constraints on political power) post-communist states depending on the resources they inherited from the communist era. This leads him to conclude that there is variation among post-communist countries: Eastern and Central Europe ended up with the former type of states whereas the post-Soviet states ended up with the latter because of different types of battles between the state and society over taxation. Both Ganev and Easter make a strong case for


\(^{14}\) The post-Soviet region is not unique here. See, for example, on importance of the state in Africa: Politics and society in contemporary Africa, ed. Naomi Chazan, 3rd ed. ed. (Boulder, Col.: Lynne Rienner Publishers, 1999) 47.

\(^{15}\) Ganev 3.

\(^{16}\) Ganev 180-188.
studying interactions between the state and society, structural forces, and political contexts in the post-communist era.

3. How Does a State Make Its Decisions Regarding FDI?

If it is the state that makes policy choices regarding FDI, how does it make these choices? One possibility is that geopolitical and security considerations shape these choices. The post-Soviet states had to establish their statehood. FDI provided a possibility of linking the post-Soviet states not only to the global economy but also to other states where large foreign companies seeking to make investments were based.\textsuperscript{17} Foreign investors could serve as a “geopolitical ally” who could lobby their home government in favor of the post-Soviet states hosting FDI on other matters. For example, Azerbaijan used FDI to enhance its international standing in its territorial dispute with Armenia over Nagorno-Karabakh. Azerbaijan’s oil industry became one of the few assets that could be used for forging closer ties with foreign states and build up geopolitical support for Azerbaijan.\textsuperscript{18} A regime may therefore try to attract FDI even if it does not expect to benefit from it economically or politically if this investment promises geopolitical or security gains.\textsuperscript{19} A state may also resist FDI for the same reason.\textsuperscript{20}

My empirical research suggests that whenever the post-Soviet states sought FDI, they often revealed preference to investment from a particular country at a particular time. At the same time, however, this dissertation shows that geopolitical considerations did not play a crucial role in shaping FDI policy choices of the post-Soviet states. For example, a significant amount of Chinese FDI came into Kazakhstan’s oil and gas sectors during the last decade. Nazarbaev used Chinese FDI to empower Kazakhstan in negotiations with Western powers. Also, the Chinese have often been willing to overpay for assets, to take on larger risks than

\textsuperscript{17} Clifford Krauss, “Potential Crackdown on Russia Risks Also Punishing Western Oil Companies.” \textit{The New York Times}, 27 March 2014.
\textsuperscript{18} David I. Hoffman, "Oil and State-Building in Post-Soviet Azerbaijan and Kazakhstan," PhD Dissertation defended at University of California, Berkeley, 2000, 30.
\textsuperscript{19} For discussion of how Russia has been using energy sector as a policy tool, see Andrew Barnes, "Industrial Property in Russia: The Return of the State and a Focus on Oil," \textit{SAIS Review} 27:2 (2007): 56.
\textsuperscript{20} See, for example, Rosaria Puglisi, "Clashing Agendas? Economic Interests, Elite Coalitions and Prospects for Cooperation between Russia and Ukraine," \textit{Europe-Asia Studies} 55.6 (2003): 832.
Western companies, and to share profits or even ownership with representatives of the regime. Certainly, Chinese presence has not strengthened Kazakhstan’s security as the country is now heavily dependent on Chinese loans. This suggests that domestic (political) factors play a larger role than geopolitical ones.

It is possible that political regimes make their choices regarding FDI based on how FDI affects their main constituents. For example, Pablo Pinto’s partisan theory of investment argues that entry of FDI has clear distributive consequences and the degree of a government’s openness to FDI therefore depends on the host government’s partisan alignment. Labor-based parties or coalitions are more likely to pursue pro-FDI policies, when FDI is likely to result in higher labor demand. On the contrary, governments that cater to domestic businesses often pursue restrictive FDI policies in order to reduce competition for domestic businesses.21 Jones Luong and Weinthal present another version of partisan explanation by identifying the level of political contestation (whether or not there is strong opposition that can challenge the regime) as one of the key factors determining ownership patterns in the energy sector.

Both Pinto and Jones Luong and Weinthal put politics, specifically power maintenance, into the centre of their analysis, which is what this dissertation also aims to do. However, while I find that post-Soviet regimes did limit access of foreign capital to key sectors in order to cater to the interests of domestic big business (as Pinto does too), the population mattered little in determining policy choices regarding FDI. Authoritarian regimes usually used predispositions of the population toward FDI simply to justify decisions that had already been made. Neither Pinto nor Jones Luong and Weinthal look at the state as a site of powers and resources that can empower the government vis-à-vis the society, including big business. This leads them to overlook the fact that states that may resemble each other can pursue different goals and have unequal capacities to achieve these goals.

21 Pablo Martín Pinto, Partisan investment in the global economy: why the left loves foreign direct investment and FDI loves the left (New York: Cambridge University Press, 2013) 6-7.
4. This Dissertation’s Approach

My dissertation is rooted in historical institutionalism (HI), the approach that takes history “seriously.”\textsuperscript{22} Since policy-making is “an inherently historical process,”\textsuperscript{23} HI is well-equipped to study it. Among the different strands of new institutionalism, HI is best equipped to capture and explain the evolution of policies over time.\textsuperscript{24} This approach uses a long-term yet dynamic perspective on policy-making. Also, HI places institutions into a context and pays attention to both formal and informal institutions, which is important given the significance of informal institutions in the post-Soviet states. HI avoids the pitfalls of rational choice approach that Jones Luong and Weinthal take to explaining ownership patterns in the former Soviet Union, when analysis rests on a number of \textit{apriori} assumptions that help identify necessary but not sufficient conditions for policy choices. Rigid rational choice assumptions about actors’ preferences \textit{apriori} exclude other factors that may matter too. It is especially difficult to expect actors to be rational and able to foresee potential outcomes in rapidly changing contexts, such as in the post-Soviet states.

At the same time, even for HI authors institutions by themselves do not provide sufficient explanatory leverage over policy outcomes. Institutions simply “bind the components of the state together and structure its relations with society.”\textsuperscript{25} A study that focuses exclusively on institutions and how they function may overlook the goals that different actors pursue through these institutions.

Within the literature that discusses FDI in the former Soviet Union, Oksan Bayulgen takes what I consider to be a “thin” view of institutions. She argues that some domestic groups viewed the arrival of foreign capital as an opportunity and others viewed it as a threat,\textsuperscript{26} which is similar to what this dissertation asserts. According to Bayulgen, the potential losers and winners shaped investment policies in their interests through domestic political institutions in a

\textsuperscript{22} Political Science: the State of the Discipline 698.
\textsuperscript{23} Hugh Heclo, \textit{Modern social politics in Britain and Sweden: from relief to income maintenance}, (New Haven, Yale University Press, 1975).
\textsuperscript{24} For conceptualization of change in historical institutionalism, see, for example: Kathleen Thelen, “How Institutions Evolve: Insights from Comparative Historical Analysis,” in: \textit{Comparative Historical Analysis in the Social Sciences} (ed. James Mahoney et al, 2003) 208-240.
\textsuperscript{25} Hall 19.
\textsuperscript{26} Oksan Bayulgen, \textit{Foreign Investments and Political Regimes: the Oil Sector in Azerbaijan, Russia, and Norway} (New York: Cambridge University Press, 2010) 2. This is not so different from Pinto’s analysis yet Bayulgen’s focus is much more clearly about the role institutions mediate these relations.
democracy, under authoritarianism, and in hybrid regimes to a different extent depending on the institutional constrains imposed by that particular regime. I argue instead that although a study of institutions can tell us about power distribution within a state, it is unable to identify the source of this power and explain the ends towards which this power is used. Consolidated democracies and autocracies may indeed be better at providing the optimal climate for foreign investors. However, it is not a given that these regimes will make a choice in favor of FDI. In fact, one can argue that a consolidated democracy or autocracy can provide an optimal climate for domestic investors too. Whether or not it will depends on domestic power politics.

That is why I draw on state-society literature in my work that looks not only at the state as a set of institutions but at the political regime in charge of the state that builds its own relations with key social and economic actors. As Kohli argues, “[p]atterns of state authority, including how the politics of the state are organized and how state power is used, have decisively influenced the economic context within which private decisions are made.” Institutional constraints in their own turn are shaped by these different patterns of authority. A thicker view on institutions may be analytically messier, yet it is the one that is better grounded empirically.

5. The Role of Business

The literature offers a variety of ways to conceptualize business: business as capital, sector, firm, association, or network. I draw on more than one conceptualization, yet my view of business is closest to “business as a firm.” I take into account the specifics of the local context I work with: the exact boundaries between firms that belong to Financial-Industrial Groups (FIGs) are often blurred and the identity of owners and the share of their ownership and control over firms are difficult to determine.

The role domestic business plays in determining policy choices in the post-Soviet region is closely tied to its origins. Private business formally did not exist during the Soviet era, whereas

---

27 Bayulgen 2.
30 For discussion of other conceptualizations, see: Business and the State in Developing Countries, ed. Sylvia Maxfield and Ben Ross Schneider (Ithaca: Cornell University Press, 1997).
the state (a particular, communist type of it) was a powerful actor already back then. As my interviewee noted,

the Soviet system of blat underwent transformation. Some part of the nomeklature became businessmen, another part became state officials (nachalniki, i.e. the bosses in Russian). The first group became businessmen at the permission of the nachalniki. That is why [in the post-Soviet context] one cannot say that business captured the state and started to command. It is more appropriate to say that these [business and the nachalniki] are the branches of the same tree. The [Soviet] nomenkature was the trunk of this tree. 31

Ganev’s work shows that post-Soviet business is closely tied to the state. It is dependent on the extraction of resources from the state. Even though political regimes in charge of the state often did not allow domestic business to gain official ownership over property, the latter frequently received de facto control over economic assets in exchange for its political loyalty. 32 The state became demiurge of domestic business. 33 The state also provided “sticks” that maintained business’ dependence on the regime, such as state inspections (tax, fire, labor safety etc.) that focused on finding any kind of violation and could threaten the existence of business itself.

The nature of relations between the state and a domestic business community that was closely tied to the Soviet nomenclature shaped the nature of post-Soviet capitalism. Jadwiga Staniszkis, who was among the first to apply Max Weber’s term “political capitalism” to post-communist countries in 1991, noted “a peculiar linkage of political power and capital [in Eastern Europe], changing the foundations of the dominant position on the part of the ruling apparatus, but not disturbing the system of domination.” 34 A later work by Gil Eyal et al has challenged this view arguing that the term “political capitalism” applies to post-Soviet countries and China, but not to Central European countries. Due to the existence of a relatively strong civil society in Central Europe, in Central Europe capitalism was being built by an intelligentsia who took it as “its historic, ethical mission … to create capitalist institutions under the watchful eye of democratically elected parliaments, exposed to the scrutiny of free media.” 35 On the other hand, in countries like Russia “capitalists” arose predominantly from the former nomenclature, before

31 Interview with Vladimir Dubrovskiy, senior economist, CASE Ukraine, Kyiv, 30 September 2009.
the creation of institutions of capitalism. Therefore, according to Gil Eyal et al, Russia had “capitalists without capitalism.”

Even if the regime is usually the driving actor in policy-making, business shapes policies too, in two major ways. The first is by shaping the nature of the state itself. The power of business adds to state capacity. The nature of the state, business, and the relationship between the two influence the quality of policy-making.

Business influences not only policy outcomes but policy choices themselves. In the late 1970s, Charles Lindblom started an important conversation about the role of business in Western capitalism. In market-oriented systems, he argued, business is in a privileged position vis-à-vis the government because of its power to invest. Governments’ stay in office is dependent on business performance. In the post-Soviet states, the regime often depended on the support of domestic business, especially when political power was most vulnerable, such as exit from power or bid for reelection. The power of business to invest mattered much less than the power to deliver some valuable resources or help the regime utilize these resources. For example, as this dissertation demonstrates, the interlocking incentives shared by economic and political actors to keep FDI out clearly forced Yeltsin’s Russia to resist FDI in the oil and gas sector.

6. The Role of Foreign Investors

A specific feature of FDI policies is the potential for influence by external actors – foreign investors who have invested into a country or are interested in investing, and foreign governments acting on behalf of their companies. Even though my research assumes that domestic factors drive policy choices about whether or not to open up to FDI, foreign investors have opportunities to shape these choices too.

Dependency literature popular in the mid-20th century viewed the “periphery” countries as highly dependent on foreign capital coming from the “core” states. Although this literature

---

36 Eyal, 5.
38 Handley 3.
40 For example, the works of Vladimir Lenin and Paul Baran on imperialism are arguably most rigid. See discussion of Baran's views on development in Peter B. Evans, Dependent Development: the Alliance of Multinational, State, and Local Capital in Brazil (Princeton, N.J.: Princeton University Press, 1979) 19. The later authors who wrote
offered a powerful explanation for why some states stayed underdeveloped, it suffered from reductionism as it considered foreign investors from the core to be essentially the only actor with power across the entire developing world. By denying agency to the developing states, the dependency literature made the same assumption as the “do-all-you-can” literature. However, while the latter was usually highly optimistic about the outcome of international capital mobility for the underdeveloped countries, the former was highly critical of the outcome of this dependency for the “periphery.”

The reality was, in fact, mixed. Peter Evans, who built on dependency theory, argued that alliances between a developing state, its bourgeoisie, and foreign capital could lead to development depending on what the state did: as the example of Brazil’s industrialization demonstrated, “the centrality of the state to accumulation on the periphery is incontrovertible.”

This conclusion is applicable to the post-Soviet states too. The state is not only a crucial actor in attracting capital from abroad but can also serve as a source of capital itself.

Another way the state can regain agency vis-à-vis external forces and actors is by fostering these external dependencies in order to retain power. For example, based on his study of Africa’s colonialism and underdevelopment, Jean-Francois Bayart argues that locals have not always been victims of external dependencies. Sometimes, they have actually served as the beneficiaries and facilitators of it. Domestic elites may use these dependencies to obtain resources for sustaining their regime at home. By acknowledging the role of political regimes vis-à-vis foreign capital, Bayart creates room for bringing domestic politics back into the dependency literature.

Policy choices regarding FDI have their own consequences for domestic politics of the recipient state. In particular, bargaining with foreign investors can have an effect on the state itself. Trans-national capital may strengthen underdeveloped states. As Evans notes, expansion of state apparatuses and increase in state capacity across sectors often follows the entry of transnational actors into local economies. Yet, Evans’s state capacity is not the transformative

within traditions of the “dependency theory” (Caio Prado, Jr., Sergio Bagu, Florestain Fernandes) also looked at the relations of developing states with the external world and viewed dependencies as real yet less absolute and less fixed. See Evans 25-27.
41 Evans 43.
43 Bayart 231.
state capacity that allows the state to achieve its developmental goals.\textsuperscript{44} Foreign investment changes the balance of power between the state and local capital in favor of the former but does not necessarily increase power as a resource that can be used to the benefit of all. Private domestic owners have to work through and with the state to achieve its goals.\textsuperscript{45} Therefore, in certain situations foreign investors redefine domestic politics even without any direct and purposeful interference into it. As my research shows, the mere prospect of mass entry of FDI into Kazakhstan at the regime’s invitation was a powerful resource that allowed President Nazarbaev to gain an upper hand over his (potential) opponents.

7. The State-Regime Interaction

After a decade of scholarly neglect, the literature on post-communism finally began treating the state seriously in the early 2000s. An important question this literature asked was about exactly what role the state played in the region’s economic transformation. In the 1980s, the seminal volume by Evans, Rueschemeyer, and Skocpol brought the state back into the general political economy literature as an autonomous actor that shaped social and political processes and was shaped by them. The volume was a reaction to pluralism’s preoccupation with the study of interaction among societal actors and their influence upon the state.\textsuperscript{46} However, the state-society literature built on “bringing-the-state-back-in” had its own flaws: whereas modernization and dependency approaches suffered from socioeconomic determinism, the statist literature suffered from political determinism.\textsuperscript{47} That is, state-focused literature overlooked the role of everyday politics in determining socioeconomic outcomes. Michael Mann’s question about who governs the state allows us to keep politics in focus.\textsuperscript{48} We need to enhance our understanding of how both structural and political factors shape political and economic development of the post-Soviet states.

\textsuperscript{44} I am borrowing the term “transformative capacity” from Linda Weiss.
\textsuperscript{48} Michael Mann, The sources of social power (New York: Cambridge University Press, 2012).
My work is one attempt to bring the state back into the post-Soviet literature. In order to keep politics in focus, I make an analytical distinction between the “state” and the “regime.” 49 Unfortunately, scholars of the post-Soviet region have often conflated these two terms or discussed one while ignoring the other. 50 In the literature on the post-Soviet region, the terms are frequently used interchangeably even though the broader literature has established that differences between “regime” and “state” can be considerable not only in theory but also in practice. Therefore, the literature misses an opportunity to analyse simultaneous processes of post-Soviet regime formation and state building.

The larger theoretical and empirical literature that distinguishes between the two terms is well-developed and makes the differentiation based on two criteria. The first is actor-based: some actors are considered to be part of the state while others are considered to be part of the regime (technocratic-administrative positions versus political versus). O’Donnell calls this the “state-as-bureaucracy” view of the state. 51 A minister is usually considered to be part of the regime whereas a bureaucrat, a soldier, or a policeman are all considered to be part of the state. Based on this view, the regime and the state often have different capacities and durability. The state tends to be more permanent and less susceptible to changes than the regime. 52 However, occasionally a regime may remain cohesive and hold on to power even “as the state on which it relies crumbles away and loses its ability or resolve to coerce, administer and extract resources.” 53 Even in the process of democratization, which should be a clear process of regime change, “[t]he crucial move toward democracy – to the extent that it does emerge from within the authoritarian power system itself – may be located within the regime or within the state; the results differ decidedly.” 54

49 In this dissertation, I also use the term “government” to refer mostly to “engine” of the regime, the ruling body of the state. It is narrower than the regime since it does not refer to how power is maintained. The regime runs the state through the government.
52 For example, Robert M. Fishman, "Rethinking State and Regime: Southern Europe's Transition to Democracy," World Politics 42.3 (1990): 428; Grzymala-Busse, 1fn1.
53 Fishman 428-429.
54 Fishman 427.
The second criterion for differentiation between the regime and the state is based on different understandings of interest. Guillermo O’Donnell warns against reducing the state to the state apparatus or the public sector – these are part of the state but they do not represent the state in its entirety. Politicians and bureaucrats come and go but the state persists. O’Donnell views the state as a set of social relations formalized in a legal system. This system of laws represents what he calls a “constitutive dimension of the state.” Although the legal system often creates and sustains inequality, law in general is a public good as it creates social predictability that is backed by actions of public bureaucracies. The state gains its public dimension through enforcement of legal norms. This perspective views the state as serving – or claiming to serve – the public interest. In contrast, the regime is more closely tied to private interests – its representatives are focused on maintaining power and prioritizing their political survival, which is a form of private interest since the public does not necessarily benefit from sustaining particular individuals in power.

The discussion of public versus private interest is a good starting point for analyzing the role and nature of the regime and the state in the post-Soviet region. In modern bureaucratic states, regime representatives are supposed to be constrained from using the state and its resources for their private gains. In democracies, the distinction between public and private interests is relatively easy to make. Only those policies that claim to echo the preferences of the public are viewed as legitimate. The regime does not decide on public policies unilaterally and therefore generally has to consider wider, public interests. This distinction is more difficult to make in authoritarian settings, where leaders face fewer constraints and often use public institutions for private benefits. Sometimes, they can build up public institutions that “accidentally” end up serving the public, but this does not happen often. When appointments to state positions are made based on political loyalty rather than merits, actor-based differentiation between the regime and the state is of limited use. We can, however, learn how the merging of

---

55 O’Donnell 1356.
57 O’Donnell 1356.
58 O’Donnell 1358.
61 For example, Politics and Society in Contemporary Africa 39-40.
public and private interests shapes relations between political power and social actors. We can also learn about the broader implications of these relations.

The post-Soviet region has struggled with state building understood as the construction of public authority. Economic transformation opened up many opportunities for regime representatives to pursue their private interests in largely authoritarian settings. When the power of the communist collective-based ideology faded away, there were no constraints imposed by democratic institutions to act in the name of the public good. Any state-building efforts that did occur focused on creating and re-arranging the formal institutions of the state, yet powerful informal institutions around and within state structures served largely private interests. Private came to be presented as public and public became de facto private. In fact, the officials in a way created what William Reno in the context of Sierra Leone calls a “Shadow State” where rulers base their authority on their ability to control markets and channel rewards in their efforts to co-opt societal networks of supporters. Political rulers have sometimes deliberately undermined state structures and created alternative, often parallel, and largely informal avenues for exercising power. Similar processes have taken place in the former Soviet states. Because state capacity is a key factor influencing the outcome of transition, its erosion by political regimes has important implications.

Given the persistence of authoritarian regimes across the post-Soviet region, I take it as an alternative hypothesis that representatives of political regimes made policy choices about FDI based on what served their personal interests. In short, corruption determined these choices: whoever offered the highest bribe (either a domestic or a foreign actor) got the assets. As a result, personal interest dominated over public interest. This hypothesis builds on the second, interest-based criteria for distinction between the state and the regime. Its confirmation or rejection requires looking into the nature of the political regime and its interaction with the state. My research demonstrates that even in countries with extremely high levels of corruption and rent-seeking, policy choices have been about more than the size of the bribe. The nature and extent of corruption depends on the nature of the regime, the manner in which the regime sustains itself politically, and the type of social links it builds. As one of my interviewees noted,

---
62 Grzymala-Busse and Luong 530.
64 See, for example, Myant 124.
in Eastern Europe “one needs to deserve a right to give a bribe.”\textsuperscript{65} The personal and the political are closely interrelated in defining the manner in which a regime sustains its power, especially in authoritarian settings. This is because the desire of officials to fill their bank accounts can be realized most effectively (or can only be realized) when the regime stays in power. That is why the highest officials may sometimes be willing to sacrifice direct personal gain for the sake of maintaining political power. Corruption thus affects decision-making, but not in a straightforward and uniform way.

There is no doubt that regimes and states interact with and shape each other, especially in the post-Soviet region where regime transformation and state (re)-building took place simultaneously.\textsuperscript{66} The discussion of this interaction can be tied to either of the two conceptualizations of the states I discussed above. For example, Lucan Way has used both conceptualizations in his work. While Way’s earlier work focuses on how the Ukrainian state managed to preserve O’Donnell’s public dimension of the state despite the authoritarian regime, his later work looks at how state structures (in particular, the state’s coercive apparatus) help support authoritarian regimes in power.\textsuperscript{67}

In order to emphasize the connection between political regimes and states, scholars often use the terms “democratic” or “authoritarian state-building.”\textsuperscript{68} Some scholars begin their analysis with a discussion of the nature of the regime and move on to discuss its effect on the state; others go in the reverse order. For example, Grzymala-Busse argues that “politicization of the state” takes place when the state becomes a source of rents for private actors (political parties in her work).\textsuperscript{69} The reverse can also occur when the power apparatus of the state develops “at the expense of political mechanisms.”\textsuperscript{70} This characterization of the nature of the state through the type of regime that operates it is useful only when an author discusses the nature of interaction between the two and how they influence each other. While the processes of state and regime building are indeed “convergent and mutually reinforcing” in the post-communist region, the

\textsuperscript{65} Interview with Vladimir Dubrovskiy, senior economist, CASE Ukraine, Kyiv, 30 September 2009.
\textsuperscript{66} Grzymala-Busse and Luong 548.
\textsuperscript{68} See O'Donnell 1360.
\textsuperscript{69} Anna Grzymala-Busse, "Political Competition and the Politicization of the State in East Central Europe," \textit{Comparative Political Studies} 36.10 (2003): 1123.
\textsuperscript{70} Politics and Society in Contemporary Africa 69.
argument that “democratic statebuilding fosters democratic regime transition, autocratic state-
building fosters authoritarian regime transition, and so on” is of little use.\textsuperscript{71} The close attention I
pay to distinguishing between the regime and the state allows me to bring the state back into the
post-Soviet literature more effectively and not at the expense of ignoring the role of the political
in this discussion.

\section*{8. How I View the Regime and the State}

It is true that “[t]he state is undeniably a messy concept.”\textsuperscript{72} So is the regime. The
definition and analysis of both terms in this dissertation is geared toward answering my main
research question. I build on the second view of the state as a repository of expertise, a set of
institutions formulating and implementing policies that aim to serve some form of public good.
The state also has its own unique set of powers that distinguish it from other actors (for example,
the power to tax). In authoritarian settings, political elites often use these powers for their own
benefit and the benefit of the regime. I view these powers as inherently belonging to and deriving
from the state. This view of the state as an entity that is intended to serve the public good allows
me to make the first step toward assessing the implications of policy choices regarding FDI for a
country’s development – in particular, whether these choices were made with the aim of serving
narrow (private) or broader (public) interests.

In addition, because the post-Soviet state inherited significant physical assets, I explicitly
view the state as the owner of resources that could potentially be used in public interest. Experts
on the post-communist region were wrong to assume that “state assets inherited from the old
order would be dead weights hampering post-communist growth.”\textsuperscript{73} On the contrary, these assets
became a major source of power and opportunities for political elites in the new political and
economic order.

In my dissertation, regimes consist of a set of governing elites that have a common
interest in maintaining their political power. While I do not look in-depth at whether a regime is

\textsuperscript{71} Grzymala-Busse and Luong 530.
\textsuperscript{72} Michael Mann, “Autonomous Power of the State,” originally published in Archives europennes de sociologie,
\textsuperscript{73} Varieties of Capitalism in Post-Communist Countries 161.
the regime is not limited to specific actors that have political power but also consists of “the rules, principles, norms, and modes of interaction between social groups and state organs.” Whereas the state serves as a “locus of political power,” the regime often acts as the “gate-keeper” of state structures. It is the regime that determines who has access to the physical resources of the state and its array of unique powers. Even though the regime is the central actor in my dissertation, the questions I ask are closer to the literature on the state-society relations than the literature that focuses on topics such as regime change and consolidation.

I look at how political regimes used the power and resources of the post-Soviet states and what policy choices were made as a result. I view both the state and the regime as a source of possibilities and constraints on policy choices. Whereas the regime makes decisions about which policy choices are likely to maintain its power, the state with its physical and power resources, and the “infrastructure of governance” determines which policies can actually be implemented.

The regime and its institutions in many ways maintain the very legitimacy of the state. The regime defines the “rules, principles, norms, and modes of interaction between social groups and state organs.”

8.1. How the Regime Influences the State

In the post-Soviet region, state preservation and state destruction often took place simultaneously. Assets located in the key economic sectors provided regimes with an important resource for maintaining political power and a source of rents and outright property steal for individual representatives of the regime. At the same time, the majority of authoritarian leaders maintained the basic infrastructure of the state since their political power depended on the survival of the state. This work provides important insights into the nature of interaction between the regime and the state by showing how the two shape each other: the regime can strengthen or

74 My work echoes Huntington’s distinction between form and degree of government. Huntington argues that “[t]he differences between democracy and dictatorship are less than the differences between those countries whose politics embodies consensus, community, legitimacy, organization, effectiveness, stability, and those countries whose politics is deficient in these qualities.” Huntington 1.
76 Fishman 428.
78 Politics and Society in Contemporary Africa 39.
weaken the state while the state of the state itself influences the durability of the regime. It
shapes the state by the way in which it uses the state, its resources, and powers, and the goals it
pursues during this utilization.

The broader literature on the state and society offers insightful ways to assess the effect
of the political (regime) on the structural (the state). We can evaluate how the regime influences
the state in two dimensions. The first one is most easily visible and thus easier to assess. It
focuses on the cruder strength of the state: for example, the ability of the state to coerce and
order other, societal actors to do something against their will (without reference to the purpose of
the command). I call this state force. Increased reliance on force of the state by the regime
impacts the nature of the state that is formed as a result of such usage.

The second dimension focuses on the power of the state to achieve broader ends. I draw
here on Atul Kohli’s understanding of power as “the currency that states use to achieve their
desired ends.” Like wealth, states have a little or a lot of this resource. The “stock” of power a
particular state has has important implications: more of this power enables states to facilitate
industrial transformation and development. For Kohli, the key determinants of variation in state
power to launch development are organizational characteristics of state institutions and the
manner in which states build their relations with societal actors, in particular big business.

I borrow the terms “force” and “power” from Robert W. Jackman’s book Power without
Force: The Political Capacity of Nation States. For Jackman, power is intrinsically relational. It
is closely (and explicitly) tied to the concept of legitimacy. Force is the much cruder ability of
the state to exercise influence, primarily in the form of coercion. The more states rely on force,
the less power they have. For Jackman, exercise of force is an indication of state weakness rather
than power. It can also make the regime “unsuccessful” – i.e., unstable, up to the loss of power.
It is important make two points here. First, a regime that relies on state force rather than power
does not fall immediately – state force does allow regimes to endure for a long time. Second,

79 Robert W. Jackman, Power Without Force: The Political Capacity of Nation-States (Ann Arbor: University of
80 Atul Kohli, State-Directed Development: Political Power and Industrialization in the Global Periphery (New
81 Atul Kohli, State-Directed Development: Political Power and Industrialization in the Global Periphery (New
82 Jackman 37.
states can lose both force and power at the same time. In order to launch development, states need power rather than force. Therefore, Jackman’s work, which is focused on presenting a theory yet to be tested empirically, is a good complement to Kohli’s work that makes an empirical enquiry about how state power relates to economic development.

In my dissertation, a strong state (a state with high capacity) is the one that relies on power rather than force. A weak state is the one that relies on force. However, force is more than coercion. It is close to what Mann calls despotic power – “the range of actions which the [state] elite [i.e., the regime] is empowered to undertake without routine, institutionalized negotiation with civil society groups.” It also comprises actions that privilege private interests over public ones. For example, in the economic sphere, one of the most common ways to exercise force is through direct state ownership and state control over economic assets irrespective of how this ownership affects prospects for long-term development.

Therefore, a related aspect of assessing the effect of the regime upon the state is looking at how private interests are managed and reconciled with public ones. I draw on O’Donnell’s view of the state as an entity that is supposed to serve and embody the public good. The role of the state today goes beyond guarding the territory. States are expected to be committed to socio-economic development as “the outcome of a social contract based on the legitimacy that flows from state-society relations.” One of the key characteristics of the ideal Weberian state is a “well-established public arena that is both normatively and organizationally distinguishable from private interests and pursuits.” However, neo-patrimonial (i.e., not modern) states have the façade of a modern state yet public officeholders usually treat public resources as their “personal patrimony.” Irrespective of whether the regime is a nominal democracy or a dictatorship, whenever neo-patrimonial states launched development, this effort was rarely successful because personal and narrow group interests undermined public goals and capacities to pursue development. A modern state is much more about the institutionalization of governing, the

---

83 Mann 113. Mann contrasts despotic power with infrastructural power, which he defines as “the power of the state to penetrate and centrally coordinate the activities of civil society through its own infrastructure.” The focus on the ends to which this power is used is weaker than Kohli’s.
84 Statebuilding: consolidating peace after civil war 60-61.
building of state authority and state power than about specific institutions per se. The state and its institutions should endure beyond the tenure of a specific ruler or regime. If it does not, the state has limited power even if it may have significant force.

Since 1991, there has been a variation of state force across the post-Soviet space, yet a rather uniform standard of neo-patrimonial states with limited state power, where public interests have been subdued for the sake of satisfying private ones.

Table 3. The Summary of State Force and State Power under Different Regimes

<table>
<thead>
<tr>
<th>Type of regime</th>
<th>State Force</th>
<th>State Power</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yeltsin</td>
<td>Weak authoritarianism</td>
<td>Tendency toward weakening</td>
</tr>
<tr>
<td>Putin</td>
<td>Consolidated authoritarianism</td>
<td>Strengthened</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>Consolidated authoritarianism</td>
<td>In the early 1990s, some weakening, yet overall strengthened</td>
</tr>
<tr>
<td>Ukraine (Kuchma)</td>
<td>Consolidating authoritarianism</td>
<td>Tendency toward weakening</td>
</tr>
<tr>
<td>Ukraine (Yushchenko)</td>
<td>Weak democracy</td>
<td>Weakening</td>
</tr>
<tr>
<td>Ukraine (Yanukovych)</td>
<td>Consolidating authoritarianism</td>
<td>Tendency toward strengthening</td>
</tr>
</tbody>
</table>

In Russia, “shock therapy” economic reforms and Yeltsin’s initial strategy of maintaining power through decentralization weakened the state. The state seemed to have lost both the force and the power to command. Formal institutions were yet to be created. Informal institutions and personalized relationships within the political regime and between the political and economic elites gained dominance. The state privatized a large portion of property and de facto lost control over the property it continued to formally own. At the same time, the state did not fully
disintegrate. Its levers for exercising force (or potentially power) remained intact. President Putin subsequently made these levers visible and potent again.

Kazakhstan’s Nursultan Nazarbaev largely preserved the formal and informal levers of the state through careful political manoeuvring. Formally, Kazakhstan remained a unitary state. Informally, power was de-centralized. Nazarbaev never lost control over the state and its structures to the same extent as Yeltsin did. After energy prices began rising during the second decade of independence, Nazarbaev’s regime was able to re-assert the state’s formal presence in the economy and strengthen the existing mechanisms of control. His rule remains heavily centralized up to this day. Even though Russia under Putin and Kazakhstan under Nazarbaev have seen impressive economic growth in the past decade, in its essence the state in both cases has remained neopatrimonial. It needs to be noted that without revenue from export of oil and gas, these economic outcomes would have been much bleaker.

In the 1990s, Ukraine’s President Leonid Kuchma also used the state to maintain his power. Privatization of key industrial assets took place later than in Russia or Kazakhstan. Throughout the 1990s, Kuchma offered access to the state and its resources to his political allies in exchange for their political loyalty. The state lost some of its force compared to the Soviet era. It also lacked power. Still, state structures as such remained intact. Ukraine is the only country among my cases that has had a relatively long period of unconsolidated democratic rule during Yushchenko’s presidency. Yet, as my research suggests, more democratic rule did not strengthen the state. Ukraine under Yushchenko was more democratic than any other regime I analyze in this dissertation yet the state remained neo-patrimonial: the multiple new institutions created during Yushchenko’s presidency served the short-term interests of specific people in power rather than long-term public interests. I do not have a consolidated democracy among my cases. However, the variation in the types of regimes (more democratic/more authoritarian) among my cases suggests that the form of the government does not have a clear effect on the power of the state. Victor Yanukovych’s authoritarian regime that succeeded Yushchenko’s focused overwhelmingly on increasing the force of the state, but not its power.

---

How the regime influences the state then largely depends on the nature of the regime itself and its relations with domestic societal actors, and in particular, big business. Two main factors shape these relations. The first one is concentration of a bulk of resources in the hands of the post-Soviet state, which turned the state into an attractive object for predation by various actors. In the post-Soviet region, individual representatives of political regimes had much better opportunities for “capturing” the state than business elites did. In order to become an oligarch, one needed to have close ties to the regime.

Representatives of political regimes had conflicting attitudes toward the state. On the one hand, they engaged in “privatization of the state by the state”\(^{88}\) when regime officials hijacked public institutions for the purpose of satisfying private interests. The regime also used state resources for maintaining itself in power. On the other hand, the regime never intended to achieve complete withdrawal of the state from the economy. Access to state resources was to serve as a continuous “carrot” for building future alliances. The state’s regulating and controlling functions served as the “stick” that allowed the regime to exert pressure in order to keep its allies in place. Exercising these functions also opened up rent-extortion opportunities for individual politicians. For its part, big business was also not interested in a complete withdrawal of the state from the economy. State ownership of a partially privatized business provided access to state resources and a variety of benefits for that firm, such as subsidies and lower tariffs. These benefits usually came without a cost since at this point the state controlled its property poorly.

The second factor that shaped business-regime relations was the fact that all post-Soviet regimes were to a smaller or larger extent concerned about their legitimacy in the eyes of the population. Even though the population played little role in shaping the policies that regimes pursued, none of the authoritarian regimes I study in this dissertation could afford to ignore the population completely. I treat legitimacy simply as passive or active acceptance of political power of a political regime. The less legitimate the regimes were, the more resources they needed in order to win (re)-election. The more resources they required in order to stay in power, the more difficult it was to find these resources. Yeltsin’s uncertainty about the prospects of

\(^{88}\) Olga Khryshtanovskaya, the original author of this term, defines it more narrowly as privatization of state assets by state officials formally in charge of these assets. Olga Kryshnanovskaya, "Biznes-Elita I Oligarkhi: Itogi Desyatletiia," Mir Rossii 4 (2002). <http://www.isras.ru/files/File/Publication/Magazines/Kryshnanovskaya_2002_n4_p3-60.pdf>. I argue that not only was state property privatized in this way, but state functions too.
reelection in 1996 forced him to seek help from domestic big business, which only intensified the inter-dependence and the illegitimacy of both business and his regime in the eyes of the public. In contrast, Putin’s legitimacy as a resolute, attractive (tastes differ!), and powerful politician strengthened him vis-à-vis domestic business and allowed him to re-assert the force of the state against big business and societal actors.

Similarly to Putin, Ukraine’s Yushchenko came to power in the second decade of independence, after the relations between the regime and big business had already been formed. Initially, Yushchenko also received a boost of legitimacy because of his role in the Orange revolution and his personal popularity. However, unlike Putin, who acted quickly to restore state force and strengthen the regime vis-à-vis domestic big business, Yushchenko proved unable and unwilling to change the underlying system of relations between business and the regime. The state had both weak force and weak power under Yushchenko. This suggests that democratization without any reform of the relations between the regime and big business is likely to be unsustainable.

From the regime’s perspective, the most successful strategy for maintaining power was to share state resources with a number of big businesses but retain control over this sharing. Ukraine’s Yanukovych failed at the former while Yushchenko failed at the latter. In contrast, Nazarbaev’s regime was successful at both, as was Kuchma to some extent. In this context, “pluralism by default” which characterizes weaker, authoritarian regimes, in many ways helped to sustain Kuchma’s regime in power as it gave a sufficient number of economic actors a stake in maintaining his regime yet made it still possible for the regime to control the distribution. We are used to thinking about neopatrimonialism as a characteristic of states that lack the distinction between the private and the public and where political authority is based on clientelism, including patronage and rent seeking. Yet, as Handley notes, neopatrimonialism is not restricted to the state but “arises out of ongoing tussles between leading political and economic actors.” A neopatrimonial state (that is, the political regime in charge of it) often seeks to draw business into an “incestuous relationship with itself.”89 It does so selectively, privileging some over others (very often the privilege takes the form of grating access to state resources), ceasing to privilege

or tempting with granting privilege to those who do not enjoy it at the moment. This selectivity only reinforces its power over business.\textsuperscript{90} Usually, in a neopatrimonial state a political regime fears seeing a strong institutionalized business community emerge from the bottom up, although in some cases it may contribute or even foster business institutionalization in a top-down manner if it is confident enough that it can maintain its control over institutionalized business.

Not only the regime but big business too cares about its legitimacy. The public perception of big business as thieves significantly weakens their property rights and makes them vulnerable to each other (by increasing the possibility of hostile takeovers) and to the regime (making it easier to take away property). Participation in neopatrimonial activities, whether or not fostered by the regime, erodes business’s reputation at home. Lack of domestic legitimacy also undermines the standing of post-Soviet big business internationally drawing it once again closer to the political regime.

8.2. How the State Influences the Durability of the Regime

Political regimes have thus left their mark on the state but the durability, or even survival of the regime is ultimately dependent on the state of the state. None of the regimes I considered in this dissertation saw the state first and foremost as a public good and thus worked to build strong state institutions that could outlast their own regime. All regimes viewed state power instrumentally. However, the level of destruction they wrought varied. Some regimes destroyed yet also built the state at the same time. Others exclusively focused on the destruction of state power. For example, Kazakhstan’s Nazarbaev destroyed the state by personalizing state power and undermining formal institutions but also modernized the state by making merit-based government appointments. He did not lose focus on the efficiency of state institutions because his legitimacy depended on what the state could or could not deliver. Looking back, Ukraine’s Victor Yanukovych brought about his own collapse: he was so “greedy and short-sighted”\textsuperscript{91} that he looted resources and was unwilling to share these resources with anyone. Ruthless stealing eventually resulted in a major fiscal crisis, which led Yanukovych to trade in the nation’s prospects of signing an EU association agreement for a possibility of a loan from Russia’s President Vladimir Putin. Yanukovych badly needed the loan in order to save his political power.

\textsuperscript{90} I thank Paul Kingston for helping me to reinforce and clarify this point.
\textsuperscript{91} Interview with Vladimir Dubrovskiy, senior economist, CASE Ukraine, Kyiv, May 2014.
The downfall of Yanukovych’s regime in the aftermath of protests on Maidan in December-February 2014 is another manifestation of the dependence of the regime upon the state of the state. While no one could predict how the events would unfold in January – February 2014 or not predict that Yanukovych would seek refuge in Russia (his loss of power was not inevitable), the larger, structural pre-conditions that undermined the regime were set in place long before Maidan.

In this dissertation, a “strong” regime is a consolidated one (either a democracy or a dictatorship) whereas a weak regime is vulnerable to breakdown. For authoritarian regimes specifically, “strength” means stability, i.e. the ability of an autocrat to maintain power. A strong authoritarian regime has a “solid foundation,” which consists of, among other things, large amounts of revenue at its disposal, a strong coercive apparatus, and/or a cohesive ruling party, which are likely to help the regime survive despite being challenged by the opposition. Sometimes, it does so by allying itself with domestic societal or external actors. Such alliances can help the regime maintain its power in the short and medium term yet can also weaken it in the long term since it makes the regime dependent on the interests of its political ally.

9. Dependent Variable

My dependent variable is the policy choices that three post-Soviet states made regarding FDI. These policy choices have been more than simply decisions about whether or not to allow foreign investors in. Instead, they have formed part of a larger elite’s vision on economic development. Even though choices about FDI do not always come in the shape of “policy” understood as a coherent set of steps taken to achieve a goal in a public sphere, we can still trace purposeful efforts on the part of regimes in the post-Soviet states to attract or to prevent FDI from coming in.

I view policy choices as determined from within, under the influence of domestic politics, rather than unilaterally imposed from the outside. I do not aim to explain how international capital behaves or what drives foreign investors. Rather, I aim to explain why the host states

---

92 Way 8. Way ties the strength of the authoritarian regime to the strength of its state institutions of coercion and patronage.
sometimes welcomed and at other times resisted foreign capital. Even though I discuss policy implementation, I do not problematize it.

This work focuses primarily on how the initial policy choices toward FDI were made. The third chapter is devoted to discussion of development of sectors during the Soviet era. I also point out how the late Soviet era institutional reforms shaped the policy choices of the post-Soviet states at the very beginning of independence. However, in my analysis, policies are not static and undergo changes. The factors causing policy change may differ from those that led a policy to be chosen in the first place. For example, the increase of oil and gas prices was a significant external factor that redefined the relationship between regimes and domestic and foreign investors. At the same time, the level of sector’s development (to some extent a product of historical contingencies) continued to affect subsequent policy choices regarding FDI. Also, these policy choices were still heavily rooted in the triangle of relationships between the regime, business, and foreign investors. I pay particular attention to how different political and economic interests were aligned in favor of FDI or contradicted each other and what policy choices regarding FDI have been made as a result.

The potential range of policies adopted is wide. A regime can actively seek foreign investors and give them preferential treatment. It can treat foreign and domestic investors equally. It can also give official or unofficial preference to domestic investors. Finally, a sector (or even the entire economy) can be completely closed to FDI. It is useful also to employ Jones Luong’s and Weinthal’s differentiation between ownership and control over assets to arrive at a more precise typology of policy choices.93 However, when applying these terms to particular empirical outcomes, we need to go beyond a country’s legislation to identify cases when there could be a mismatch between de jure and de facto ownership and control.94 For example, the state can dominate a sector or an enterprise even without formal ownership. That is why I view ownership as not commensurate with control. The degrees of both need to be established empirically. The major difficulty in operationalizing ownership is that information about

94 For Jones Luong and Weinthal, ownership is about “whether legislation (broadly construed) mandates that the state own rights to develop the majority of petroleum deposits and hold the majority of shares in petroleum sector.” The state is regarded to have control if “legislation limits the form of foreign oil companies’ participation (that is, the types of contracts they can sign.” See Pauline Jones Luong and Erica Weinthal, Oil is Not a Curse: Ownership Structure and Institutions in Soviet Successor States (New York: Cambridge University Press, 2010), 7, 9.
ownership structure of companies may not be publicly available. However, it may be possible to obtain information through sources such as local newspapers and magazines or reports in foreign press. The level of control is even more difficult to establish. Its operationalization requires looking at the way companies make important decisions and which actor dominates this process. The focus on informal mechanisms of control and ownership, however, should not come at the expense of ignoring the formal ones. For example, the forms that FDI took when it did come in are indicative of the degree to which a host country has been willing to surrender its ownership and control over assets in the key sectors.

Table 4. An Overview of the Main Developments in the Key Sectors of the Studied Post-Soviet States

<table>
<thead>
<tr>
<th>Sector</th>
<th>Russia</th>
<th>Ukraine</th>
<th>Kazakhstan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oil and gas</td>
<td>Yeltsin (1991-2000): both oil and gas developed by domestic actors: extensive privatization in the oil sector while preservation of more significant formal ownership in the gas sector. Latent government control. <strong>No interest in attracting FDI.</strong> Putin (2000-now): growing state ownership and control over both oil and gas; strengthened government control. <strong>No interest in attracting FDI; control over FDI that did come in.</strong></td>
<td>Significant state ownership in the sector yet no serious effort to set up production under any of Ukraine’s three presidents (rent-seeking opportunities). Weak control. <strong>No interest in attracting FDI.</strong></td>
<td>Privatization by foreign investors (major international companies), poor mechanism of government control. <strong>Overwhelming focus on attracting FDI.</strong> Increased state ownership and efforts to exercise government control after energy prices began rising around 2000. <strong>Efforts to increase government control and ownership in the sector yet focus on retaining FDI.</strong></td>
</tr>
<tr>
<td>Metallurgy</td>
<td>Yeltsin (1991-2000): privatization by domestic private business; weak government control. <strong>No interest in FDI.</strong></td>
<td>Privatized by domestic business groups in the late 1990s-early 2000s. Generally weak government control.</td>
<td>Privatization by foreigners (mostly “murky” companies, with alleged ties to Kazakhstan’s President</td>
</tr>
</tbody>
</table>

95 While ownership is often undisclosed in the post-Soviet region, I do not need to establish exact portions of shares any owner has in a company of interest or the exact identities of owners besides whether or not they are foreign or domestic for the purposes of my research. Information about state ownership may also be more available to the public than about domestic private ownership.

96 That is why while examining the actual policy choices, I pay attention to whether and to what extent FDI came in through Production Sharing Agreements (PSAs), joint ventures, equity purchases.
| Putin (2000-2014): property remains in domestic private hands yet government control over the sector increased significantly. **No interest in FDI.** | **Overall, little interest in attracting FDI (with the exception of Kryvorizhstal sale to Arcelormittal in 2004).** | Nazarbaev and his family) in the 1990s. **Mass inflow of FDI from murky companies (little “real” FDI)**

More domestic (including state) ownership since the late 1990s, but still strong president’s personal control over both domestic and foreign actors working in the sector combined with (secret) ownership in the sector |

Policies that are similar on the surface may result in very different outcomes.\(^\text{97}\) I do not aim to explain policy outcomes per se but instead considers whether or not policies are designed to serve broad societal interests or the narrow interests of particular political and/or economic elites. Policies will be judged to be serving the broader societal interest if, for example, they result in improvement of the population’s living conditions, development of infrastructure or generation of funds for advancement of broad-based development in the future through economic diversification. The entry of foreign capital can also potentially create conditions for mutual empowerment of the state and domestic business.\(^\text{98}\) Policies will be considered to serve narrow interests if their implementation brings private benefits to a closed circle of elites or is used directly to sustain a regime in power. My dissertation thus considers interests as part of both the dependent and independent variables. At the same time, I do not assume that policies chosen based on narrow interests will serve exclusively these interests. While none of my three cases matches the “ideal type” of a developmental state, we also cannot assume that all of them focus equally on the short-term interests of elites and disregard the interests of the broader publics and long-term development. For example, political alliances between a regime and well-organized |

\(^{97}\) Kohli 12.

\(^{98}\) State Power and Social Forces: Domination and Transformation in the Third World.
domestic business can sometimes lead to policies that in one way or the other serve broader societal interests due to the constraints these actors put on each other. 99

10. The Independent Variables

My first independent variable (IV) is the level of the sector’s development, i.e. the general state of the sector influenced by, among other things, the amount of resources that had been invested into the sector, the availability of adequately trained human resources, equipment, technologies, and infrastructure to maintain production. The knowledge about the resources a sector has at its disposal is also a characteristic of the state of the sector (for example, the availability of data on resources in the ground).

Initially, Soviet-era economic development policies (and specifically investment decisions) led to a variation in levels of development that existed in the same economic sector across the Soviet republics. Russia’s oil and gas sector, for example, was developed extensively during the Soviet era. In contrast, while the Soviets discovered oil and gas in Kazakhstan they did not develop them due to lack of technologies and capital. In Ukraine, even exploratory works were not fully conducted. 100 This means that our three post-Soviet states faced different “starting points” when they were making their choices about the future of these sectors.

The level of the sector’s development during the Soviet era certainly influenced officials’ perceptions after independence about whether they could develop this sector on their own (with the help of state or private companies) or whether they needed foreigners due to lack of critical inputs, such as domestic capital, technologies, and human resources. After gaining independence, Russia could develop oil and gas on its own whereas Kazakhstan and Ukraine could not. If we turn to the metallurgical sector, this was generally well-developed in all three states. Due to a heavy emphasis on the construction of new production capacities at the expense of re-construction and technological upgrading of enterprises by the Soviet planners, all three republics had significant un- and under-utilized production capacities, which allowed domestic

---

99 See Handley,
100 I will discuss briefly why these policies were formulated in the first place in the next chapter. Admittedly, these three countries have different levels of these reserves. Ukraine has the least. At the same time, its actual reserves could be more significant than it is believed to be the case – we just do not know because their prospecting was not conducted.
elites to develop these sectors without inviting foreigners en masse.\textsuperscript{101} Whenever post-Soviet elites believed they could develop a sector on their own, they generally did so.\textsuperscript{102} States were not necessarily concerned with long-term development of these sectors for the benefit of the broader public. Sometimes, at least initially, it all came down to squeezing out short-term personal gains and maintaining production at a certain, even if minimal level.

It needs to be noted that identifying Soviet legacies, their effect on the post-Soviet era, and the causal mechanisms behind this affect remains beyond the scope of this project. Rather, the state of sector’s development that was achieved during the Soviet era is a factor that explains the initial policy choices toward FDI and becomes a factor that affects policy evolution over time. At this point, the state of the sector is no longer closely tied to the Soviet past. Whether we take a thicker or a thinner definition of Soviet legacies, these legacies necessarily interact with other causal mechanisms and processes, sometimes reinforcing or contradicting one another.\textsuperscript{103} The level of development sectors achieved during the Soviet times “mattered,” yet political elites made their own choices too.

A related factor (my second IV) is the strategies that political regimes pursued to maintain their political power and satisfy private interests of regime officials. I therefore identify the specific vulnerabilities of a regime that affect its ability to hold onto power, while considering also how these regimes interacted with the state of the post-Soviet states. Regimes can be particularly vulnerable around the time when a leader is being reelected or when he (unfortunately, never a she in the post-Soviet context) is leaving office and is susceptible to persecution by the successor. Other vulnerabilities can originate in, among other factors, inter-ethnic relations or the incumbent’s old age (as in Kazakhstan, for example). A weak regime may need to secure support from a particular social group or actor (domestic or foreign). By contrast, a stronger regime with independent sources of legitimacy can make policy choices that go against particularistic interests. Regimes viewed sectors and their assets as a resource that could be used for power maintenance and assigned a particular political role to these sectors, which

\begin{itemize}
\item[101] Kazakhstan may seem like an exception here since it saw significant levels of formally foreign ownership yet foreigners were often Nazarbaev’s partners according to numerous sources.
\item[102] Jones Luong and Wenthal start with this proposition as an \textit{apriori} assumption whereas I consider it necessary to investigate it empirically.
\end{itemize}
determined policy choices toward FDI. A more developed sector certainly increased the “political” value of a sector for the regime yet it did not predetermine the role the regime assigned to a sector in maintaining itself in power. The three main roles were i) as a source of revenue generation for the regime (through official channels), ii) as a site for rent-seeking for the regime and its political allies (unofficial), and iii) to facilitate the distribution of property among political allies. These roles are not mutually exclusive. Quite often, a sector fulfilled more than one role at the same time.

11. The Structure of the Dissertation

In the chapters that follow, I explore the policy choices Russia, Kazakhstan, and Ukraine made toward FDI. Chapter 3 provides a historical overview of development of, first, oil and gas and, second, metallurgy and mining for the three republics during the Soviet era. It identifies the most important features of this development in order to establish key contingencies that affected the post-Soviet era. In the following chapters, I investigate how these choices were made in each of the three republics by looking at the nature and the strength of the political regimes that became established and by their interaction with the state, domestic business, and (potential) foreign investors.

---

104 The fourth role that can be identified is the role of maintaining social peace (for example, Gazprom’s supplies of cheap gas to the households, which also was clearly political as it helped to maintain Yeltsin’s regime in power).
Chapter 3. Economic Development of the Republics during the Soviet Era

Soviet decision-making in the economic sphere was heavily centralized. Soviet planners made their choices about development based on what “made sense” for the entire Union, without concern for specific republics. As a result, at the time of USSR’s dissolution, levels of development across sectors and across the NIS states varied significantly. In this chapter, I present the republics and elaborate on the first factor that, as I argue, affected FDI policy choices the post-Soviet states made. The level of development that the two studied sectors achieved during the Soviet times defined (but did not determine) the range of policy choices the post-Soviet states had regarding these sectors after independence.

This chapter aims to assess the level of development oil and gas and metallurgy and mining achieved during the Soviet era. How the political regimes of the post-Soviet states then used these sectors is covered in the empirical chapters that follow.

1. Introducing the Republics

1.1. The RSFSR

The Russian Socialist Federative Soviet Republic (RSFSR) occupied the central place in Soviet political and economic systems. It was the biggest, the most populated, and the most economically significant Soviet republic. The RSFSR was also home to a large share of Soviet natural resources. Early in the 20th century, the overwhelming majority of Russian industry was located in the European part of the Russian empire. The Asian part of the RSFSR underwent significant development during the Soviet era, especially after World War II had destroyed industries in the West of the USSR and after oil was discovered in Western Siberia. The Soviet leadership recognized the republic’s special place within the USSR’s economy. In December 1982, Yurii Andropov, at the time the General Secretary of the Communist Party of the Soviet

---

Union (CPSU), stated that “every Soviet republic was doing more than its share for developing the Soviet Union’s economy, but this was particularly true of the Russian republic.”

The RSFSR was also the most important republic politically: the Communist Party of the USSR, the government, and all union ministries were located in Moscow, the capital of the RSFSR and of the USSR.

In general, the pattern of capital distribution among republics was relatively stable. The RSFSR received about 60 per cent of all Soviet investments, yet its levels of investment per capita were higher than for other republics. Whereas other Soviet republics competed for union funds for themselves, in the RSFSR competition often took place among regions of the republic.

1.2. Kazakh SSR

Kazakh SSR (KazSSR – today’s Kazakhstan) was the second largest Soviet republic based on its territory, fourth in terms of industrial production, and third in terms of agricultural output. It was very rich in energy and other mineral resources. The east became an important centre for non-ferrous metal mining. The centre specialized in coal and copper mining. The north and the west produced energy. The south was primarily involved in agriculture and lagged behind the northern two thirds of the republic in terms of development.

Although Kazakhstan underwent significant industrialization during the Soviet era, its development was never an end in itself for Soviet planners. Kazakhstan’s economic and industrial development proceeded unevenly both spatially but also over time. Immediately after World War II, development of Kazakhstan’s mineral resources was considered an all-union priority. Significant investment went into infrastructure and construction of new mining and processing facilities. The republic received per capita funding levels that were substantially higher than the Union average.

Metallurgy, machine building, and heavy and light industry witnessed significant development. In the late 1970s, industry constituted about half of the

---

3 The rest of European SSR got around 18-20 per cent, 6 per cent went to Kazakhstan, 3-4 per cent went to the Caucasus, and 6.5 per cent to Central Asia. See Dellenbrant 144.
4 I will refer to Kazakh SSR as Kazakhstan for the sake of simplicity even though it was not its formal name during the Soviet era.
5 See Dellenbrant 162-163.
republic’s GNP and about 35 per cent in its national income. Within the industrial sector itself, production of capital goods accounted for three quarters of overall industrial production.⁶

After 1975, Soviet planners no longer prioritized Kazakhstan’s development.⁷ Per capita investment levels slowed down, even though they were still higher than the Union average.⁸ Retirement of fixed assets, especially those with high energy consumption, was very slow. At the same time, Kazakhstan’s capital investment financed a higher share of new construction than the Union average, suggesting an emphasis on extensive rather than intensive development. The dominance of heavy industry with obsolete technologies became an obstacle to the republic’s economic restructuring after independence.

Due to the centralized nature of Soviet decision-making, Kazakhstan’s elites (along with the elites of other republics with the exception of Russia) lacked any experience at running the republic. Kazakhstan directly controlled only 8 per cent of its economy. The republic shared control of 48 per cent of the economy with Moscow, and 43 per cent was controlled directly from the centre.⁹ In addition, Kazakhstan’s economy was very closely integrated with Russia’s southern Siberia. Northern Kazakhstan, where the majority of manufacturing, mines, and processing facilities were concentrated, became “an appendage of the metallurgical complex in West Siberia and the Urals.”¹⁰ That is why Kazakhstan was very reluctant to leave the USSR when the latter began collapsing.

### 1.3. Ukrainian SSR

The Ukrainian SSR (UkrSSR – today’s Ukraine) was the second most populous Soviet republic and the second largest producer of industrial and agricultural output (after Russia).¹¹ In the 20th century (especially before World War II), Ukraine underwent very extensive

---

industrialization. Within the republic, the Donets-Dnieper region that included the Donets Basin Coalfield (known as Donbas) was economically the most developed. It was tied more closely to Russia than to other parts of Ukraine. Donbas supplied approximately 70 per cent of European Soviet and one third of overall Soviet coal output (about 230 million tons).

At the same time, Ukraine’s economy suffered from structural imbalances. The republic was mostly a producer of raw materials, such as coal and metals. Heavy industry constituted approximately 70 per cent of Ukraine’s industry. Machine-building, metal-working industries, and the service sector were less developed. The slowdown of Ukraine’s growth after the war was also concerning. Between 1940 and 1968, its industry grew less than the Union industry overall and than the industry of nearly all other Soviet republics. Ukraine’s share of the total Soviet coal production fell from 50.3 per cent in 1940 to 33.6 per cent in 1965. The share of ferrous metallurgy fell from 59.3 per cent to 44.3 per cent. The two main reasons for the slowdown were significant war damages and insufficient resource allocation by Moscow. Ukraine’s industry began experiencing difficulties in the 1960s, exactly the period when the stepped-up development of Siberia began. The contest between the Siberian lobby advocating heavy investment in their region and the Ukrainian lobby that argued in favor of investing in their republic ended with the victory of the former. By the end of the 1980s-early 1990s, Ukraine had a stagnant and technologically backward industry that suffered from under-investment and dependence on imported energy.

16 Kubijovyc, 702, Volume 1.
17 For discussion of the consequences of the war for Ukraine, read, for example, Gordijew, Ihor and I.S. Koropeckyj. 1981. “Ukraine.” In: Economics of Soviet regions 278. Gordijew and Koropeckyj also note that Ukraine’s shares in the total USSR investment after the war “were consistently lower than the Ukrainian shares in the total output and population of the USSR.” See Economics of Soviet regions 296.
19 The post-Soviet republics: a systematic geography 53.
2. Soviet Management of the Economy: General Characteristics

Soviet management of the economy shifted back and forth between centralization, when Moscow made the most important decisions, and de-centralization, when republics were allowed to have some say. Throughout its existence, the USSR tried to combine two governance principles – branch and territorial, yet the former always at the end dominated.20

Immediately after the war, the system was highly centralized. Planning and resource allocation focused on national sectors and branches. 95 per cent of investment capital went to all-union ministries while the remaining 5 per cent went to the republics.21 The Soviets recognized that departmentalism (ведомственность'), the practice when ministries pursued their institutional interests at the expense of common interests, was a major negative consequence of building up large branch-based ministries. Departmentalism resulted in significant economic losses as the focus on branch ministries weakened or even destroyed territorial ties between enterprises of different industrial branches located next to each other and limited possibilities of solving administrative issues through the use of local material, human, and financial resources.22

The Soviets tried to counteract departmentalism by increasing enterprise efficiency and moving from extensive to intensive development, which required a more exact match between available technologies and tasks that needed to be fulfilled.23 Ukraine’s republican authorities in particular promoted the idea of decentralization.24 In 1957, Khrushchev proposed transferring power from ministries to regional economic councils (совнархозы) that would make local authorities more involved.25 Across the USSR, approximately 100 economic councils were created and given direct control over major enterprises under supervision of the republican branches of the State Committee for Planning (Госплан). In 1961, совнархозы controlled 93 per

21 Boris Z. Rumer, Soviet Central Asia: "a tragic experiment" (Boston: Unwin Hyman, 1989) 4.
22 Valentin Mefodievich Marchuk, Organy gosudarstvennogo upravlenia USSR na sovremennom etape (1964) 51.
23 The post-Soviet republics: a systematic geography 53-54.
cent of industry and 77 per cent of USSR’s investment funds. The reform solved the problem of departmentalism by creating a new problem: localism. Ukraine and some other republics now constantly under-fulfilled delivery quotas for development of the RSFSR’s east and Kazakhstan. This system did not work well for Moscow.

In 1965, Brezhnev’s Chairman of the Council of Ministers Alexei Kosygin reinstituted the ministerial system: twenty-three new industrial ministries were created while existing state committees were given more authority and responsibilities. Under the new rules, union republics prepared recommendations that concerned industries located on their territories and directly subject to central ministries. In practice, the heads of all-union ministries only pretended to listen to these recommendations and rarely implemented them as the recommendations were non-binding. Although Kosygin’s reforms did not achieve their original goals, their long-lasting legacy became administrative recentralization.

In 1973, Brezhnev initiated reforms that aimed to correct the failings of the central planning system, in particular, its focus on quantity rather than quality and lagging innovation. The new system of associations consisted of a complex agglomeration of sub-Ministerial entities. Factories were re-grouped and placed under production associations. The new industrial associations were to be funded from profits of constituent enterprises. Still, the system remained centralized: even though production associations had some degree of freedom, they remained subordinated to the ministries.

The 1977 Constitution established two types of ministries: union ministries, which operated exclusively at the union level, and union-republic ministries, which were responsible to union-level ministries and to a particular republic’s Council of Ministries. The all-Union ministries and state committees managed their sectors or coordinated inter-sectorial management on the entire Soviet territory directly. The ministries aimed to maximize output while minimizing investment. The ministries did not have direct incentives to reduce the cost of production that

26 Rumer 4.
27 Kubijovyc, Volume 1, 703.
28 Rumer 8-9.
29 Hewett 244.
31 Dellenbrant 65.
was carried out by individual enterprises.\textsuperscript{32} The union-republican ministries and state committees worked through corresponding ministries, state committees, and other institutions of union republics.\textsuperscript{33}

A number of republics had official input into the policy-making process in specific sectors at the central level through their ministries at union-republican level. Some of these ministries were formed in the early 1950s: for example, the UkrSSR established its own ministries of coal, the iron and steel (ferrous metallurgy) industry, and ministry of higher education; the KazSSR established its ministry of non-ferrous metallurgy; the Azeri SSR had its petroleum ministry.\textsuperscript{34} The power of these ministries always remained limited. Even in Ukraine, which had more decision-making powers than other republics, “the dictates of central ministries [were] almost irresistible.”\textsuperscript{35} Whenever a Soviet union-republic ministry asked for additional decision-making powers, a republic had to surrender these. Whenever the two levels of bureaucracy disagreed, Moscow predominated.\textsuperscript{36}

By the 1980s, the centrally commanded Soviet economy had run into serious structural problems and began stagnating. The general secretary of the CPSU Mikhail Gorbachev tried to improve the system through a series of reforms that became widely known as \textit{perestroika} (reconstruction). Launched in 1986, the reforms aimed to modernize the Soviet economy through utilization of advanced technologies, decentralization of economic management, and stimulation of enterprise performance in the marketplace.\textsuperscript{37}

Gorbachev was particularly disillusioned with the centralized system of economic management where the ministries made most important decisions. One of the key tools of economic decentralization was the Law on Enterprises, which came into force in 1988. The Law awarded managers of state enterprises greater decision-making powers. The system of state orders, which covered less than total output capacity, replaced the old mandatory production and

\textsuperscript{32} The post-Soviet republics: a systematic geography 46.
\textsuperscript{33} USSR 1977 Constitution, Article 135.
\textsuperscript{35} Rumer 9.
delivery targets. Enterprises received more control over financial resources and could now keep a larger share of their earnings. That is why even though bank credits were significantly reduced, enterprises enjoyed new liquidity that allowed managers to rapidly increase wages and social expenditures in order to strengthen their positions at the enterprises. The Law also allowed Soviet firms to participate in foreign trade directly and permitted joint ventures (JVs) between Soviet and foreign firms that would produce on the Soviet territory. Gorbachev’s reforms did not save the USSR, but they did empower the so-called “industry generals” (Soviet managers) across republics and across sectors. Decentralization of economic decision-making allowed the nomenklatura to “strip the state of industrial assets or joining with organized crime to extort wealth from the embryonic private sector.”

3. Soviet Oil and Gas Industries

The USSR had the world’s largest reserves of natural gas and was the second largest producer of this resource. Having surpassed the US in 1976, for some time the USSR was also the world’s largest producer of oil. Approximately 90 per cent of Soviet energy sources were located in the RSFSR.

3.1. Soviet Oil

In the USSR, oil had a long history of development. The first region to produce oil was Baku in Azerbaijan. Initial methods of oil extraction were primitive, yet over time research on the nature of petroleum and geological structures led to significant increases in production. Baku was responsible for nearly all oil produced in the Russian Empire in 1901. Foreign investors played an important role in their development. The family of the Swedish inventor Immanuel Nobel was particularly active. Late in the 19th century, four “formidable rivals” dominated Baku

39 The post-Soviet republics: a systematic geography 60.
40 Understanding contemporary Russia, ed. Michael L. Bressler (Boulder: Lynne Rienner Publishers, 2009) 76. This process is often referred to as “nomenklatura privatization.” See, for example, Juliet Ellen Johnson, A fistful of rubles: the rise and fall of the Russian banking system (Ithaca: Cornell University Press, 2000) 36.
41 Western estimates put the Soviet energy reserves at 58 billion barrels of crude oil and 52 trillion cubic meters of natural gas. A Study of the Soviet Economy, Volume 3, 181.
oil extraction: the Standard Oil Company of America, the Rothschilds, the Nobel Brothers, and a loose consortium of Russian oil producers. Periodic Bolshevik strikes and demonstrations in 1901-03, the revolution of 1905, World War I, the collapse of the Czarist regime in 1917, the civil war of 1918-20, and the 1920 Polish invasion of Russia negatively affected Baku’s “oil boom.” By the end of the civil war, crude oil production had fallen to less than 30 per cent of pre-revolutionary levels. The destiny of the oil industry was sealed in 1920, when the Bolsheviks consolidated their power and introduced War Communism that called for industry nationalization. Foreign investors lost their property without compensation. Foreign investors returned once again briefly when the Soviets invited them to sign concessions for development of Russian oil fields and timber as part of the New Economic Policy. Foreign companies restored crude oil flows and bolstered confidence in the Bolsheviks. Soviet exports increased from a mere 31.3 thousand tons in 1920 to over 2 million tons in 1926, which allowed the USSR to pay for imports of machinery. At that time, the Soviets accepted foreign firms as “a necessary evil” because of their dependence on foreigners’ technology and expertise. During the Stalin era, all experimentations with mixing command and market economies were terminated when the regime established central control over the economy. The state provided investment into the construction of pipelines and new refining facilities, promotion of exports, increased exploration and development, and equipment upgrade.

For some time, the Soviets were lucky with oil: as soon as oil production in one region began decreasing, they discovered another oil-rich region. When Azerbaijan and the smaller fields in the North Caucasus started to show signs of exhaustion, the Soviets found oil in the Volga-Urals region, which became their “second Baku.” Production shares by these regions reversed almost fully: whereas in 1940, Azerbaijan produced 71.5 per cent of the total Soviet oil output, dropping steadily to 8.8 per cent in 1965, the share of the Volga-Urals region during the same period rose from 5.8 per cent to 71.5 per cent. The Volga-Urals region was conveniently located in the east of the European USSR, with a developed railway and water transportation.

44 Considine.
system. It was also located close to large oil consumers in the Urals and Western Siberia. Oil in the Volga-Urals region was located at relatively shallow depths. Annual oil production in the Volga-Urals reached 224.8 million by 1975, after which a steady decline began. By 1990, Volga-Urals was back to annual production of 108.8 million tons.

The Soviets were lucky once more. When the Volga-Urals region began running out of oil, exploratory drilling in Western Siberia led to the discovery of large oil deposits. Central planners were highly enthusiastic about the region’s potential. However, the underdevelopment of Western Siberia’s infrastructure, its remoteness from the European USSR and severe climatic conditions made the extraction of hydrocarbons difficult. Development of Western Siberian oil would require massive resources. Scientists and planners from Belorussia and Ukraine were especially critical of the plans to develop Siberia rapidly, arguing that their republics and other parts of Western USSR had energy resources that were not being exploited. Others insisted that the USSR had no choice but to develop Western Siberia if it wanted to maintain oil production. By the mid-1960s, the second view ultimately gained dominance.

The Siberian region did not disappoint. Whereas in 1966 Western Siberia produced 2,849 million tons of oil, by 1974 production increased to 116,425 million tons. At its peak in 1988, Western Siberia produced almost 408,000 million tons. By the mid-1970s, West Siberia provided more than two thirds of gross additions to reserves while receiving approximately 15 per cent of total investment into drilling. From 1964-1970, the increased production capacity cost one third less than the average for the industry. As table 5 (below) demonstrates, by the end of the USSR’s existence, Western Siberia was by far the leading oil producing region.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Russia</td>
<td>199,191</td>
<td>282,010</td>
<td>405,</td>
<td>Na</td>
<td>534,375</td>
<td>550,590</td>
<td>557,513</td>
<td>552,740</td>
</tr>
</tbody>
</table>

48 Dellenbrant 86-87.
49 For a detailed discussion of the debate, see Slavkina 52-66.
50 Elliot 100.
### Table 3.2. Soviet Gas

<table>
<thead>
<tr>
<th>Region</th>
<th>Total 1</th>
<th>Total 2</th>
<th>Total 3</th>
<th>Total 4</th>
<th>Total 5</th>
<th>Total 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>N Caucasus</td>
<td>19,971</td>
<td>34,156</td>
<td>23,037</td>
<td>18,412</td>
<td>10,521</td>
<td>10,116</td>
</tr>
<tr>
<td>V-Urals</td>
<td>173,634</td>
<td>208,357</td>
<td>224,905</td>
<td>185,869</td>
<td>135,544</td>
<td>122,853</td>
</tr>
<tr>
<td>Komi</td>
<td>2,223</td>
<td>5,609</td>
<td>7,120</td>
<td>18,075</td>
<td>18,215</td>
<td>18,269</td>
</tr>
<tr>
<td>W Siberia</td>
<td>953*</td>
<td>31,416*</td>
<td>154,679</td>
<td>322,459</td>
<td>365,805</td>
<td>389,665</td>
</tr>
<tr>
<td>Ukraine</td>
<td>7,339</td>
<td>13,501</td>
<td>11,544</td>
<td>4,853</td>
<td>4,756</td>
<td>4,652</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>21,500</td>
<td>7,287</td>
<td>5,840</td>
<td>5,053</td>
<td>3,909</td>
<td>3,902</td>
</tr>
<tr>
<td>Kazakh</td>
<td>1,688</td>
<td>13,161</td>
<td>23,890</td>
<td>18,836</td>
<td>21,493</td>
<td>21,688</td>
</tr>
<tr>
<td>Turkmen</td>
<td>9,636</td>
<td>14,430</td>
<td>15,307</td>
<td>7,150</td>
<td>5,423</td>
<td>5,359</td>
</tr>
</tbody>
</table>

Note: * estimate

Source: Considine 97.

3.2. Soviet Gas

In many ways, the story of Soviet gas development is similar to that of oil as these two resources are usually located together. Initially, gas was discovered in Azerbaijan, yet the majority of oil-well gas was vented and flared. Production only increased after the industry had recovered from the Civil War and new and efficient methods of gas extraction had been developed. Despite a steady increase in output, gas continued to play a minor role as an energy source because Soviet planners concentrated on oil.

Gas industry began very rapid development after World War II, mostly as an accidental by-product of oil exploration. New fields were discovered in the Saratov, Volgograd, Orenburg, and Kuybyshev regions, in Ukraine, and later in the Northern Caucasus, Central Asia, and Russia’s Tiumen region. The new fuel policy adopted in 1956 gave a significant boost to the gas sector. The sixth Five-Year Plan aimed to increase gas output by more than four times by 1960. The sector’s administration also saw changes. Gas industry used to be a subsidiary of oil. In
August 1956, the Main Directorate of the Gas Industry (Glavgaz for short) became the main division of the gas industry at the USSR’s Council of Ministers. In 1965, the South Russian region (Krasnodarskiy and Stavropol’skiy regions) produced about 64.2 billion cubic meters of gas, or 50.3 per cent of all-Union gas production. The Uzbek and Turkmen SSRs were very promising. Gas was also discovered between the Ob’ river and the Urals in Siberia. The development of these Siberian fields (Medvezhye, Urengoi, and Yamburg) began in the early 1970s. By the mid-1970s, gas sector was facing similar problems to those facing oil.

3.3. Problems with Oil and Gas Production in the USSR

Even though in 1975 volumes of oil extraction in the USSR were higher than in the US, large problems began looming over the sector already at that time. For a long time, the Soviet leaders ignored these problems. The sheer abundance of resources and nature of the command economy (which did not create incentives for efficient production) led Soviet officials to take a short-term perspective on development of these resources. As a result, they disregarded preservation of energy and increasing possibilities for future resource extraction.

Methods used to develop these resources were technologically primitive. In the early 1970s, it became obvious that Soviet extractive technologies were inferior to those used in the West. For example, poor quality of steel allowed the Soviets to drill only up to 2000 meters. The turbo-drill with its high speed, low torque, and light weight was suitable for the hard rocks of the Volga-Urals. Its use allowed the industry to avoid problems caused by the poor quality of pipe and tool joints. However, the turbo-drill was ineffective in the softer rocks of Western Siberia. Furthermore, the geology of promising Eastern Siberia was different from Western Siberia and required yet another type of specialized extraction equipment. The Soviets, despite their well-developed domestic steel industry, ended up buying steel pipes abroad. The USSR struggled to pay for the imported technologies. The purchase of Western technologies also

51 See Slavkina 33.
53 See, for example, Goldman 36; Considine 90.
54 Siberia: problems and prospects for regional development 125-126.
55 Goldman 40-41. Whitefield notes that the Ministry of Ferrous Metals, in fact, refused to commission a factory that would produce corrosion-resistant pipe for use in other branches, despite enormous investments that had been made. See Stephen Whitefield, Industrial power and the Soviet state (New York: Oxford University Press, 1993) 58.
tended to inhibit domestic innovation. The adaptation of these technologies to Soviet production processes required significant resources.

One of the main weaknesses of the command economy was that its incentive system was not conducive to sustainable economic growth. Planners discounted the long-term future in order to meet current production targets. For example, secondary recovery of hydrocarbons would have allowed the Soviets to extract more energy from old wells. The use of this method would involve heavy costs at the beginning while output increases only came later. Oil field administrators were reluctant to apply this method since it would have worsened performance indicators that affected their bonuses. In Western Siberia, the reported recovery ratio of petroleum was only 30-40 per cent. Gas discovered together with oil was often simply flared because of administrative hurdles. Soviet oilmen tried to increase output through water-flooding – a production technique that involved injecting water into the field in order to push oil toward the wells and up to the surface. Whereas in other countries water-flooding was usually used in the later stages of an oil field’s life cycle, the Soviets applied it from the very beginning. This technique enabled them to take a new field to its maximum output faster yet also shortened the life of a field, reduced total recovery, and sharply raised production costs.

Part of the reason why the Western Siberian oil boom did not last was inadequate investment. Although some blamed the region for pulling resources away from other regions, Siberia actually received too few resources given the volume of reserves it had and the rate of their development.56 The Soviet planning system was inherently inflexible: the basic structure of Soviet investment remained almost unchanged from 1961 to 1975 and did not reflect variations in steadily rising exploration and development costs.57

Weak central management was a persistent problem of Soviet energy policy. The Council of Ministers and the Party Central Committee oversaw the energy sector yet constantly lacked the staff for doing this effectively. The system could provide a unified overview and develop strategy at the very top, where the general objectives and output targets were set and investment decisions were made. However, the implementation of decisions and reporting lagged behind. Four large, vertically integrated ministries were responsible for the energy sector: the Ministry of

56 See, for example, Slavkina 75; Siberia: problems and prospects for regional development 103-104.
57 Considine 114.
Petroleum, the Ministry of Gas Industry, the Ministry for Construction of Oil and Gas Enterprises, and the Ministry of Geology. Poor horizontal communication between these four ministries and departmentalism were a major problem. The decision-makers at the very top had to “fit them [the ministries] together as well as they [could] and somehow cope with the ragged edges between them.”

In 1965, production associations were established as the main organizational unit of the oil sector. They were supposed to unite enterprises and structural subdivisions where each would carry out a certain type of production activity. The Soviets hoped that this measure would increase the flow of information between ministries and enterprises and help create economies of scale in research and development. Within a sector, production associations were usually created on territorial basis combining sectoral and territorial principles of management. The reforms of the mid-1970s strengthened production associations at the expense of the oil industry enterprises that actually carried out the operations known as NGDU (Neftegazodobyvaushchee upravlenie), which were the field directorates in the sector. Still, production associations could not make investment decisions or independently sell extracted resources. These decisions were part of the national economic plan and had to be approved by central authorities.

The Ministry of Gas was perceived as an efficient institution with important political clout, which led the central Soviet leadership to task it, rather than the Ministry of Petroleum, with offshore oil production. The Ministry had a reputation for being more aggressive in exploratory drilling and having higher organizational ability than the Ministry of Petroleum or the Ministry of Geology. The Ministry of Gas also had more experience with imports of Western technology than other energy ministries.

59 V. A. Kriukov, Institutsional'naia struktura neftegazovogo sektora: problemy i napravleniia transformatiei, ed. Valerii Vladimirovich Kuleshov (Novosibirsk: Izd-vo IOPP SO RAN, 1998) 76. Different production associations were subordinated to a variety of ministries – some to the union and USSR union-republic ministries, some to republic union-republic and republic-subordinated ministries. See Koropeckyj 136.
61 Even the corresponding ministries did not always have this competency since issues such like these were determined in the all-Union plan and approved by the Party and highest government bodies. Kriukov 77-78; The Oxford handbook of the Russian economy 345.
The Ministry of Geology was in charge of exploratory drilling. Since the number of drilled meters served as a measure for Ministry’s performance, Soviet geologists drilled a large number of shallow holes, even if exploration did not lead to any discoveries. Over time, geologists needed to increase their drilling depths in order to find oil and gas. Wells drilled below 4,500 meters were becoming more and more common. Whereas in 1955 there were 4,800 such wells, by 1971 this number rose to 460,000. However, even this was not enough to maintain the production volumes. Increased drilling depth lowered rig productivity and raised the average cost of drilling per meter.

The problems the sector faced at the time reflected the general stagnation of Soviet economy. Average annual rates of industrial growth declined from 7.8 per cent in 1970-80 to 4.3 per cent for 1980-88. Since the 1970s, capital productivity declined in all economic sectors. Hydrocarbons, especially oil, became the major export commodity and thus the chief earner of hard currency. In fact,

… the real “zastoi,” i.e. stagnation of the national economy started only when the Soviet political and part of the economic management leadership acquired an illusion that the main contradictions between the external economic activity and concern for supporting a certain standard of living for the population, on the one hand, and real possibilities of under-reformed national economy, on the other hand, could be solved through continuation of growth of extraction and export of hydrocarbons …this illusion appeared and took root by the mid-1970s.

Energy exports served as a temporary solution to deeper structural problems of the command economy, allowing the USSR to pay for various imports, including those of equipment needed for production of oil and other goods. At the same time, the sector itself required more and more investment. The Soviet leadership systematically discounted the true costs of developing and producing oil. When the world oil prices dropped in the first half of the 1980s,

63 Goldman 46.
64 Robert Wellington Campbell, Trends in the Soviet oil and gas industry (Baltimore: Published for Resources for the Future by the Johns Hopkins University Press, 1976) 18. For more discussion of the problems with the Soviet exploratory drilling, see Considine 118-119.
66 Slavkina 150-151.
67 Lewarne 2.
oil rents dwindled from $270 million per year in 1980-1981 to less than $100 billion in 1986.68 The oil sector could no longer sustain itself or the Soviet economy.

3.4. Seeking Solutions

One potential solution to falling oil production was to look for new energy sources offshore. A large part of Soviet offshore oil extraction took place in the Caspian Sea. In 1970, the Neftyanye Kamni field in the Caspian Sea was responsible for over 60 per cent of Soviet offshore production. The north of the Sea of Okhotsk came second in importance. In these two regions, drilling was relatively easy as oil was located relatively close to the surface. In order to develop deeper fields, the Soviets needed imports of Western equipment yet struggled to pay for it. Because approximately two-thirds of the USSR’s hard currency earnings came from oil sales, the Soviets needed to produce more and more oil to pay for Western technology. For decades, offshore petroleum production remained miniscule: in 1960, the USSR produced only 4.8 per cent of its oil offshore, 3.7 per cent in 1970, and 1.6 per cent in 1980.69

The Soviets also tried to solve their energy problems by increasing gas production. In 1980-81, they launched an ambitious campaign to raise natural gas output by 50 per cent within five years, mostly counting on production from the Urengoy gas field in Western Siberia. During 1971-1978, investment into gas production more than tripled. The rising cost of production affected the gas sector much less than oil. Gas was the only energy producer that achieved its five-year targets established in 1976. While the long-term future of oil production was in jeopardy, natural gas sector became the priority fuel-producing industry in the 1980s. It helped that in Western Siberia, gas reserves were concentrated in a few supergiant fields, which allowed the industry to focus on a relatively limited area. In contrast, the oil fields were numerous, yet smaller and scattered over larger territory.70 The major challenge for the gas sector was low

69 Lewarne,
70 Siberia: problems and prospects for regional development 73.
pipeline capacity, which hindered transportation from Western Siberia to the European part of the USSR and the rest of Europe.\textsuperscript{71}

Cooperation with foreigners was a third major way in which Soviet leaders dealt with oil production problems.\textsuperscript{72} By the 1980s, the Soviets cautiously began opening up. In 1977, the Japanese Petroleum Development Corporation discovered oil and gas off Sakhalin’s coast and established a JV. Another, Soviet-Canadian JV was formed in the far north. Negotiations took place with a number of Western companies on possibilities of drilling in the deeper parts of the Caspian and Barents Seas.\textsuperscript{73} In 1982, offshore petroleum became one of the first spheres where JVs with foreign firms could obtain temporary licenses. The Soviet legislation mandated that the Soviet share of the JV had to be at least 51 per cent. The chairman of the board and the JV director had to be Soviet citizens. JVs were subjects to all Soviet degrees and restrictions.\textsuperscript{74} While foreigners could not obtain an equity interest in a license, a JV could obtain exploration rights via a long and complex approval process. By the end of 1987, twenty-three JVs were working in the sector.\textsuperscript{75} By 1990, approximately 3,000 JVs were registered, yet fewer than 4 per cent worked in the field of energy and minerals. Very few of these worked in the sphere of exploration and development of oil and gas or equipment production for the sector.

3.5. Oil and Gas in Soviet Kazakhstan

Nature endowed Kazakhstan generously with oil and gas. Some oil was produced on its territory even before the Bolshevik revolution. It was, however, the discovery of the Mangyshlak field in the 1960s that substantially increased oil production in the republic. The majority of oil and gas were located in the west, near and in the Caspian Sea. Some oil was also discovered in central Karaganda and southern Kyzylorda regions. In 1975, the Kazakh SSR was responsible for only 4.9 per cent of total Soviet production (the republic did come second after the RSFSR in terms of the all-Union production).

\textsuperscript{71} Although between 1981 and 1985, six pipelines with a total of 20,000 km were built to transport gas from the Urengoi gas field, Shabad estimated that about ten more pipelines were needed to move the projected increased gas production from West Siberia in the 1990s. See Siberia: problems and prospects for regional development 74

\textsuperscript{72} During Andropov, the “solution” was to reduce demand, during Gorbachev the Soviets tried to increase supply. Lewarne 14-15.

\textsuperscript{73} See, for example, Goldman 129.

\textsuperscript{74} For a more detailed discussion of the requirements, including about the participation of the republics, see Considine 222-223.

\textsuperscript{75} See Considine 225.
During the Soviet era, Kazakhstan’s energy resources were generally underdeveloped. Soviet officials knew about its rich oil reserves but postponed their development. Oil from West Siberian and Volga-Urals fields was considered to be of higher quality. Also, the cost of oil extraction in Kazakhstan was higher than in other regions.\(^\text{76}\) Oil deposits located in Western Kazakhstan required specialized technologies for exploration and processing.\(^\text{77}\) The Soviet Ministry of Ferrous Metallurgy failed to produce corrosion-resistant pipe for the extraction of high-sulfur oils and gases in the Caspian Basin and in the KazSSR.\(^\text{78}\) When the giant Uzenskoe field was discovered on the Mangyshlak peninsula in 1961, it was injected with water early on. Poor management of the reservoir, inappropriate and excessive use of water injection, and overproduction of the easier, more permeable production horizons during the first fourteen years of production damaged the field.\(^\text{79}\) The enhanced oil recovery techniques the Soviets used to extract oil were considered controversial in the West.\(^\text{80}\) When the USSR became interested in offshore extraction, the Gas Ministry formally in charge of it was reluctant to explore the highly promising eastern shore of the Caspian Sea, off the coast of Kazakhstan, because this region was even more technologically challenging than Western Caspian Sea.

In 1974, Soviet geologists discovered Tengiz, one of the world’s largest and deepest oil fields located along the northeast shores of the Caspian Sea in Kazakhstan. It lies three miles deep in a high-pressure formation under a salt dome half a mile thick.\(^\text{81}\) In Tengiz, oil is mixed with "sour gas" – hydrocarbon gas with a high concentration of toxic hydrogen sulfide.\(^\text{82}\) Because investment funds were scarce in the late 1970s and 1980s, development of Tengiz was delayed.\(^\text{83}\) In 1985, an explosion at Tengiz led to a fire that lasted over a year. The Soviets could

\(^{76}\) For example, in 1955 the average cost of oil extraction for the USSR was 4.92 rubles per ton, 2.06 rubles per ton in the Volga-Ural region, and 9.55 rubles in KazSSR. Campbell, 103. KazSSR’s oil production cost fell to 5.42 rubles per ton in 1971 but was still above the USSR average of 4.37 rubles and 3.40 rubles in Western Siberia. Campbell 103.


\(^{78}\) Gustafson 188.

\(^{79}\) Considine 175-176.

\(^{80}\) Gustafson 132.

\(^{81}\) Kjaiser and Pulsipher 2007, 1303.

\(^{82}\) Chevron company website (http://www.chvron.com/news/currentissues/tengiz/).

\(^{83}\) Levine 116. The same concerns Kumkol field. Peck, 46.
not extinguish it with their own efforts and had to turn to foreigners for help. The foreign investors who arrived at Tengiz in the early 1990s found the site in a state of dilapidation.\textsuperscript{84}

The KazSSR had gas too yet its volume was miniscule compared to gas reserves elsewhere in the USSR. That is why the development of the republic’s gas fields was not on the immediate agenda.\textsuperscript{85} About 40 per cent of KazSSR’s gas reserves were contained in the Karachaganak field, which was discovered in 1979 in the Uralsk region. Test production began in 1984. Similarly to Tengiz, Karachaganak proved difficult to develop. Gas was located relatively deeply and contained significant amounts of condensate, hydrogen sulphide, and liquid paraffin. It thus required treatment before transportation.

To sum up, during the Soviet era oil and gas of KazSSR remained underdeveloped. In 1990, the republic produced 25.8 million tons of oil, which constituted only 0.05 per cent of the share produced by Russia.\textsuperscript{86} The Soviets lacked the technologies and investment to develop hydrocarbons in KazSSR. Western Siberian resources were easier to recover. However, geological explorations were carried out and a number of enterprises specializing in drilling and production were established in KazSSR in the mid-1960s. The Soviet Ministry of Geology paid significant attention to drilling in KazSSR and considered it a very promising area for energy production in the future.\textsuperscript{87} Significant seismic work was undertaken in the Caspian too but resources stayed undeveloped underground. When foreign investors came in the early 1990s, Soviet data on the size and characteristics of the republic’s reserves were readily available.

3.6. Oil and Gas in Soviet Ukraine

In the 1940s-50s, Ukraine was an important producer of natural gas in the USSR. In 1940, its share was 15.5 per cent rising to 33.1 per cent in 1956. In 1971, Ukraine’s gas reserves accounted for one fifth of Soviet gas reserves and one third of Soviet gas extraction. The pipeline that connected the Dashava fields in western Ukraine to Moscow and extended west of L’viv was one of the first ones the Soviets had built. It was Ukraine’s gas that the USSR committed for

\textsuperscript{85} For a detailed data on Kazakhstan’s gas reserves as of 1966, see Campbell 107. Kazakhstan had very few reserves that are proven and fully explored. The majority of its reserves were forecast. See Elliot 19.
\textsuperscript{86} \textit{The post-Soviet republics: a systematic geography} 63.
\textsuperscript{87} Siberia: problems and prospects for regional development 101.
export to Western Europe. This made sense from Moscow’s perspective as the USSR was unable to transport Siberian gas to the Soviet Western border until early to mid-1970s. Ukraine itself, but also Belarus, Lithuania, Latvia, and, to a smaller extent, Russia thus depended on gas supplied from fields located in western Ukraine. Heavy exporting led to over-exploitation of these fields and their depletion at an alarming rate. Whereas in 1965 western Ukraine had sizeable reserves of 73 billion cubic meters (bcm), in 1967 annual production dropped to 13 bcm. By 1970, Ukraine was unable to produce more than 11 bcm due to rapidly decreasing pressure in gas wells. The Soviets fulfilled their export contracts at the price of continuous gas shortages in Western Ukraine, Belarus, and the Baltics.88 Ukraine’s contribution to Soviet gas extraction further dropped when richer gas fields were discovered in Siberia. Although extraction rates continued to grow, the rate of reserves growth lagged behind.89 The possibilities of increasing gas production in Ukraine were limited. By 1991, the republic’s share in the Soviet natural gas production was only 3 per cent.90

Ukraine produced some oil, yet its share of all-Union production was miniscule. In the 1960s-1970s, several oil deposits were discovered, such as Dolynske (38.3 million tons), Gnidyntsvsk’ke (38 million), and Lelyakivs’ke (52.4 million).91 In the oil sector too, extraction rates were higher than reserve growth rates. Oil production achieved its peak in 1970 and began declining afterwards.92 Drilling conditions were difficult as many wells were located at depths between 4,000 and 7,000 meters.93 As with offshore drilling in the Caspian Sea, the Soviets lacked the technologies and equipment to develop Ukraine’s offshore oil since the Soviet turbo-drill and seismographic system could not penetrate the depths of several thousand meters. That is why oil in the promising Black Sea region largely remained unexplored. Whenever production conditions became difficult, oil fields were abandoned.94 In 1990, Ukraine produced only 5.3

91 Oleksandr Malynovs’ky, Naftogazovyy sector Ukrayiny: Prozorist’ Funktsionuvannya ta Dokhodiv (Kyiv-Sevastopol’) 65.
92 Considine 97.
93 Elliot 106; Campbell 15.
million tons of oil, which constituted 0.01 per cent of Russia’s oil production.\textsuperscript{95} Late into the Soviet era, Ukraine experienced constant fuel shortages, which undermined its overall development.\textsuperscript{96}

4. Soviet Metallurgy and Mining Sectors

Similarly to oil and gas, nature endowed the USSR generously with metals and minerals. The USSR was one of the world’s largest producers of aluminum, asbestos, cement, chrome ore, coal, copper, diamonds, gold, iron ore, lead, manganese ore, natural gas, nickel, petroleum and refined products, phosphate rock, platinum group metals, potash, sulphur, and zinc. The majority of Soviet metals and mineral resources were located in Russia, Kazakhstan, and Ukraine.\textsuperscript{97} For the Soviet leadership, the development of metallurgy was the cornerstone of industrialization. The achievements were truly impressive. In the late 1950s, ferrous metallurgy underwent what Soviet sources referred to as a scientific-technical revolution, which resulted in the enlargement of metallurgical production units. This trend continued into the 1960s and 1970s.\textsuperscript{98} Production output doubled and even tripled in some spheres within metallurgy within a twenty-year period. Table 6 (below) reveals the growth trend of the sector between 1960 and 1979, which doubled or even tripled for some of the main outputs.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cast iron</td>
<td>46.8</td>
<td>66.2</td>
<td>85.9</td>
<td>103.0</td>
<td>109.0</td>
<td>232.9</td>
</tr>
<tr>
<td>Steel</td>
<td>65.3</td>
<td>91.0</td>
<td>115.9</td>
<td>141.3</td>
<td>149.1</td>
<td>228.3</td>
</tr>
</tbody>
</table>

\textsuperscript{95} The post-Soviet republics: a systematic geography 63.

\textsuperscript{96} Ukraine remained an important producer of coal for the Soviet Union responsible for 1/3 of all Soviet coal production. See Ukrainskaia SSR 76-81. For detailed discussion of problems with Ukraine’s economy as of early 1980s, see Economics of Soviet regions 291-294.

\textsuperscript{97} See David Humphreys, Mining and metals in the CIS: between autarky and integration, ed. Royal Institute of International Affairs. (London: Royal Institute of International Affairs, 1994) 10.

\textsuperscript{98} For example, whereas in the early 1960s the sector was introducing blast furnaces with the volume of 1719 square meters, by 1967 the volume was 2700 square meters. Istoriia sotsialisticheskoi ekonomiki SSSR, ed. Ivan Andreevich Gladkov and Institut ekonomiki (Akademiia nauk SSSR). (Moskva: Nauka) 275, Volume 7.
4.1. Metallurgy and Mining in the RSFSR

The RSFSR accounted for a lion’s share of mineral resources of the Soviet Union. The republic’s ferrous and non-ferrous metallurgy sectors were very well-developed. Its territory contained several mineral-rich regions, such as the Far East, Siberia, Ural, and Kola Peninsula. The charcoal-based iron industry that had been founded during the era of Peter the Great was located in the Urals. It produced more pig iron than Britain in the middle of 18th century before it gradually lost out to Ukraine’s coal-based iron industry. Russia was also responsible for a significant portion of Soviet gold, diamond, platinum, and base metals output. A major part of non-ferrous metallurgy production (platinum, nickel, copper, cobalt, gold, and silver production) came from Norilsk located north of the Arctic Circle.

4.2. Metallurgy and Mining in Ukraine

Ukraine’s ferrous metallurgy experienced particularly impressive development during Soviet times. The republic had its own ministry of ferrous metallurgy, even if the ministry’s powers remained limited. Ukraine was responsible for approximately a third of Soviet crude steel production, 36 per cent of rolled ferrous metals, 43 per cent of cast iron, and 52 per cent of iron ore. Approximately 30 per cent of Ukraine’s coal, 50 per cent of its coke and ore, and 38 per cent of its ferrous metals went to other Soviet republics. Significant deposits of iron ore were

---

100 Rubinstein 51.
102 See Rubinstein 197.
105 Ekonomika Ukrainskoi SSR v edinom narodnohozistvennom kompleksse, ed. I. S. Stupnitski (Kiev: Izd-vo pri Kievskom gos. universitete izdatel'skogo obiedeniia "Vyshcha shkola, 1982) 38. For more details, see Rubinstein 81-84.
discovered in Ukraine’s four major iron ore mining regions: Kryvyi Rig’s deposits, the Dneprorudnoye deposit, the Kerch Peninsula deposits, and the Komsomolsk deposits near Kremenchug. Kryvyi Rig’s usable reserves were estimated at 18 billion tons of ore. The Kerch ores were shipped exclusively to Azovstal plant in Zhdanov. Ores from the Dneprorudnoye and the pellets and ore concentrate from the Komsomolsk complex were consumed locally in the Dnieper Bend Iron and steel district, mainly in Zaporizhya.  

4.3. Metallurgy and Mining in Kazakhstan

In order to preserve Soviet metallurgy from the Nazis, the Soviets had transferred a large share of its infrastructure into Kazakhstan during World War II. After the war, the development of metallurgy and mining continued. Soviet planners encouraged rapid development of mineral and mineral fuel deposits, such as coal, oil, copper, and lead in order to replace the resources that had been lost or threatened by the war. The sixth five-year plan approved in 1956 provided for development of a metallurgical base in Kazakhstan and Siberia.

In Kazakhstan, non-ferrous metallurgy was particularly developed. The union-republican Ministry for Non-Ferrous Metallurgy within its structure contained the Ministry of Non-Ferrous Metallurgy of Kazakh SSR. The republic’s share of Soviet non-ferrous metallurgy (by the value of fixed capital) rose from approximately one-tenth in 1961 to about one-eighth in 1974. As of 1979, non-ferrous metallurgy constituted 10.7 per cent of industrial output in the KazSSR. The republic possessed considerable reserves of copper, zinc, lead, nickel, cobalt, and other metals and minerals. In particular, northwestern Kazakhstan accounted for almost all Soviet production of this chromite that was based in one deposit. The Dzhezkazgan copper deposit in central Kazakhstan was an important source of this metal in the USSR. Almost half of Soviet lead smelting and refining capacities were located in the republic. The Ust-Kamenogorsk and Leninogorsk Lead and Zinc plants, the Irtysh Chemical and Metallurgical Plant, and the Ust’-
Kamenogorsk Titanium and Magnesium Plant were located in the Altai region in the east. Lead and zinc were produced in Chimkent.\footnote{Rubinstein 93. For a detailed discussion of Kazakhstan’s non-ferrous metallurgy, see Rubinstein, 92-124}

The republic’s ferrous metallurgy was also developed. Its share of Soviet output doubled from 3.5 per cent in 1961 to 7 per cent in 1974. About 10 per cent of Soviet iron ore and 4 per cent of rolled iron were produced on Kazakhstan’s territory. The republic’s useable iron-ore reserves constituted approximately 53 per cent of the total useable reserves in the Asian part of the USSR. They were mostly located east of the Urals in the Kustanai region.\footnote{Boris Z. Rumer, Soviet steel: the challenge of industrial modernization in the USSR (Ithaca, N.Y.: Cornell University Press, 1989) 143.} The Karaganda metallurgical complex (Karmet) was formed by 1970 and became the second largest steel complex east of Urals responsible for nearly all rolled iron produced in the republic. It was an important supplier of coking coal to the Soviet Urals’ iron and steel industry.\footnote{Intensifikatsiia ispol’zovaniia toplivno-energeticheskikh resursov, ed. Tumebai Ashimbaevich Ashimbaev and ekonomika instituty (Qazaq SSR ghvylm akademiasy). (Alma-Ata: "Nauka" Kazakhsko? SSR, 1989) 144. For the list of other enterprises from the sector, see D. Shamukhanov, Sozdanie i razvitie chernoi metallurgii v Kazakhstane (Alma-Ata: Nauka, 1981) 4.}

4.4. “Natural” Challenges of Development

Despite impressive development, over the years Soviet metallurgy and mining began to face important challenges. Many of them were “natural,” i.e., metallurgy and mining of any country would have likely faced them at some point. For example, the USSR lacked adequate amounts of bauxite, which was the principle input for production of aluminium. As domestic production of bauxite was declining, the USSR had to import increased quantities of bauxite.\footnote{A Study of the Soviet economy Vol.3, 239.} Over time, the USSR began to run out of resources that were easy to extract and cheap to produce. As another example, the USSR had more than 100 billion tons of recoverable reserves of iron ore. About ninety per cent of them were located in Ukraine (Krivoi Rog) and Russia (the Kursk Magnetic Anomaly – the KMA). The higher grades of resources were nearing exhaustion yet many remaining resources were inaccessible for exploration. One solution was extracting from open pit mines yet the depth of these mines was increasing too.\footnote{See N. I. Mitiaev, Osnovnye proizvodstvennye fondy chernoi metallurgii. lzd. 2, perer. i dop. -- ed. (Moskva: Metallurgia, 1984) 99. Rumer 151.} Because iron ore from open-pit mines was poorer in iron content than ore from underground mines, it had to be
enriched, which raised production costs.\textsuperscript{116} Whereas in 1940, 85 per cent of ore could go immediately to iron and steel plants, by 1989 this figure was only 20 per cent. The Soviets found a partial solution by using pelletizing based on US technologies developed after World War II, which allowed them to get to an iron content of 60-68 per cent. The majority of output by these plants was comparable to their western counterparts’ based on quality.\textsuperscript{117} Another “natural” problem was that production was moving further and further away from markets. For example, the steel industry developed rapidly in the east, yet mineral deposits in the east, including Siberia, remained unexplored. The majority of well-developed deposits were located in the European part of Russia. In ferrous metallurgy, concentration of production increased efficiency but in some cases caused shortages of inputs.\textsuperscript{118}

4.5. Institutional Inefficiencies

Many of the “natural” problems of Soviet metallurgy and mining could have been solved with an adequate amount of investment, improved technologies, and a different incentive structure, yet these were exactly the factors that the command Soviet economy could not deliver. In the late 1980s, the Soviet mining industry represented a model of “how mineral resources should not be exploited.”\textsuperscript{119} Some of the main problems were institutional inefficiencies and the emphasis on extensive, not intensive development.

Three types of organizations with various degrees of control oversaw the Union’s metals and mining enterprises: ministries or quasi-ministerial bodies, research institutes, and all-union industry associations.\textsuperscript{120} The system was heavily centralized yet coordination among these institutions was poor leading to significant inefficiencies.\textsuperscript{121} For example, apatite is often mixed with iron in the ground. Since the Ministry of Ferrous Metallurgy was responsible only for iron ore output, a million tons of apatite that could have been used in production of fertilizer were wasted annually. The Ministry often simply disposed of valuable materials it was not responsible for, such as gravel, vanadium, titanium, nickel, chrome, cobalt, copper, and even platinum. The

\textsuperscript{116} Rumer 148-149.
\textsuperscript{117} A Study of the Soviet economy 258.
\textsuperscript{118} Istoriia sotsialisticheskoi ekonomiki SSSR, 275, Volume 7.
\textsuperscript{119} A Study of the Soviet economy 272 (vol 3).
\textsuperscript{120} A Study of the Soviet economy 233 (vol 3).
\textsuperscript{121} The Ministry of Ferrous Metallurgy, the Ministry of Non-Ferrous Metallurgy, the Ministry of the Coal Industry, the Ministry of the Chemical Industry, the Ministry of Gas Industry, the Ministry of the Petroleum Industry, and the Ministry of the Construction Materials Industry. See, for example, Goldman, 47.
Ministry of Non-Ferrous Metallurgy in its turn discarded significant quantities of ferrous metals. Better coordination would have prevented some of this waste. Elimination of all the waste would have required a major overhaul of the Soviet incentive structure. In 1989, the Ministries of Ferrous Metallurgy and Non-Ferrous Metallurgy were merged into one Ministry of Metallurgy, which was made responsible for almost all non-ferrous mining and smelting. However, by then the de-centralization trend at the lower levels dominated the centralizing trend at the top.

Another problem that affected metallurgy and mining along with entire Soviet economy was the lack of incentives to produce high-quality output. For example, the highly sought rolled products of low-alloy steel were considered unprofitable as their production consumed significant labor and energy resources, yet enterprises received no compensation and therefore avoided producing them whenever possible. By the 1980s, low quality steel production significantly affected the oil and gas sector, the chief revenue producer for the USSR. Gorbachev unsuccessfully tried to solve the problem by refocusing ferrous metallurgy on quality improvement and expansion of the assortment of steel products.

Gorbachev’s Law on State Enterprises was another attempt to improve the functioning of the sector but it was too late as the law only speeded up processes of decentralization fostered by the reforms. Before its adoption, enterprises could retain 30 per cent of the “profit” they made. The remaining 70 went to the state coffers. The enterprise financed its investment from depreciation funds and the profits it was allowed to keep. However, because many enterprises were de facto unprofitable, capital investment came from the state. Beginning in 1991, the state could take back only 45 per cent of the operating surplus. Relevant ministries were to receive nothing, which further marginalized them. Enterprises gained more room to maneuver as they retained a larger share of the “profit” and could thus obtain convertible currency for part of their exports. However, in order to retain a “profit,” enterprises first had to make it. Not all of them managed to do so since prices for produced goods remained controlled. In the late 1980s, enterprises often had to rely on traders in order to export to the West. However, the incentives to

125 There was no profit as such in the Soviet Union’s command economy. It may be more appropriate to talk about the surplus.
make a profit remained insufficient: enterprises often raised exports or stopped them altogether before the end of the year. The goal was to meet annual targets but not exceed them.\textsuperscript{127}

Measures to make the sector fulfill its quotas were also ineffective. For example, in 1987, several key metallurgical enterprises of the UkrSSR were deprived of what was known as the “fund of material encouragement.” Central authorities promised to reduce this fund by three percent for each percentage point of the plan that was not fulfilled and increase it by 15 per cent if the plan was fulfilled. However, in a centralized system where an enterprise did not have control over production, such measures were often ineffective. In 1987, none of Ukraine’s metallurgical plants fulfilled its obligations on deliveries.\textsuperscript{128} When central investment allocations dwindled, enterprises began growing agricultural produce for their workers and making their own machinery, which allowed them to survive yet these measures were hardly conducive to long-term development.\textsuperscript{129} The sector simply “muddled through.”

4.6. Extensive, Not Intensive Development

A related problem of the entire Soviet economy that affected the metallurgy sector was the emphasis on extensive (based on expanding the quantity of inputs in order to increase output and therefore expensive) rather than intensive (based on improved skills and productivity) development. Very often, political agendas dominated over economic rationale: in metallurgy, the goal of self-sufficiency in primary raw materials had to be achieved no matter how much it cost.\textsuperscript{130} Yet, the development of metallurgy and mining required massive capital investment as the sector was becoming increasingly energy intensive and geological conditions were worsening.\textsuperscript{131} Problems with technological upgrading and re-equipment manifested themselves in all sub-spheres of metallurgy yet solutions were not easily available.

Instead of the much-needed increase, investment actually decreased over time as the Soviet economy began running into problems. In 1961-65, Soviet ferrous metallurgy received 9.5 per cent of all capital investment into industry and 3.5 per cent of total investment into the

\textsuperscript{127} A Study of the Soviet economy 243.
\textsuperscript{129} Rumer.
\textsuperscript{130} A Study of the Soviet economy Vol.3, 238.
\textsuperscript{131} For absolute numbers for particular years, see Istoriia sotsialisticheskoi ekonomiki SSR, Volume 7, 272.
Soviet economy. In 1976-1980, the share of ferrous metallurgy fell to 7.2 per cent and 2.6 per cent respectively. Moscow had planned to increase its investment into ferrous metallurgy sector for 1981-1985 by one third compared to 1976-1980 yet at the end increased it only marginally. At the end of the USSR’s existence, all the efforts were directed at exports of hydrocarbons to earn the hard currency that was so crucial for the economy. The base metal industries that were consumed within the USSR were significantly under-capitalized. Within metallurgy, gold, platinum, and nickel were exceptions since a large share of them went for export. Military and defense sectors attracted a large part of the country’s heavy engineering capacity. This affected the production of mining equipment and machinery, which caused constant shortages of equipment for mine development and mineral processing.

As a result, the modernization of metallurgy and mining suffered. In the 1960s, open-hearth furnaces gained popularity across the USSR. However, they became technologically obsolete over time. Soviet metallurgy tried to transition to more efficient oxygen converter steel production. Nineteen converters were initially built and their capacity was increasing. However, in the end, the Soviets failed to implement this transition fully. The Soviets also tried to improve open-hearth furnaces, which were able to produce 1 million tons of steel each yet were still less efficient than the alternatives. Many Soviet aluminum smelters had begun producing before World War II. Their old age was not necessarily a problem as long as smelters remained efficient, well-maintained, and gradually upgraded. This was not the case with Soviet metallurgy. The majority of Soviet aluminum smelters employed Soderberg technology that had not been installed in the West during the preceding two decades. The only exception to the general lack of modernization was the Noril’sk plant, which received considerable investment during the 1980s. Even the modern Soviet smelters were “surprisingly inefficient” by Western standards. In some spheres, the Soviets lacked capital to install domestically available technologies.

132 Mitiaev 15. For more detailed discussion of investment trends in Soviet ferrous metallurgy, see Rumer, 205-206. Need to find data on distribution of this investment among republics.
133 Leggett, Robert E. “Soviet Investment Policy: the Key to Gorbachev’s Program for Revitalizing the Soviet Economy.” In: Gorbachev's economic plans: study papers 239.
135 Istoriia sotsialisticheskoi ekonomiki SSSR 271, Volume 7.
Another major problem was the ineffectiveness of investment allocation and utilization. The Soviets directed an overwhelming part of their capital investment into an expansion through the construction of new enterprises, new departments, and machinery within existing enterprises. Even though construction was more resource-intensive than reconstruction, it was easier to build new plants by applying standardized techniques on a large scale. Reconstruction took place on a smaller scale. It required specialized techniques that construction organizations were lacking. The Soviets recognized the problem. In the 1970s, they tried to find solutions by focusing on the upgrading of existing assets and limiting new construction. “Reconstruction” (the term that was used for technological upgrades) became a key component of economic policy. The central planning bureaucracy counteracted branch ministries’ plans for new construction and redirected resources for renovation and expansion of existing enterprises. The official share on reconstruction in ferrous metallurgy increased from 60 to 80 per cent between 1970 and 1980. The policy seemed to work.

In reality, however, the sector continued to acquire new capacities. Their construction was simply disguised as the reconstruction and expansion of existing enterprises. At the same time, the cost of construction itself was rising. There was also a significant time lag between the end of construction and beginning of production at the new plants. A study of effectiveness of capital investment in metallurgy during 1966-1980 conducted by the Central Economic Scientific Research Institute of the RSFSR Gosplan concluded that capital investment per ton of increase in output at new plants was about 55 per cent of those that went for reconstruction and expansion of existing enterprises. Some republics were affected more than others. For example, in 1975 73 per cent of all capital investment went into reconstruction of ferrous metallurgy in the USSR but only 39 per cent in the Kazakh SSR. Underutilized capacities were a “waste” given that they diverted resources from other, more important goals. However, they also provided concealed opportunities to boost production in the short-term. After General Secretary Andropov threatened to fire Kazanets in 1983, steel production increased significantly after falling for four consecutive years before that. This fact suggests that “the existing economic

---

137 See Mitiaev, 16.
mechanism and existing production capacities [were] capable of achieving – and in short order – a much greater increase in output than might be expected under ordinary conditions.”\textsuperscript{141}

Insufficient reconstruction continued to be a severe problem – that is why in July 1985, Gorbachev fired the Soviet Minister of Steel Ivan Kazanets for inefficient allocation of capital investment. Gorbachev pointed out that about half of the 50 billion rubles that were invested into the sector during the preceding 15 years was channeled into new construction, in particular into expansion of iron ore mining and pig iron production. As a result, improvement of the quality and assortment of finished steel products did not take place. The new plan prescribed using 50 per cent of investment into ferrous metallurgy in 1986-1990 for renewal of existing plants, directing 30 per cent for improvement of product variety and quality. Only 20 per cent would go into capacity expansion. This was a large change compared to previous plans, which allocated up to 75 per cent into capacity expansion.\textsuperscript{142} Given that the 1988 Law on State Enterprises reduced the centrally allocated investment capital, this overhaul in investment allocation did not result in significant changes. The same concerns the opening up of the sector to foreign investment that began in 1987. Approximately 60 JVs were created in the sphere of metallurgy yet they failed to make a change for the better. The collapse of the USSR was just four years away.\textsuperscript{143}

5. Conclusion

Seventy years of command economy inevitably shaped the post-independence era of the Soviet republics. However, the Soviet legacies these states faced were not uniform across republics and across sectors. That is why some post-Soviet states were in a better position to develop particular sectors of their economy than others. That is why, I argue, not only the nature of the sector but also the differences in the level of sectors’ development across republics affected the ability of post-Soviet states to develop these industries after independence. These legacies acted as contingencies: they did not single-handedly determine the policy choices the states made during the post-communist period as other factors were important too.

\textsuperscript{141} Rumer 88.
\textsuperscript{142} Harris, Cheryl A. “Modernization of the Soviet Steel Industry: What Lies Ahead?” in Gorbachev's economic plans: study papers 311.
The transition to capitalism did not immediately take care of all inefficiencies and compensate for lack of capital that were the main issues for all sectors during the Soviet era. However, the duration and extent of the collapse that followed depended on variations in the levels of development that different sectors had experienced during the Soviet era. In Russia, oil and gas underwent significant development during the Soviet times. The sector could continue production using inefficient technologies and assets remaining from the USSR. There were also significant sectoral interests ready to shape the decision-making process to suit their own interests. In Kazakhstan, the resources had been prospected but not explored. There were no domestic capabilities to develop these resources and no significant interest groups to take control over the sector into their hands. The political elites looked for opportunities to enhance their own power within the republic by inviting foreigners in. Finally, Ukraine’s oil and gas resources were considerably smaller. They had neither been prospected nor explored.

All three post-Soviet states I study inherited a large mining and metallurgy sector that had suffered from under-investment and poor management that resulted in inefficiencies. Nevertheless, the sector had undergone significant development during the Soviet era and had extra production capacities. The metallurgy sector in all three countries needed capital but still could maintain production. The problems created by the collapse of the USSR were as important as the Soviet legacies themselves. The extra capacities combined with broken production chains were a challenge, yet after the chains were slowly reconstructed, those extra capacities became an asset rather than a liability.
Chapter 4: Yeltsin’s Russia: Building Patronage Ties with Domestic Business

High level of development of oil and gas and metallurgy and mining in Russia during the Soviet times allowed Russia to keep these sectors’ assets in domestic hands after independence. In the long run, both sectors (and, in fact, the entire Russian economy) needed capital and advanced technologies that could come through FDI. However, in the short-run, sectors could maintain their production due to the prior investments made by the Soviet Union.

The majority of Russia’s private companies in key economic sectors were established due to their connections to Yeltsin’s regime. The regime provided selected business access to state resources and in this way secured its own survival. Indeed, the political elite itself actively participated in the looting of state resources. Foreign investors may have had access to the needed capital and superior technologies, but they could not help Yeltsin’s politically weak regime maintain its power. Foreign ownership would have also resulted in a loss of control over the economy’s most profitable assets and the associated rent-seeking opportunities. Since both domestic business and the regime focused on the short term, attracting FDI was not on the immediate agenda.

1. Yeltsin’s Political Regime and Its Relations with Business and the State

As Gorbachev was losing his popularity over the course of controversial perestroika, Boris Yeltsin emerged as a popular new leader pushing for radical reforms. In 1990, Yeltsin was made Chairman of the Supreme Soviet of the RSFSR and won the first free presidential elections in the RSFSR a year later.

Russia introduced fundamental changes to its economic system even before the USSR fell apart.¹ While the Union government worked to retain control over the republic’s assets, ¹ Joseph R. Blasi, Kremlin capitalism: the privatization of the Russian economy, ed. Maya Kroumova and Douglas Kruse (Ithaca, N.Y.: ILR Press, 1997) 19-20.
Yeltsin tried to gain the allegiance of enterprises located on Russia’s territory by offering them lower taxes and de-regulation. When the USSR ceased to exist in December 1991, Russia introduced radical economic reforms known as “shock therapy.” These called for very fast and simultaneous liberalization of prices, economic stabilization, and privatization, and brought mixed results. Although consumer goods reappeared on the shelves, hyperinflation wiped out the population’s savings and depreciated wages, placing these goods beyond the reach of most Russians. Both privatized and still state-owned enterprises faced hard times adapting to these new conditions. The “honeymoon” period of Yeltsin’s initial popularity and support for his reforms did not last. His political regime was weak throughout most of its tenure and turned self-preservation into its main goal. The roots of this weakness lay in the way the regime maintained power first of all.

One of the key challenges Yeltsin’s regime faced was preserving the power of the federal centre vis-à-vis the regions. In his struggle for power with Gorbachev in 1990-1991, Yeltsin tried to gain allegiance of Russia’s regions by encouraging their leaders to take on as much sovereignty as they could handle. He did not anticipate the extent to which regional leaders would follow his advice. Some regions, such as Chechnya, started threatening secession. Powerful regional economic interests were often the driving force behind regional opposition to Moscow. The struggle for power between the federal centre and the regions undermined state capacity and threatened political survival of the regime itself.

Even though the formal institutional framework established after Yeltsin’s shooting of the parliament in 1993 granted extensive powers to the president, Yeltsin was unable to consolidate his power. A formidable challenge came from the left-dominated lower house of the

---

5 In October 1993, President Yeltsin, whose relations with the parliament had been deteriorating for some time, ordered the tanks to fire on the parliament after some Russian deputies who were trapped inside the building broke out and tried to take control of the television station. After a ten hour battle, the deputies surrendered. See, for example, Jonathan Steele and David Hearst, “Yeltsin Crushes Revolt,” The Guardian, 5 October 1993.
6 Some authors argued that Russia de facto had “superpresidentialism” under Yeltsin. The term was originally coined by Timothy Colton.
Parliament – the State Duma. Although Yeltsin was often able to by-pass the Duma by issuing decrees, his power was unstable as it was based on personal relations with a narrow circle of people. Yeltsin thus actively engaged in organizational outsourcing: “[i]n essence Yeltsin ‘rented’ organizational capacity from various outside formal and informal groups – oligarchic networks, regional governments, and political parties – who provided support at key moments.”

Yeltsin’s decision not to engage in party-building, however, undermined his ability to control his allies and subordinates.

Individual representatives of domestic business known as the “oligarchs” across the post-Soviet space became a key ally for Yeltsin early on. The peculiarity of Russia’s transition was that it was a weak political regime rather than the market that played a role of a *demiurge* in the creation of domestic business by granting the latter access to state resources. In the course of privatization, the regime gave birth to its own political ally. Other goals, such as the creation of a competitive environment, the formation of a class of effective owners, attracting strategic investors or even filling in the budget often came second. Instead, big business shared the regime’s interest in preventing the reversal of reforms that benefitted them the most.

### 2. The Origin of Russia’s Big Business

All Russia’s oligarchs, in one way or the other, owed their initial success to the state through their ties to Yeltsin’s regime. Marshall Goldman identifies three groups of Russian business based on origin. The first group consisted of former factory managers, who were in a particularly good position to take advantage of the opportunities that opened up in 1988-1992, when state controls over trade and export began disintegrating, yet domestic prices stayed low.
Some managers remained committed to the old system while others pursued the opportunities the new system offered. By the time privatization officially started, Soviet-era managers had established control over their enterprises. Many of them did little to adapt these enterprises to market economy and eventually lost ownership to outsiders.

The second group was represented by the so-called *nomenklatura* that consisted of senior officials in Soviet ministries or regional industrial administrations. The most evident difference between enterprise managers and the *nomenklatura* was the larger scale of opportunities for self-enrichment open to the latter. The party *nomenklatura* formulated the rules of the game during the Soviet era and after independence and actively used the opportunities they themselves created. The *nomenklatura* was also in a position to finish an informal privatization process before the start of the official privatization. In particular, the former party elite gained access to assets in the lucrative natural resources sector.

The third group consisted of individuals who prior to 1987 had been at the margins of the society and often outside the law. Excluded from positions of power, these people gained their starting capital by capitalizing on inefficiencies of the Soviet planning system. They were also dependent on the state. Many had been part of the Youth Communist League Komsomol and worked as “authorized agents” of the *nomenklatura* in return for access to resources.

Russian big business went through several stages in its development. Initially, “industry generals” seemed to be best positioned to win from the mass privatization that took place in 1993-1994. The Soviet-era directors “were divided among those who remained “orthodox” until

---

16 According to Olga Kryshtanovskaya’s calculations, approximately 41 per cent of Russia’s big business have *nomenklatura* origins. See Kryshtanovskaya 38.
19 Among other things, they provided consumers with goods that were in shortage in official markets and assisted factory managers in supplying the necessary production inputs “off the books.” Goldman 117-118.
20 Kryshtanovskaya calls them the “authorized agents” of the *nomenklatura* Kryshtanovskaya 23. For example, Mikhail Khodorkovskiy built his MENATEP bank through access to state institutions.
the end and those who realized that market economy offered them opportunities for personal self-enrichment. Those who were willing to pursue these opportunities managed to accumulate enterprise shares that had been dispersed among a large number of shareholders and emerged as the new official owners. However, at this stage, control over enterprise finances and assets was more important than formal ownership because property rights were weak. During this initial period, the first trading-financial groups started to form around stock exchanges, banks, and former unions of external trade.

The biggest Russian companies were established between the second half of 1995 and 1997. At this time, employees and the state reduced their share of ownership while enterprise management and outsiders (mostly banks and investment companies) increased theirs. Russia’s financial institutions bought enterprise shares during voucher auctions in 1993-1994 in a variety of sectors. The banks wanted to turn the large industrial enterprises into their customers and at the beginning did not have any strategy for development of these enterprises. When the initial sources of “easy” money dried up, commercial banks refocused their attention on the exporting sectors, primarily oil and metals. The bankers eventually understood that in the long-run, industrial assets were more reliable than assets in the banking sector. Many of them acquired ownership in these sectors during the “loans-for-shares” auctions (discussed below) and became Russia’s first Financial-Industrial Groups (FIGs). The financial crisis of 1998 proved it was a wise decision on their part.

---

23 Pappe, 87.
24 Rossiskaia promyshlennost’: institutsional’noe razvitie 19-23.
25 In the early stages, these banks acquired enterprises in a wide range of industries (consumer goods, construction, textiles and others). FIGs started to take shape as banks formed holding companies to manage their assets in these industries. These ties with the industrial sector proved to be beneficial. As Johnson notes, the emerging FIGs could provide the banks with “guaranteed enterprise customers, tax havens, less uncertainty in lending, and enterprise revenue with which to carry out short-term financial dealings.” See Johnson 185.
26 Johnson 185.
27 Pappe 40.
3. Relations between Big Business and the Political Regime

The alliance between Yeltsin’s weak political regime and the oligarchs was based on mutual dependence. Yeltsin’s reelection in 1996 was far from being certain. First, he was unpopular with the population as the shock therapy turned out to be much more a shock than therapy. Yeltsin’s main contender and the leader of the Communist Party Gennadiy Zuganov promised to reverse the transition from communism to capitalism. Although the state still had significant resources at its disposal, the regime did not necessarily have the capacity to utilize them to maintain its power. It had instead to rely on the oligarchs for financial and organizational resources and favorable media coverage. Domestic business in its turn depended on privileged access to the state that could be granted by the regime for its survival.

The “loans-for-shares” auctions clearly manifested this mutual dependence. In the aftermath of a March 1995 Cabinet meeting, Yeltsin’s regime exchanged access to state assets for political support and resources for reelection. Vladimir Potanin offered a loan to the state on behalf of the Inter-Bank Credit Alliance banking consortium. State shares in a number of industrial and resource assets were to serve as collateral for the loan. Banks were to exercise operational control over these assets. If the government did not repay the loan within three years, the creditor had the right to sell state shares to recoup the credit. By the end of 1995, the agreement was finalized.

Some authors argued that the state needed the bankers’ loan to fill in the budget. It is clear, however, that the loans-for-shares auctions took place because of a political agreement. Revenue was not the main factor behind the auctions since the government first placed its own money into the accounts of participating banks. The banks then offered the state a loan back. According to some accounts, the money that the banks supposedly gave to the state continued to

---

28 Barnes 114.
29 Fortescue 55.
30 For example, Bim points out that the twelve government-organized loans-for-shares auctions generated 4.7 trillion rubles ($1.01 billion), which was 78.3% of the total funds the government received from the monetary stage of privatization Bim, 481. This was also an explanation the involved officials presented to the public. See, for example: “Vynuzhdenaya Mera. Predstavitel’ Minimushchestva Opravdyvaet Ideu Zalogovykh Auktsionov.” Segodnya, 11 April 2000.
be placed in these banks’ accounts. In the majority of cases, the auctions were not competitive as the winner paid just above the initial price (see the table below). The regime did not intend to repay the loan and the circle of potential winners was predetermined from the very start. Outsiders were excluded in a variety of ways. In one case, the local airport was arbitrarily closed at the time of the auction. After the loans for shares were announced, “practically every enterprise considered it to be its duty to begin bargaining with the state” about the conditions of its participation in the auctions, with some of the enterprises rejecting the idea of participation completely. Few managers succeeded in taking their enterprise off the list of auctioned enterprises. The fact that the final transfer of shares was to take place no earlier than September 1996 (three months after presidential election) also highlighted the political nature of the auctions. As Iakov Pappe noted, “privatization was a strategic goal independent from what were the tactical interests at the moment. That is why it would have certainly continued in the 1990s under any political conditions. However, the specific form it took (i.e., loans for shares) were determined by the fact that [the regime] needed to urgently find itself an ally.”

**Table 7. Results of Loans for Shares Auctions**

<table>
<thead>
<tr>
<th>Asset auctioned</th>
<th>Percentage of shares auctioned</th>
<th>Starting price, $ mln</th>
<th>Winning bid, $ mln</th>
<th>Winning institution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Surgutneftegaz</td>
<td>40.12</td>
<td>66.7</td>
<td>88.9</td>
<td>Surgutneftegaz Pension Fund</td>
</tr>
<tr>
<td>Norilsk Nickel</td>
<td>38</td>
<td>170</td>
<td>170.1</td>
<td>ONEKSIMbank/MFK</td>
</tr>
<tr>
<td>Mechel</td>
<td>15</td>
<td>5</td>
<td>13.3</td>
<td>Imperial</td>
</tr>
</tbody>
</table>

32 This is despite the fact that the official agreement stipulated that auctions were to be open to participation for anyone and not to be limited to members of the consortium that proposed them. See Fortescue, 55 Li-Chen Sim, *The rise and fall of privatization in the Russian oil industry* (New York: Palgrave Macmillan, 2008) 37-38.
35 Interview with Pappe Iakov, professor, Faculty of Economics, Higher School of Economics, 2 December 2009.
<table>
<thead>
<tr>
<th>Company</th>
<th>% Of Shares</th>
<th>Years</th>
<th>Value (ruble)</th>
<th>Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Northwest Shipping</td>
<td>25.5</td>
<td>6</td>
<td>6.05</td>
<td>MFK/ONEKSIImbank</td>
</tr>
<tr>
<td>Lukoil</td>
<td>5</td>
<td>35</td>
<td>35.01</td>
<td>Imperial/Lukoil</td>
</tr>
<tr>
<td>Sidanko</td>
<td>51</td>
<td>125</td>
<td>130</td>
<td>MFK/ONEKSIImbank</td>
</tr>
<tr>
<td>NLMK</td>
<td>14.84</td>
<td>30</td>
<td>31</td>
<td>MFK/ONEKSIImbank</td>
</tr>
<tr>
<td>Murmansk Shipping</td>
<td>23.5</td>
<td>4</td>
<td>4.125</td>
<td>Menatep</td>
</tr>
<tr>
<td>Yukos</td>
<td>45</td>
<td>150</td>
<td>159</td>
<td>Menatep, Stolichnyi, Tokobank</td>
</tr>
<tr>
<td>Novorossiisk Shipping</td>
<td>20</td>
<td>15</td>
<td>22.65</td>
<td>Novorossiisk Shipping Company</td>
</tr>
<tr>
<td>Nafta-Moscow</td>
<td>15</td>
<td>20</td>
<td>20.01</td>
<td>Nafta-fin/ONEKSIImbank</td>
</tr>
<tr>
<td>Sibneft</td>
<td>51</td>
<td>100</td>
<td>100.3</td>
<td>Stolichnyi/Menatep</td>
</tr>
</tbody>
</table>


Ownership of the key economic assets enhanced bankers’ political and economic standing. After loans-for-shares, big business strengthened its connection to the regime by entering politics from 1996 till the first half of 1998. At this time, the bankers were the most powerful actors in big business, which led the media to write about the “rule of seven bankers” (semibankirskchina). The bankers had formal and informal powers to protect their interests. For example, they were able to stop the implementation of decisions that went against their interests. As one of my interviewees put it, “the oligarchs influenced political decisions because they had supported Yeltsin in 1996. They did so forcefully, openly. They thought that he owed them.” At the same time, the power of the bankers had its limits: business did not capture the state. The auctions undermined the legitimacy of big business as the population considered rules guiding privatization to have been unjust. This lack of legitimacy reinforced dependence of business and

---

36 Pappe 91. Vladimir Potanin became a vice premier, Boris Berezovskiy became deputy secretary of the Security Council, Vladimir Lisin headed a department within the Presidential administration.
37 Interview with Valeriy Zubov, a deputy of the State Duma, member of the faction “Just Russia: Motherland/Pensioneers/Life,” member of the Duma Committee on economic policy and entrepreneurship, Moscow, 11 December 2009.
the regime on each other while further eroding their legitimacy. For example, after ONEKSIIMBank gained ownership in Noril’sk Nickel, it still had to put in a lot of effort into gaining control over the plant, which it eventually did with the help of the regime. By then Yeltsin had secured his reelection and the government was under pressure to pay its bills, most notably wage arrears that far exceeded what the bankers could offer. Irresponsible borrowing by Russian banks and the government led Russia to default on its debts in August 1998. When the 1998 crisis hit Russia, the regime once again used state resources to alleviate the effects of the crisis on the bankers. The bankers who had acquired assets in the industry survived the crisis and began to focus on the development of their assets in industry rather than in the financial sector. The need to concentrate on the most pressing problems made business and the government more “mutually moderate and passive” towards each other.

4. Policy regarding FDI

In the 1990s, Russia’s economy needed capital in order to transition to capitalism. While the state initially possessed an impressive stock of valuable assets, it largely withdrew from the investment process. The government took out foreign loans to pay its bills. Capital investment into the economy declined rapidly. Banks were too weak to provide capital. Before 1998, bank loans to the private sector constituted only 5 per cent of GDP. The average charter capital of Russian commercial banks at the end of 1992 was less than $150,000. That is why Russian banks could not be considered banks in the conventional sense since they did not play the role of primary financial intermediaries. The extremely high interest rates they set were also a

39 For details, see Johnson, 203-209.
40 See Johnson, 218-219.
41 Pappe, 92.
42 Kondratyev V.B., Yu. V. Kurenkov, and V. G. Varnavskiy et al., Osobennosti Investitsioonoy Modeli Razvitiia Rossii (Moscow: Nauka, 2005) 19.
43 For example, in 1995, Russian economy received only 29.6 per cent of investment that was made in 1989. See A. A. Frenkel', Ekonomika Rossii v 1992-1995 gg.: tendentsii, analiz i prognoz (Moskva: Finstatinform, 1995) 81.
44 For comparison, the number was 20 per cent for Poland, 60 per cent for the Czech Republic, and 90 or more for the developed economies. See: Shaping the economic space in Russia: decision making processes, institutions and adjustment to change in the El'tsin era 66.
46 Shaping the economic space in Russia: decision making processes, institutions and adjustment to change in the El'tsin era 66.
deterrent to borrowing. The stock market functioned poorly due to weakness of institutional environment.\(^47\) The lack of financial resources could have opened the way for the entry of foreign capital.

Yet, Russia attracted little FDI compared to its Central and Eastern European neighbors given the size and the potential of its economy. For example, in 1995 inward FDI stock constituted 1.6 per cent of Russia’s GDP. For comparison, this number was 26.7 per cent for Hungary, 14.1 per cent for the Czech Republic and Estonia, and 12.5 per cent for Latvia. The majority of FDI in Russia went into industry – 58 per cent in 1998, out of which fuel and oil processing attracted 15 per cent while ferrous metals and non-ferrous metals received 2 and 3 per cent of FDI respectively.\(^48\) In Russia, foreign investment accounted for only about 5-6 per cent of capital inflows in the economy. In industry, internal sources accounted for 72 per cent of capital in 1999. This share decreased to 60 per cent in 2003.\(^49\)

A poor investment climate was certainly part of the explanation why Russia did not see more FDI in the 1990s. Legislation on foreign investment and other areas of economic activity was confusing and contained a number of contradictions. Implementation was a big problem. Investment procedures were very burdensome: in order to obtain all the necessary permits, foreigners had to deal with numerous institutions and the procedures were lengthy. Laws focused on setting limitations on foreign investors rather than creating favorable investment climate.\(^50\) While factors such as political uncertainty, deficiencies in legislation and its implementation, “red tape,” corruption, and poor corporate culture certainly played a role, why Russia had such a poor investment climate to begin with is worth an independent investigation. As one of my interviewees noted, the image of Russia as a very corrupt country where it was dangerous to do business was promoted by the Russian business, which in this way was getting rid of unwanted competition.\(^51\) Therefore, there was no real demand for FDI on the part of the regime and the rising domestic business class. The regime saw no political benefits to letting foreigners in. The

\(^47\) Kondratyev V.B., Yu. V. Kurenkov, and V. G. Varnavskiy et al., 17.
\(^49\) See: Dolgopyatova, “Corporate Ownership and Control in Russian Companies…,” 267.
\(^51\) Interview with an expert, Moscow, 2009.
oligarchs were concerned that the entry of foreigners would deprive them of opportunities to build up their own fortunes.

Even though Russia needed capital, a lack of capital was not the main problem facing its industry in the 1990s. In fact, well-connected people could get capital rather cheaply.\(^{52}\) Since Russia’s economy underwent massive industrialization during the Soviet times, the biggest task was to modernize and change the incentive structure rather than to launch development from scratch. Industry could work for some time without significant new capital investments utilizing old capacities and other production reserves. Intensive technological modernization could be postponed. In fact, “perhaps the most insidious obstacle to industrial restructuring [was] the fact that the country [could] get by without it – not prospering exactly, but certainly surviving.”\(^{53}\) Those who controlled industrial assets had very short time horizons, in part because there was a possibility of losing those assets due to weak property rights. They squeezed as much as was possible in the short term while disregarding the long-term. Very little investment went into modernization of enterprises. Few had “an understanding that property comes with responsibility and that this property [that came under their control] required a major upgrade.”\(^{54}\) In order to maintain control over the enterprise, those who had it in the first half of the 1990s preferred to finance any investment from those enterprises’ own funds rather than turn to the outsiders for help.\(^{55}\)

Russia’s rising domestic business class feared that letting foreigners in would lead to competition for assets, which they would not be able to win. Because Yeltsin’s regime had previously empowered the oligarchs by granting them access to state resources, their views on FDI “mattered” much more than in Kazakhstan. Russia also did not have strong political support for FDI. Both the elite and the society “were open to receiving help from foreigners but were not...

\(^{52}\) Interview with Mikhail Kroutikhin, Partner and Analyst, RusEnergy, Editor-in-Chief, *The Russian Energy Weekly*, Moscow, 2 December 2009.


\(^{54}\) Interview with Valeriy Zubov, a deputy of the State Duma, member of the faction “Just Russia: Motherland/Pensioners/Life,” member of the Duma Committee on economic policy and entrepreneurship, Moscow, 11 December 2009.

\(^{55}\) Kondratyev V.B., Yu. V. Kurenkov, and V. G. Varnavskiy et al., 17-18. In 1994, enterprises’ own funds were responsible for 64.5 per cent of all investment. See Frenkel' 85.
prepared to award foreigners full control over strategic assets." 56 Foreigners were accepted as donors but not as investors. 57

The elites also saw no benefit doing more than paying lip service to FDI. Yeltsin’s regime “did not need to undertake any artificial measures for ideological approachment with the West … and therefore did not require foreign investment as some form of platform for establishing the relations with the West.” 58 This stands in sharp contrast to Kazakhstan, where Nazarbaev’s regime used FDI to pursue its strategy of Westernization and legitimization. In Russia, even more importantly Yeltsin’s regime needed to find an ally that could support itself in power but also that the regime would have leverage over. That is why the regime preferred to give control of national wealth to domestic oligarchs rather than foreigners. As Pappe notes, “during the difficult period of 1995-1996, when Yeltsin needed to save his regime, foreigners could not and did not want to help him out.” 59 During Yeltsin’s bid for reelection, foreigners could not ensure positive coverage of Yeltsin in the Russian media, as the Russian oligarchs could and did. That is why “granting access to foreigners to large assets that were undergoing privatization, including loans for shares, did not make any ‘technological sense’ for Yeltsin [from the point of view of getting reelected]. A sale of enterprises to foreigners would have been an additional argument for Yeltsin’s opponents in efforts to oust him from office.” 60 Also, the federal parliament and several regions strongly opposed foreign investment as a “sellout” to foreigners. 61 Russian society and elites “agreed to receive assistance from foreigners, but they were not ready to give the strategic objects into the complete management of foreigners.” 62

At the level of declarations, the strongest supporters of FDI were the so-called “young reformers,” who viewed foreign capital as an important factor influencing the success of reforms

56 Interview with Valeriy Zubov, a deputy of the State Duma, member of the faction “Just Russia: Motherland/Pensioneers/Life,” member of the Duma Committee on economic policy and entrepreneurship, Moscow, 11 December 2009.
57 Interview with an expert, Moscow, 2009.
59 Interview with Pappe Iakov, professor, Faculty of Economics, Higher School of Economics, 2 December 2009.
60 Interview with Pappe Iakov, professor, Faculty of Economics, Higher School of Economics, 2 December 2009.
62 Interview with Valeriy Zubov, a deputy of the State Duma, member of the faction “Just Russia: Motherland/Pensioneers/Life,” member of the Duma Committee on economic policy and entrepreneurship, Moscow, 11 December 2009.
they launched. However, the “young reformers” often did not implement the policies they favored because they needed to make political compromises. Some of them were also not committed to the principles they preached. For example, Anatoliy Chubais, who was considered to be a “young reformer,” lobbied in favor of Vladimir Potanin’s Oneksimbank and Oleg Deripaska’s interests in the metallurgical sector. Interests in conjunction with power maintenance strategies explain Russia’s policy regarding FDI better than actors’ declared ideological views.

5. Oil and Gas

During the Soviet era, the oil sector was held together by tight political control because of the sector’s importance for the entire economy. After the weakening of control from the centre, the sector began breaking up into many small units, a process that continued into the late 1990s. Gorbachev’s 1987 Law on State Enterprise in 1987 that intended to grant autonomy to enterprises created a lot of uncertainty in the oil sector. For example, it was unclear whether the Law granted decision-making powers to production associations or the NGDUs. Production associations by themselves were bureaucratic organizations while the NGDUs carried out production. In the end, production associations retained their leading role in the sector and became reinstated as state enterprises when the transformation of the sector began. The story of the big and smaller-scale struggles between different institutional leftovers from the old system that resulted in different outcomes suggests that the transition process to capitalism and its winners and losers may have been less predetermined than assumed.

63 Interview with Valeriy Zubov, a deputy of the State Duma, member of the faction “Just Russia: Motherland/Pensioners/Life,” member of the Duma Committee on economic policy and entrepreneurship, Moscow, 11 December 2009. Also Zudin 53.
64 According to some accounts, Potanin paid Chubais (and some other “reformers”) a suspiciously high pre-payment for the books that were still to be written: “Sbezhav iz strany posle “Rasprodazhi Sovetskoy imperii,” byvshiy goschinovnik s radostyu zhdal ee raspada. Kak Predavali Rossiu. Kokh. Chast’ 1.” Russkaya Planeta, 8 October 2012 (available at http://rusplt.ru/articles/vlast/vlast_1247.html).
65 Gustafson 40.
66 The Oxford Handbook of the Russian economy 346.
Compared to oil, by the end of the Soviet Union’s existence Russia’s gas production was more centralized. First, it was more geographically concentrated.\textsuperscript{67} Second, transformation of the ministries into state kontserny (in Russian) in the late 1980s reinforced centralization. Kontserny were intended to be state-owned companies operating “as a quasi-autonomous and voluntary association of enterprises while technically remaining subordinate to a ministry.”\textsuperscript{68} Relations between kontserny and member enterprises were to be contractual.\textsuperscript{69} Kontserny were given more freedom (they had their own revenue and increased powers to determine prices and salaries) and possibilities to participate in market activities, yet at the same time they remained state-owned and could skew these market opportunities in their own favor.\textsuperscript{70} The enterprises that joined kontserny lost their independence. In the gas sector, all enterprises were gathered into an independent state kontsern Gazprom in August 1989. Gazprom became a fully self-financing and self-administering entity largely due to the efforts of Victor Chernomyrdin, the Soviet Minister of Gas Industry (1985-1989).\textsuperscript{71} Its creation was to a significant extent a political arrangement: in exchange for autonomy, Gazprom guaranteed gas supplies to Russian customers.\textsuperscript{72} The transformation of Gazprom into a kontsern allowed Chernomyrdin to retain personal control over Gazprom and prevent the sector from breaking into smaller units.\textsuperscript{73}

In contrast, the Ministry of Oil failed to create a kontsern in 1991, mainly due to objection of Prime Minister Ivan Silaev, who feared that creation of a giant oil kontsern would further undermine the authority of his government, which had already lost some of its powers to Gazprom – again, a political arrangement.\textsuperscript{74} A decentralized association Rosneftegaz established after the oil ministry’s reorganization in late 1991 was no match for the powerful Gazprom.\textsuperscript{75}

\textsuperscript{67} Three supergiant gas fields located in West Siberia were responsible for more than 90 per cent of Russia’s gas production as of 1991. In contrast, three largest oil fields produced only one third of Russia’s oil output and were located much further from each other. Sim 11.
\textsuperscript{68} Gustafson 72.
\textsuperscript{69} Stephen Whitefield, \textit{Industrial power and the Soviet state} (New York: Oxford University Press, 1993) 227. For more discussion of the goals of the reform, see Kriukov 85.
\textsuperscript{70} Sim 18; Whitefield 230-231.
\textsuperscript{72} See Shaping the economic space in Russia: decision making processes, institutions and adjustment to change in the El'tsin era 108.
\textsuperscript{73} Goldman 101.
\textsuperscript{74} Sim 18.
\textsuperscript{75} For discussion of Rosneftegaz, see Sim 18, 99-100.
The difference between the centralization of the gas sector and de-centralization of oil in Russia so soon before the USSR’s dissolution set these sectors into a path-dependent path. Structural predispositions interacted with political factors, which resulted in particular institutional arrangements. At the same time, these institutional arrangements did help to keep the gas sector unified and oil decentralized after Russia gained independence.

The oil sector that Russia inherited from the USSR was “highly developed, but flawed.” Its long-term development was under question because the USSR had failed to resolve some of its most pressing problems. In the 1980s, the sector’s “active” reserves were being emptied at average yearly rates of 5-7 per cent (10-12 per cent for some fields). By 1994, about 60 per cent of explored and producing reserves were on a decline. Few new deposits were discovered or put into production. The output of crude oil fell from 11.4 million b/d in 1988 to less than 7.1 million in 1993. The gas sector was doing better than oil in terms of availability of reserves. Its main problem was that future growth in extraction would have to come from regions with extreme climate conditions, such as the Yamal peninsula, and thus required significant investment and complex technologies.

Both oil and gas needed investment to maintain production in the long-term. Yet, in the short-term the situation was not too desperate. The fields discovered during the Soviet times, which Gustafson calls “legacy fields,” contained resources that could be recovered with relatively unsophisticated techniques. Westerners who came to Russia in the 1990s were impressed by the level of scientific and engineering talent among the domestic oilmen. Changes in attitude, from wastefulness to strive for efficiency, would take time to take effect, yet they were easier to achieve than setting up extraction in some key fields almost from scratch, as was the case in Kazakhstan. Western oilmen estimated that the Russians could increase net production by 10-15 per cent by introducing simple improvements.

---

76 Gustafson 8.
78 Ebel 13. For more detailed data, see Frenkel’, 34.
79 The reserve-production ratio actually allowed to double yearly extraction levels Dienes 27.
80 Dienes 27-28.
82 Gustafson 152.
In a way, as Gustafson notes, the Soviet oil that Russia inherited served as “an anesthetic”: it delayed large-scale adaptation of the sector to capitalist management and technology, keeping the sector isolated and unable to compete globally. Large repair facilities remaining from the Soviet times allowed production to be maintained, even if at a diminished rate. The sector was one of the few that produced exportable goods and earned badly needed cash. Industry insiders, a diverse number of accidental outsiders, and the regime were interested in pursuing opportunities the sector offered. Given the scope and the speed of changes that Russia was undergoing at the time, all of these actors privileged short-term over long-term thinking. They were inclined to muddle through the difficult times rather than surrender the control that had fallen into their hands.

Therefore, two types of Soviet legacies – the organization of the sector during the Soviet times and the state of its development – affected decisions and incentives within Russia’s oil and gas after 1991. Whereas the organizational aspect of Soviet legacies influenced whether or not an industry stayed in private or state hands (oil compared to gas), the relatively high level of sector’s development allowed both oil and gas to stay in domestic hands.

5.1. Political and Economic Interests in Oil and Gas Sectors

Oil and gas have been Russia’s key economic sectors throughout the independence era yet the regime pursued different strategies toward them depending on its political needs and its power vis-à-vis various societal actors. Initially, Yeltsin promoted the interests of the former Soviet nomenclature, the so-called “oil generals.” When the “oil generals” failed to retain power within the sector and lost their political appeal, the sector ended up in the hands of ambitious oligarchs who came from trading and banking sectors. This suggests that the mere availability of a prospective ally does not explain why a particular actor was, in the end, chosen as a political ally. The gas sector remained intact under the near monopoly of Gazprom, which was created in the late Soviet era as a solid hierarchical structure (one of my interviewees referred to it as “a state within a state”). Similarly to oil, gas was used to sustain the regime in power and enrich

---

83 Gustafson.
the highest officials. The fate of both oil and gas was determined by an interaction of two main factors: the level of development the sector achieved during the Soviet era and interests of the key power holders regarding the sector.

5.2. Privatization

Initially, Yeltsin’s government planned to maintain significant state ownership in the oil sector while fostering competition among partially privatized companies.86 The plan was to restructure the sector through creation of ten to twelve Vertically Integrated Companies (VICs) that would link different parts of a technological chain. The VICs were supposed to be financially sustainable and internationally competitive.87 Creation of VICs was to help avoid extreme decentralization that would have been harmful to production.

Because of the economic and political importance of the oil sector, its privatization took place separately from other sectors.88 The November 1992 decree 1403 stipulated that all enterprises be transformed into Joint Stock Companies (JSCs). A holding company would have a 38 per cent stake in each of them.89 As a result, three VICs – LUKOIL, Yukos, and Surgutneftegaz – were created as holding companies based on the Soviet-era production associations. The state was to retain the controlling packages of shares in the holding companies for three years. Federal authorities received the right to appoint directors and confirm VICs’ board members. At the same time, lower-level units would receive significant room to maneuver within their holding companies.90 However, soon the central government lost control over privatization because various actors – among them the managers of enterprises in the sector,

86 Business and state in contemporary Russia, ed. Peter Rutland (Boulder, Colo.: Westview Press, 2001) 124. On the organizational form of the sector, through which the government planned to exercise control, see Business and state in contemporary Russia 105.
87 The Oxford handbook of the Russian economy 347.
89 Presidential decree 1403 issued November 17, 1992 “On Peculiarities of Privatization and Transformation into Joint Stock Companies of State Enterprises, Production and Scientific-Production Unions of Oil and Oil-Processing Industries and Supplies of Oil Products.” Kriukov 102-103. In the oil sector, all major VICs were created through presidential decrees.
90 The Oxford handbook of the Russian economy 348.
regional leaders, banks, and trading companies – engaged in both official and informal privatization of assets.

5.3. The Era of the Oil Generals

The sector presented the oil generals with both opportunities and challenges. The empowerment of production associations during the Soviet era had put the oil generals in a strong position to succeed when the USSR collapsed. In particular, the generals were in the best position to engage in spontaneous privatization. They were also in charge of upstream producing assets that were indispensable for the sector.91 The most attractive opportunity was exporting oil to Western markets. Even when domestic prices for crude oil began rising, they were still a fraction of world prices.92 Hard currency earnings could pay for the most needed equipment supplies, provide consumer goods for the workforce, and enrich personal bank accounts of important people in the sector.93

There were also significant challenges. The oil generals were not the only actors engaged in spontaneous privatization: “[e]very day more of the state companies’ assets leaked to the private structures that were springing up all over oil country – banks, cooperatives, brokerages, exchanges, fly-by-night producers, joint ventures – as the Soviet-era stakeholders, not knowing what the future held, prepared makeshift lifeboats and began lowering away.”94 Retaining control over assets was difficult because the oil generals faced serious competitors, including criminal groups. However, perhaps the most serious competitors were the NGDUs. There was no certainty that production associations, some of which became holding companies after privatization began, would retain their assets. The new government and, in particular, its oil minister Vladimir Lopukhin, were hostile to the oil generals. Some of the initial government decrees did not mention production associations and instead favored the NGDUs as the key players in the sector. The oil generals claimed that the strikes that took place at the level of NGDUs were organized by lower-level managers as bargaining tools against the oil generals.

92 See Considine, 266-267. The system was two-tiered and part of the oil produced was available for sale at prices higher than those at which state orders of oil were purchased. However, there were formal and informal limits on this price too. It was also heavily taxed. See Considine, 240-241.
93 Dienes, 42.
94 Gustafson 65.
Getting licenses for exploration was also difficult. The February 1992 Mineral Resources Law gave the geologists led by the former Soviet geology minister Viktor Orlov the leading role in licensing oil exploration and extraction. This framework law also awarded the regions (where the geologists had strong positions) equal powers to those of the central level (known as the “two-key principle”). Yeltsin signed this Law in order to obtain the allegiance of the regions. The oil generals now had to work at both regional and central levels to secure their positions.

Exporting could have solved many of the problems the oil generals were facing yet it was not easy. The state company Transneft’ owned and managed the pipeline system. Initially, the oil generals could not take advantage of exporting since they did not “own” oil after it had entered the pipeline. The government issued export licenses to a large number of trading companies without any strategy in mind. As a result, despite steep decline in crude oil production in the early 1990s, net exports rose from 3.14 million to 3.43 million barrels per day between 1993 and 1996. The oil generals were only one of the actors who exported oil among others and had to fight for access to pipelines. They eventually had to collude with oil traders, which in the end undermined their positions in the sector.

Oil producers also faced steadily rising production costs and heavy taxation. Yet, they struggled to collect payments from domestic consumers for the delivered oil. The state itself was one of the main debtors. Prices for oil and oil products were de-regulated only in 1996 yet prices for inputs had been freed and steadily rising since the start of “shock therapy.” As late as 1994, the oil producers could not sell more than 20 per cent of oil on the open market. The taxation system left few funds in the hands of the sector: in 1992, taxes accounted for 69 per cent of the domestic oil price. Oil producers had to pay taxes on turnover rather than profits. Besides general and specialized taxes on oil production and sale, oil companies had to pay export tariffs and fees for the use of state owned transportation system. The government expected the sector to

---

95 Gustafson 44.
96 The political economy of Russian oil 2.
97 This cost the loss of control over their assets for the majority of them since the traders eventually became the dominant partners. Gustafson, 88, 95-96.
98 In 1997, only 10-20 per cent of domestic oil deliveries were paid for in cash. Approximately 80-90 per cent of oil sold domestically was paid for by barter or other non-cash payment forms. A large portion of deliveries was left unpaid. See Considine 288.
cover its domestic losses through access to foreign financial markets yet the losses were considerably higher than the sector’s earnings.\textsuperscript{99}

Yeltsin came to support the oil generals only after some time. Oil (together with gas) was to become the key sector in stabilizing Russia’s financial system and transitioning to the market economy. Exports of oil and gas could be used as securities for foreign loans. Revenues from oil and gas could fill in the budget and help the government cushion the cost of economic transformation for the population. Therefore, the sector had very high political saliency.\textsuperscript{100} If production had stopped or decreased significantly, Yeltsin’s regime would have been undermined. Disintegration of the sector to the smallest production units would have put production under threat. That is why the regime needed to reach compromises with the oil generals since “if there were a boycott or sabotage, this would have brought about colossal economic risks.”\textsuperscript{101} Privatization in the oil sector reflected this need to find political compromises. In some ways, Yeltsin’s support of the oil generals in the early to mid-1990s resembled the relationship Nazarbaev developed with foreigners. The two presidents built these alliances based on considerations of who could help keep the politically important sector intact and maintain or increase (in the case of Kazakhstan) its production level, and in this way sustain the regime in power.

The oil generals in turn also needed Yeltsin to secure their positions and fight off competitors. Their fate and fortunes were highly dependent on the government and its policies. Nearly every Russian oil company “was engaged in complex negotiations with government authorities on vital issues such as access to credits, tax privileges, export quotas, and so on.”\textsuperscript{102} The oil generals saw no alternative to the state with its powers, even if weakened, - and Yeltsin was in charge of it. For example, Yeltsin had the power oust the oil minister Lopukhin who supported radical market reforms in the sector and therefore threatened oil generals’ interests.\textsuperscript{103}

\textsuperscript{99} Shaping the economic space in Russia: decision making processes, institutions and adjustment to change in the El’tsin era 103.
\textsuperscript{100} Gustafson 17.
\textsuperscript{102} The political economy of Russian oil 68.
\textsuperscript{103} On how he was dismissed, see, for example, “My vzyali stol’ko vlasti, skol’ko bylo vozmozhno,” Forbes, 30 September 2010, available at http://www.forbes.ru/node/57754/print (last accessed March 13, 2015). Valerii Paniushkin, Gazprom: novoe russkoe oruzhie, ed. Mikhail Zygar and Irina Reznik (Moskva: "Zakharov", 2008) 21-
Yeltsin’s prerogative to issue decrees presented an attractive alternative to pushing decisions through the parliament. The Duma’s hostility to the interests of the oil generals “helps explain why the oil/gas elite ha[d] unequivocally supported Yeltsin and his administration.” The relationship between the president and the oil generals built on mutual dependency shaped the main developments in the sector since the fall of 1992 until 1996.

The November 1992 decree on privatization was a significant victory for the oil generals. As one of my interviewees noted, “the privatization schemes that were used … were partially oriented at the directors, they gave them [the oil generals] rather wide opportunities and therefore at some point turned them [the “oil generals”] into the unwilling ally of the process.” LUKoil’s Vagit Alekperov, an “oil general” himself, suggested creating VICs and helped draft the decree. Those oil generals who agreed to transform production associations into entities with private ownership initially were the winners. In 1992-1993, presidential decrees and government resolutions gave the existing largest oil and gas companies the right to explore and extract resources from the richest gas fields and from 180 oil fields. Essentially, the enterprises that had been extracting oil during the Soviet period obtained licenses to continue this extraction.

Not all oil generals wanted to turn the production associations they were in charge of into VICs. In the 1990s, Rosneft’, which would become Russia’s key state actor in the oil sector under Putin, was a “temporary parking lot” for the production associations “whose generals had


104 The political economy of Russian oil 8.


108 Interview with Vladimir Milov, director of the Institute of Energy Policy and deputy minister of energy (2002), Moscow, 25 November 2009. There was significant corruption in distribution of licenses. For oil, the payoff may have been as high as 3 per cent of the total value of the contract. David G. Haglund, Change in the former Soviet Union and its implications for the Canadian minerals sector: the cases of copper, gold, nickel and uranium, ed. S. N. MacFarlane, Vladimir Popov and Ont). Queens University (Kingston (Kingston, Ont.: Centre for Resource Studies, 1994) 79.
not wanted to join a holding company or had not had time to form one.” Rosneft’ was to hold shares of these production associations for three years. Its president Aleksandr Putilov tried to transform Rosneft’ into a genuine national oil company but did not succeed: eventually Rosneft’ lost its most attractive assets to other private oil companies.  

The November 1992 decree catered to the interests of the oil generals to a much larger extent than to the interests of the state: the state was to retain control over the sector through state ownership in the holding companies, yet there was no effective way to ensure that the oil generals obeyed the orders of state representatives. The oil generals usually made decisions regarding both operational and strategic issues at the companies they controlled. The state’s regulatory powers were very weak while enforcement through courts was not well established. Very often, the only way to exercise shareholder rights, including those of the state, was through physical entry into the meetings or access to director’s office. Mintopenergo was supposed to make appointments on the part of the state and sign yearly production contracts with oil companies outlining responsibilities of these companies before the government. As privatization proceeded, private co-owners gradually filled in these spots reserved for state representatives with their own people. The position where companies were partly state-owned, yet poorly state-controlled benefitted the insiders by giving them access to budgetary funds. Ironically, these partially state-owned oil companies often charged the highest prices for oil deliveries to state customers.  

Oil generals influenced official decisions regarding the sector through the Ministry of Energy (Mintopenergo). Yuri Shafranik, who replaced Lopukhin in January 1993, had

---

109 Gustafson 76.
110 Kriukov 106. The term “national” in the name of Rosneft’ was explicitly avoided during the negotiations surrounding the 1992 decree. Gustafson 323.
111 Kriukov 125.
112 The political economy of Russian oil 26.
113 Shaping the economic space in Russia: decision making processes, institutions and adjustment to change in the El'tsin era 114.
114 Russia’s Ministry of Fuel and Energy (Mintopenergo) was formed after the all-Union ministries of the USSR were liquidated in 1991. The Ministry’s role was mostly restricted to “legal and general regulation of the fuel and power complex” without direct control over production activities The political economy of Russian oil 5. Interview with a former senior official from the Ministry of Energy, Moscow, 16 December 2009.
extensive ties to the sector. He had been the head of Langekas that eventually joined LUKoil and later became a deputy in the Tiumen legislature. Yeltsin was personally indebted to him: due to Shafranik’s efforts, Tiumen was one of the few regions that supported Yeltsin during the coup by the communist hard liners in August 1991. Under Shafranik’s leadership, the Ministry turned into an institution that in many ways helped articulate and present oil generals’ interests. As one former decision-maker in the sector recalled, “Minister’s reception area was crowded with heads of oil companies,” many of whom came to visit a minister nearly every day. The Ministry spent more time lobbying the oil generals’ interests than regulating the sector. It became the key institution in issuing licenses, and therefore a tool in preventing outsiders from making claims regarding the sector’s assets.

The story of the oil generals Russia is striking as it portrays the mix of their power and powerlessness. The Soviet era left the oil generals in a good position to take advantage of the opportunities the new system offered. It also turned them into important political actors that Yeltsin’s regime had to deal with. At the same time, the position of the oil generals during the Soviet era did not guarantee that they would be successful after the collapse of the USSR as well. In the end, the majority of them lost their assets in the sector for two main reasons.

First, the oil generals were often unable to play by the new rules: “[b]y nature and by experience, they [the oil generals] did not seem particularly well adapted to the fledging market economy; they were red directors, crimson-cheeked, heavy-drinking, fist-thumping princes of the Soviet Union’s industrial nomenklatura.” Many did not manage to establish effective control over the assets they owned. Prime example is Sergey Muravlenko of Yukos, who, unlike LUKoil’s Alekperov or Surgutneftegaz’s Vladimir Bogdanov, failed to consolidate control over company’s oil and cash flows. Others were unwilling to adapt. Whenever the oil generals were

---

115 Since Langekasneftegaz was part of the LUKoil kontsern, Shafranik had close ties with LUKoil’s Vagit Alekperov and helped LUKoil become a JSC. He had also been a chairman of the Tiumen’ Regional Council, and as head of the oil-rich Tiumen’ region itself. The political economy of Russian oil 5.
116 Interview with a former senior official from the Ministry of Energy, Moscow, 16 December 2009.
117 The political economy of Russian oil 5. For example, it was largely due to efforts of Mintop and the Ministry of Foreign Economic Relations that the list of authorized exporters was not abolished (as the IMF demanded), but instead expanded from 14 to 179. Dienes 22.
118 Interview with a former senior official from the Ministry of Energy, Moscow, 16 December 2009.
119 Sim 125. Lukoil and Surgutneftegaz are two main exceptions.
120 Freeland 70.
121 Gustafson 129-137.
either unable or unwilling to develop a long-term perspective regarding their assets, they brought their company to financial and economic breakdown.\textsuperscript{122} The oil generals looted as many resources as possible before losing their property.\textsuperscript{123} Sometimes, the oil generals engaged in asset stripping in order to re-use the assets for gaining ownership of the company, which diverted considerable income from production.\textsuperscript{124} Voucher privatization did not provide sufficient capital for the sector over the long term.\textsuperscript{125} Due to non-payments and difficulties in exporting, the oil generals struggled to finance their operations in the short term too. By mid-1995, the three-year period during which the state was to hold a controlling package in the holding companies was running out and the sector was preparing for new rounds of redistribution.

Secondly, Yeltsin’s regime undermined the oil generals by pursuing policies that deprived the sector of revenues. The government tried to raise revenue from the sector by allowing favored traders to gain a commission through exports. Part of the earnings then went to finance government projects.\textsuperscript{126} Eventually, Yeltsin found a different political ally. Without significant financial and other resources on their hands, the oil generals could not help Yeltsin get reelected in 1996. Commercial banks were better fit to fulfill this role.

5.4. The Bankers Arrive

Commercial banks were larger than proprietary banks and therefore were stronger economic and political players.\textsuperscript{127} The oil generals tried to counteract bankers’ influence through Mintopenergo: Yuri Shafranik pushed for repaying the loans in order to preserve state ownership of the oil industry.\textsuperscript{128} Yet Yeltsin seems to have made his decision to put his bets on the bankers without Shafranik’s input. After Shafranik’s departure from office in 1996, the role of the

\textsuperscript{122} Shaping the economic space in Russia: decision making processes, institutions and adjustment to change in the El'tsin era 106.
\textsuperscript{123} Interview with Mikhail Kroutikhin, Partner and Analyst, RusEnergy, Editor-in-Chief, The Russian Energy Weekly, Moscow, 2 December 2009.
\textsuperscript{124} Shaping the economic space in Russia: decision making processes, institutions and adjustment to change in the El'tsin era 106.
\textsuperscript{125} Dienes 25.
\textsuperscript{126} Gustafson 2012 90-91.
\textsuperscript{127} The political economy of Russian oil 53.
\textsuperscript{128} Sim 64. In order to obtain the Ministry’s support for selling off the shares that had been used as collateral for loans, Goskomimushchestvo offered the Ministry a prerogative to name state representatives to the board of directors of companies with state ownership. In addition, Goskomimushchestvo and the Anti-Monopoly Committee agreed to support the decree prolonging the period when the state retained shares of strategic enterprises until December 31, 1998. The decree was offered by Shafranik and eventually signed by President Yeltsin in August 1996. Sim 64.
Ministry and the oil generals declined.\textsuperscript{129} Whereas in 1995 the boards of directors of VICs mostly consisted of oil generals and ministry officials, by 1996 bankers and financiers became much more visible.\textsuperscript{130} In December 1995, Mikhail Khodorkovskiy’s Menatep bank acquired 45 per cent of Yukos’s stock. By the early 1997, Rosprom-Menatep controlled more than 85 per cent of Yukos. Similarly, an alliance of the International Financial Company and Oneksimbank bought 51 per cent of Sidanko’s shares by 1995.\textsuperscript{131}

Even though significant assets in the oil sector changed hands in the course of “loans-for-shares” auctions, we should not overestimate the importance of these auctions: many oil generals lost property to commercial banks both before and after the auctions. The developments in the sector during the preceding five years were at least as important. The oil generals were vulnerable because they did not consolidate their assets. Only two prominent oil generals – Vagit Alekperov of LUKoil and Vladimir Bogdanov of Surgutneftegaz – managed to retain ownership because they understood early on that in order to survive in the long-term, it was insufficient to secure control over the sector’s physical assets. They also needed to consolidate control over their companies. Many companies lost out because the trading company they had to rely on to export oil to western markets gained dominance over the producer. Also, “[w]here the trader was backed by a large bank or a financial-industrial conglomerate, the relationship was even more lopsided.”\textsuperscript{132} Gustafson refers to them as “trader-bankers.”\textsuperscript{133} The Alfa group gained control over the TNK. Alfa and Oneksimbank gained control over Sidanko.

Oil companies tried to deal with their liquidity problem by establishing links with so-called “proprietary banks,” which were often the transformed financial services and accounting departments of these very enterprises.\textsuperscript{134} They were not full-fledged banks since they performed only a limited range of operations and played a marginal role in investment processes within the sector. Relying on a bigger commercial bank was dangerous: Bogdanov of Surgutneftegaz realized early on that reliance on Potanin’s Oneksimbank threatened loss of control over the

\textsuperscript{129} Interview with a former senior official from the Ministry of Energy, Moscow, 16 December 2009.
\textsuperscript{130} Business and state in contemporary Russia 111.
\textsuperscript{131} The political economy of Russian oil 34.
\textsuperscript{132} Gustafson 93.
\textsuperscript{133} This is how Gustafson calls them to underline the connection between the earlier and the later periods where some people, like Khodorkovskiy, started in trading and eventually became bankers who gained control over oil companies. See Gustafson 100.
\textsuperscript{134} For example: Sibneftebank, Langepasbank, Kapital, etc. The political economy of Russian oil 50-51.
assets. In contrast, Yukos’s Muravlenko relied on Mikhail Khodorkovskiy of Menatep Bank until he lost control over Yukos. However, the FIGs did not win because they had capital and the “oil generals” lacked it; they won because the FIGs were more “entrepreneurial” than the oil generals in finding capital. Even more importantly, the oil generals failed because they did not manage to establish control over oil and cash flows. Control - “legal, financial, and physical” – was key. During the loans-for-shares auctions, central authorities clearly favored businesses that had strengthened their positions in the sector due to government policies, their own entrepreneurial spirit, and good luck. The most successful oil companies run by the oil generals – Lukoil and Surgutneftegaz – even managed to benefit from loans for shares auctions that resulted in loss of control over the oil companies by their Soviet-era colleagues: both Lukoil and Surgutneftegaz agreed to participate in the loans-for-shares with the condition that their debt to the federal budget would be written off. The shares of both companies were at the end bought out by the business entities associated with the oil companies themselves. Political connections certainly helped bring about this positive outcome.

Unclear about the long-term prospects of retaining ownership in the sector, the bank-led FIGs initially simply plundered resources from the holding oil companies. They changed their attitude after the 1998 financial crisis. When the crisis undermined the power of the banks, they refocused their efforts on industrial assets. In the oil sector, the balance shifted from “coalitions of internal control whose goal was survival to coalitions of external control whose goal was the growth of the company and its assets.” The companies that were created during

135 Gustafson 113, 124-125. The bankers also won over the geologists: Gustafson 94.
136 In 2011, Roman Abramovich revealed that during the 1995 loans-for-shares auction, he bought Sibneft’ for the company’s own money using foreign credits that were given to the company’s producing unit and oil processing plant in exchange for long-term contracts on oil supplies and through the affiliated bank transferred this money to the government: Yulia Smirnova, “15 otkrytiy, kotorye prines protsess Berezovskogo I Abramovicha,” Forbes, 15 January 2011, available at http://m.forbes.ru/article.php?id=76314 (last accessed March 13, 2015).
137 Gustafson 104.
139 The bankers mostly gained ownership in the holding companies, which in their turn had majority stakes in subsidiaries. However, this did not mean that ownership in the holding companies would bring control over the subsidiaries. In order to gain this control, the holding companies needed to undermine the values of subsidiaries through measures such as “share dilution, transfer pricing, asset stripping, and biased corporate restructuring.” See Russia's post-communist economy 314-315.
140 Kriukov 147-148.
these years were more mature than the companies run by the oil generals in the early 1990s and they established their own relations with key ministries and agencies.141

The traders and the bankers who had strengthened their positions in the sector then became Yeltsin’s key political allies. The support of Yeltsin’s bid for reelection in 1996 gave the oligarchs leverage over the regime and by extension access to the state and its institutions. However, neither the oil generals earlier nor the oligarchs in charge of the oil sector could unilaterally dictate to the government. For example, when the government decided to raise export duties after oil price increased in 1999, the oil companies failed to reverse this decision.142 Although the majority of oil companies were privatized in the 1990s, resources in the ground belonged to the state, which opened the way for using these ownership rights in the future. The state ability to allow or restrict access to the oil transportation system managed by state-owned Transneft’ gave the government the biggest leverage over oil companies.143 The government maintained a rigid system of export quotas and export taxes in order to keep domestic oil prices low and ensure there was enough oil for the domestic market.144 Sometimes access to a pipeline was also used as a means to compensate for weak state capacity. For example, in June 1998, deputy PM Victor Khrystenko threatened to reduce the access of Bashneft’, Sidanko, TNK, Tatneft’, and ONAKO to export pipelines until they paid their tax arrears.145 The oil sector, “despite its apparent escape, remained enmeshed in a system of state controls that, although half-comatose in the 1990s, had the potential to be revived at virtually a moment’s notice if provided with political energy and resources.”146

5.5. Regional Authorities

Yeltsin’s strategy of maintaining his political power through decentralization turned regions into important players in the energy sector. The federal centre officially formulated

141 Interview with a former senior official from the Ministry of Energy, Moscow, 16 December 2009.
143 Initially, Transneft was owned fully by the state. Despite plans to privatize it, by 1998, the state still owned 75 per cent of the company. Company’s employees owned the remaining 25 per cent. See The political economy of Russian oil 129. For detailed discussion of how the allocation of export capacity was officially regulated, see Considine 276.
144 Considine 249. The Soviet quota system was replaced in March 1995 a new one based on quarterly export allocations, still to be approved by the government. The “special exporter status” was preserved until March 1995. Considine 269-270.
145 The political economy of Russian oil 130.
146 Gustafson 14.
policies toward natural resources, yet regions could influence implementation of these policies. Whoever wanted to work in the sector had to gain the allegiance of regional authorities, which was often more challenging than building relations with central authorities.

Both the 1992 Subsoil Law and the 1993 Constitution stated unequivocally that management of mineral resources fell under the joint jurisdiction of central authorities and the authorities of a given territory (the “two keys” principle). Mintopenergo’s Yuri Shafranik actively promoted this principle in order to secure the support of local actors for decisions made in Moscow. 147 Unfortunately, neither the Constitution nor other legislative acts contained details about how this joint jurisdiction would be exercised. 148 Since a license for oil or gas extraction had to be approved at both federal and regional levels, whenever “one of the keys would not turn it was impossible to open the door into the subsoil basement.”149 Some of the fiercest struggles over natural resources took place at the regional level itself between the regions (oblast’) and their autonomous districts (okrugs).150 The okrug governors gained authority over Production Sharing Agreements (PSAs), environmental regulations, and taxation. In the early 1990s, the former Soviet geologists promoted the okrugs since they had good representation at this level, which threatened the positions of the oil generals.151

Oil was an important revenue generator for the regions. 152 In addition to a number of federal taxes, oil companies were expected to pay local taxes and levies, which quite often “were thinly disguised mechanisms for allowing local bureaucrats, still in place but freed from control at the centre, to ‘feather their own nests.”153 These rents allowed local officials to maintain their power. 154 Similarly to the federal elite, regional political elites used their levers of control over the energy sector for personal enrichment and maintaining their power. The regions also actively

147 Interview with a former senior official from the Ministry of Energy, Moscow, 16 December 2009.
148 Moe and Kryukov 597.
150 The political economy of Russian oil 134.
151 The former geology minister Viktor Orlov pushed for the two keys principle for oil exploration at the central level. Gustafson 67-68.
152 See Considine 250-251. For example, in 1996 “Bashneft” was responsible for 48 per cent of all revenues received by the republic. Kriukov 108.
153 Considine 251.
participated in formation of oil companies. By the end of 1995, the regions owned three companies – Tatneft’, Bashneft’, and Komitek.

5.6. Russia’s Gas: Why the Paths With Oil Diverged

Unlike oil, Russia’s gas sector stayed monopolized in the hands of Gazprom and largely avoided privatization. The nature of the sector certainly “mattered” since gas was cheaper to produce than oil but was also more difficult and costly to transport. The unified structure of the Soviet gas sector produced fewer players than in the oil sector. The reforms that took place in the sector in the late 1980s and the role of Chernomyrdin and Gaidar also helped to preserve the sector intact.

The corporate leaders of Gazprom, first and foremost Chernomyrdin, had more power over the Kremlin than western Siberia’s “oil generals.” Chernomyrdin had built an impressive career in the sector during the Soviet times, which culminated in his appointment as the minister of gas in 1985, a post he retained until the collapse of the USSR. Chernomyrdin’s success in capturing control over Soiuzgazeksport, the gas-export arm of the Soviet Ministry of Foreign Trade, secured Gazprom a stable source of income from gas exports throughout the 1990s. This sharply contrasts with oil, where producers had difficulties exporting oil. Also, because of Chernomyrdin’s efforts Gazprom had become a kontsern during the late Soviet era, which helped to keep the sector centralized.

In 1992, Yeltsin’s decree allowed limited private ownership in JSC Gazprom. By 1994, employees owned 15 per cent of Gazprom’s shares while 33 per cent were given to the public in exchange for vouchers. 40 per cent belonged to the state. The management retained strict

---

156 Gustafson 58.
157 Dienes 30.
158 Gustafson 70.
159 Almost 35 per cent of its shares were sold at heavily discounted prices exclusively to those living in the regions and okrugs in proportion to the value of Gazprom’s assets located on these territories. Given that these territories were sparsely inhabited, this provision presented opportunities for people with connections living in these regions to gain access to valuable shares, whereas the majority of Russian citizens were excluded from the deal. Dienes 17.
control over the company during the cash-based stage of privatization. Any domestic seller of Gazprom’s shares was obliged first to offer shares as a buy-back to Gazprom at their book value. The board did not recognize any share transactions that it regarded as going “against company’s interests.” Gazprom was given the right to export gas based on state contracts and could retain 38 per cent of foreign currency revenues for the deliveries. In 1992, Gazprom obtained control over operations within the entire sector and the fixed assets, including the trunk pipeline network. By 1995, Gazprom had licenses for the development of 70 per cent of its gas reserves. The gas sector was basically preserved unreformed from the Soviet times: “everyone was afraid that if it was touched [i.e., if reforms were launched], there would again be a breakdown as was the case in the 1990s. That is why, the attitude was: it [the gas sector] is working so let it continue to work.”

Yeltsin’s regime used Gazprom’s monopolistic position in the gas market and state ownership in the company to sustain itself in power. Gazprom was certainly not a “normal” company. First, the gas sector was perceived as the “goose that would lay the golden eggs.” In contrast to oil, which had significant problems with maintaining its level of production, the gas sector was “the most successful industrial sector of the last two [during the Soviet era] decades,” where only minimal decline in output became apparent as late as the first quarter of 1991. Initially, Gazprom’s exports became the major source of hard currency for the budget. In 1994, Gazprom single-handedly provided almost 3 per cent of the budget revenue. The company tolerated late or no payments for consumed gas from both individual and industrial consumers. Low gas prices for Russian households functioned to preserve social peace. The federal government approved domestic gas prices throughout the 1990s whereas oil prices were eventually liberalized in the mid-1990s. Russian government also used Gazprom as a source of geopolitical “carrots and sticks’ for Russia’s “near abroad” – also a largely political decision combined with opportunities for rent-seeking. The gas monopolist with a 40 percent state ownership was expected to fill the budget via exports yet was incurring significant losses domestically. It could not afford to pay taxes at home since domestic consumers could pay for only a quarter of the delivered gas. In 1997, barter accounted for half of the domestic payments.

---

161 Dienes 18.
162 The Oxford handbook of the Russian economy 368.
163 Interview with an expert, Moscow, 2009.
164 Stern 19, 13.

Victor Chernomyrdin was the key player determining the fates of both oil and gas yet he supported privatization for oil and opposed it for gas sector. In each of these sectors, Chernomyrdin pursued his personal interests and also ensured that the sector fulfilled the role it was prescribed by the regime in sustaining the latter’s political power. In preserving Gazprom intact, Chernomyrdin acted as a politician who tried to stabilize the political power of Yeltsin’s authoritarian regime. Surprisingly, the second key player (after Chernomyrdin) in maintaining Gazprom as one company in state hands was Yegor Gaidar, the chief architect of neoliberal reforms. Gaidar turned out to be a pragmatic: he understood that “[o]il kept the budget balanced, but gas kept the lights on and the homes heated.”\footnote{Gustafson, 70-71. Initially, planned to restructure the gas sector and break Gazprom into several enterprises. The official justification why this did not take place was the peculiarity of the gas sector, which required central control, as the experts argued, and the need to report on the contracts of gas supplies that were signed for the next 10-15 years. See “Gazprom,” \textit{Lenta.ru}, available at \url{http://lenta.ru/lib/14160013/full.htm} } Chernomyrdin also pursued personal interests in Gazprom: some sources claimed that Chernomyrdin privately owned Gazprom’s stock.\footnote{Under a secret agreement, Oleg Sokovets, Chernomyrdin, Vyakhirev were supposed to buy out about 30 percent of Gazprom’s shares owned by the state, but the deal was revoked in 1997. See Goldman 101-102.} Control over Gazprom granted Chernomyrdin access to tremendous financial and organizational resources, which he skillfully converted into political power. For example, the company became an important sponsor of his “Our Home Is Russia” Party\footnote{Jonathan P. Stern, \textit{The future of Russian gas and Gazprom}, ed. Oxford Institute for Energy Studies. (New York: Oxford University Press, 2005) 172.} and supported his candidacy as Yeltsin’s successor. In return, Chernomyrdin provided political patronage to the gas monopolist. Yeltsin’s concern over this symbiosis between Russia’s main gas company and the PM’s growing political and economic power eventually led to the latter’s dismissal in March 1998.\footnote{Sim 108. Boris Berezovskiy’s “increasingly public backing of Chernomyrdin as a future presidential candidate” became the main trigger for the dismissal. See Johnson 214.}

In the oil sector, Chernomyrdin promoted the interests of the “oil generals” and pushed for gradual privatization of the sector. Because oil was Chernomyrdin’s “native sector, he searched for compromises [with “oil generals”] with some sense of some corporate
solidarity.” As a result, his government was often referred to as “the government of the energy complex.” Chernomyrdin supported conversion of production associations into integrated companies that fit the oil generals’ interests in order to maintain the industry intact since the sector faced the threat of disintegration from below. The regime could not afford to let this happen given the importance of oil for Russia’s economy. In a way, because of the much more dispersed state of the oil sector, supporting the oil generals at the level of production associations was a centralizing policy itself. At the same time, Chernomyrdin never fell hostage to his relations with the oil generals. In 1994-1995, he pressured oil and gas producers to freeze prices and continue deliveries to customers who did not pay their bills. In 1995, his government increased demands toward oil and gas producers to pay tax arrears in order to ease the budget crisis. A large share of concessions for export of oil was removed.

In the gas sector, the state retained 40-per cent ownership in Gazprom, yet for some time did not de facto control the company. Chernomyrdin was one of the key actors behind this privatization scheme. Managers and employees were allowed to purchase 15 per cent of Gazprom’s shares. The managers got the majority of these shares and a substantial part of the 28.7 per cent that were sold at voucher auctions. Gazprom’s head Rem Vyakhirev was formally in charge of a 35 per cent ownership package in Gazprom and effectively had an operating control over the company. When Yeltsin learnt about the extent to which Vyakhirev ignored the 1994 agreement on trust management of state shares, he quickly acted to restore the control of the state (and regime too) over Russia’s flagship company. By mid-1997, the regime introduced a requirement that Gazprom’s leadership co-ordinate voting with state representatives from the board of directors, insisted on a thorough audit of the company, and fostered competition among gas extracting enterprises. This suggests that the overwhelmed

---

171 Gustafson 76.
172 Business and state in contemporary Russia 115.
174 State representatives voted on behalf of the remaining 5 per cent of Gazprom’s stock owned by the state. Shaping the economic space in Russia: decision making processes, institutions and adjustment to change in the El'tsin era 106.
175 Peregudov 282.
176 Shaping the economic space in Russia: decision making processes, institutions and adjustment to change in the El'tsin era 107. The trust agreement mentioned specifically Vyakhirev’s name whereas state representatives could not vote on behalf of the state. See Paniushkin, 46.
state in the hands of Yeltsin’s weak political regime remained the leading actor in the relations with business, which competed with others for exercising influence over the state.  

6. Policy Regarding FDI in Oil and Gas

FDI could have been the answer to many of the problems that Russia’s oil and gas were facing in the 1990s, such as the lack of capital and technological backwardness. In 1991, a high-level government commission calculated that in order to restore production at the level of 1989, the country needed to inject funds equal to half of the Soviet budget.  

In 1995, the Ministry of Energy estimated that Russia required 5-13 billion dollars of investment per year into the sector. Throughout the 1990s, world oil prices were low and oil exports brought substantial, yet still insufficient revenues to make the needed investment. Borrowing abroad was difficult due to vague corporate structure of Russian oil companies. These loans also often came with conditions that these companies could not fulfill. The entry of banks into the sector did not reduce the shortage of capital since the banks themselves lacked capital. In 1996, Menatep’s vice president Aleksei Golubovich noted that there were “two sources of capital for industry – the state and foreign investors, and none other.” The Russian state did not and could not become the sector’s main source of funds because it lacked capital itself. In fact, the government itself was using revenues from oil and gas to fill in the budget. At the same time, Western oil majors were looking for new fields to explore and increase their reserves balance. Russia was certainly an attractive destination as it contained impressive reserves of conventional oil. Yet, between 1994 and 2001, Russia’s oil sector received only $3,228 million of FDI, which was close to the figure for Azerbaijan with its much smaller oil sector ($3,029 million).

---

177 Zudin 52.
178 Gustafson 48.
180 Quite often bank loans available to Russian oil companies came from foreign export-import banks, which required purchase of equipment produced in these countries as a condition for getting these loans. V. Alekperov, Neft’ Rossii. Vzglyad Top-Menedzhera, (Moscow: 2001) 19-20.
181 Johnson 196.
182 Gustafson 170.
One of the reasons why so little FDI came in was that the sector’s high level of development during Soviet times led the country’s leadership and private actors to believe that production in the sector could be maintained through domestic means, with the help of state and private actors.\textsuperscript{184} Output decline in the early 1990s was caused less by “deficiencies in the oil reserve base and technology than … a series of underlying political, economic and organizational problems related to the ongoing economic transformation.”\textsuperscript{185} One problem was that the oilmen were not used to thinking about oil in terms of profit-making.\textsuperscript{186} However, even this thinking could be changed.

Also, the Russians could wait. The oil and gas sector needed capital in the long-term, but it could survive without significant capital investments in the short-term. Lukoil’s Alekperov argued that FDI should play a secondary role in Russia’s economic recovery and urged the state to help the sector locate its own capital.\textsuperscript{187} Some companies were indeed able to find internal funds to maintain production.\textsuperscript{188} A more important factor was that both the government and the emerging business were afraid to lose control over the sector. Even the generally pro-FDI government officials argued that in order to restore production from deposits that neared their exhaustion, it was sufficient to attract Western credits whenever the oil companies could utilize foreign equipment and technologies on their own.\textsuperscript{189} The oil producers also eventually learned that some operations that they could not perform themselves could be contracted out without surrendering ownership or control.\textsuperscript{190} Russian producers of equipment were disappointed that whenever foreigners came, they refrained from purchasing Russian equipment, another argument against FDI that was often heard in the parliament.\textsuperscript{191} After the initial contact with Western oil companies, “the Russians soon realized that the majors were cautious about spending real money, and they were surprised and disappointed.”\textsuperscript{192} Both groups – the “oil generals” who

\textsuperscript{184} Interview with an expert, Moscow, 2009.
\textsuperscript{186} Gustafson 153.
\textsuperscript{187} Alekperov 36.
\textsuperscript{188} Interview with Pappe Iakov, professor, Faculty of Economics, Higher School of Economics, 2 December 2009.
\textsuperscript{189} According to Konoplianik, deputy minister in the Ministry of Energy in 1991-1993, Russia would have needed foreign investors in the long term to develop new oil and gas regions and to discover new deposits in technologically challenging conditions, not in the short term. Konoplianik, 59-60.
\textsuperscript{190} Gustafson 166.
\textsuperscript{191} Interview with a former senior official from the Ministry of Energy, Moscow, 16 December 2009.
\textsuperscript{192} Gustafson 171.
managed to retain control over their assets, and the “traders-bankers,” who wanted to wrest this control from the oil generals, such as Mikhail Khodorkovsky – were against a mass inflow of foreign investors.193

Another important reason why FDI did not come in was that foreign investors were not an attractive political ally for the regime. Foreigners could not help Yeltsin get reelected as domestic business had. Association with foreigners in the public’s eyes was more a political liability than a gain.194 If the government lost ownership in the sector, it would have had less leverage over the revenue-generating sphere and in such a way would undermine its own standing. Too many government officials had extensive ties to the sector and were lobbied by oil companies against the entry of foreigners.195 For example, when Victor Chernomyrdin was the Minister of Oil and Gas, he withdrew the Shtokman gas field contract from a foreign consortium that was led by Norsk Hydro and awarded it to a group of Russian companies.196 The Russians wanted capital without surrendering control while large Western oil companies were unprepared to take on large financial risks without control.197 In 1997, due to a severe budget crisis President Yeltsin lifted restrictions on the sale of oil assets despite resistance from the Duma and regional authorities. Yet, companies themselves could impose restrictions on foreign ownership of their shares.198 The government promised that foreigners would be able to compete in privatization of the oil sector in 1998, after the bankers – the regime’s key political ally – had gained ownership in the sector.199 However, after the 1998 financial crisis, as oil prices began rising and the output stabilized, domestic oil companies could finance their investment on their own and lost interest in FDI as a source of capital.200 One of the largest foreign investors into Russia was Cyprus – most likely Russia’s own capital re-entering the country disguised as foreign capital.201 Between 1992 and 1995, capital flight from Russia’s oil sector was approximately 7 billion dollars. For comparison, by 2000, 6 billion dollars went into its oil and gas sector.202

---

194 Interview with Pappe Iakov, professor, Faculty of Economics, Higher School of Economics, 2 December 2009.
195 Heinrich, Julia Kusznir, and Heiko Pleines, 505.
196 Haglund, 68.
197 Gustafson, 180-181.
198 The political economy of Russian oil 36.
199 Gustafson 183.
200 Interview with an expert, Moscow, 2009.
201 Krivoshechekova and Okuneva 75.
202 Heinrich, Julia Kusznir, and Heiko Pleines 495.
offered USD 610 million and then an additional 600 million for oil rehabilitation projects, Russian companies were reluctant to take the money because of all the conditions they needed to fulfill. The government resisted attempts by the World Bank to use loans as a way of promoting reforms in Russia’s politically most salient sector.\textsuperscript{203} In Russia, the political risks were a larger deterrent to foreign investment than the risks of extracting oil under difficult geological conditions.\textsuperscript{204}

Investment climate “mattered” too in determining the levels of FDI, but was itself shaped (intentionally and unintentionally) by the struggle for property among domestic actors. Foreigners could not rely on protection by legislation: passing bills through the Duma was difficult and there was no guarantee that adopted laws would actually be implemented. Foreigners also could not rely on the “informal [ties] of friendship and loyalty among former Soviet-era colleagues” that survived since the Soviet times.\textsuperscript{205} The regions presented another challenge as they expected would-be foreign investors to make substantial investments into the local infrastructure that had been neglected during the Soviet era; foreigners resisted writing “blank cheques” to different actors claiming to have decision-making power. The fragmentation of authority among federal, regional, and local elites made the process even more complicated since for these political and industrial groupings, making an investor pay for infrastructural and social development and protection of environment was one way to demonstrate that they were “in charge” of a resource. All of them were in charge, to some extent, which made it difficult for foreign investors to cater to so many interests.\textsuperscript{206}

The Western companies that came to develop Russia’s oil did best when they attempted to work in the periphery on virgin opportunities, such as projects in the Arctic frontier, where the Russians lacked the technology to extract oil and where there were fewer established players, such as the oil generals from West Siberia, to prevent their entry. Work in the periphery also offered possibilities for exporting oil: a foreign company could build their own export terminal

\textsuperscript{203} Gustafson 162.  
\textsuperscript{204} Gustafson 173.  
\textsuperscript{205} Gustafson 178.  
\textsuperscript{206} Stern 46.
and avoid using the state-run pipeline system if the field was close to the sea. Such an investment would face less resistance from other Russian companies that competed for export volumes.207

Below, I will discuss the three main vehicles for FDI that were employed in Russia’s oil sector in the 1990s.

6.1. Joint Ventures

The first inflows of FDI came in through joint ventures (JVs) established in 1988-1989 after Gorbachev allowed foreigners to work in the USSR. At the time of USSR’s collapse, over 100 JVs were negotiated in the oil sector. Eventually, approximately 70 were registered, out of which only 40 were active.208

In the early 1990s, the JVs became the main form of FDI into the oil sector and the main vehicle for collaboration between the oil generals and Western oil companies.209 Their establishment was accompanied by a short period of euphoria on the part of both Russian and foreign partners.210 The JVs offered benefits to both the Russian side and foreign investors. Russian companies that formed JVs mostly worked on small and medium-sized technologically challenging deposits with underdeveloped infrastructure.211 Formation of a JV made it easier to obtain credit from abroad.212 Even more importantly, the Russian government awarded the JVs a number of privileges. For example, until September 1997, the JVs were exempted from paying export duties and had the right to export 100 per cent of their output. The JVs where foreign participation was higher than 30 per cent did not have to sell hard-currency earnings to the state.213 For upstream producers, the JVs “suddenly provided, for the first time, a flow of hard currency they could manage themselves, and no less important, they opened up a window on the outside world.”214 The JVs became one of the main survival tools for Russian oil producers. Quite often, exports by the JVs exceeded their production volume, which suggests that the

207 Gustafson 173.
208 Gustafson 155.
209 They were first officially allowed by the resolution of the Council of Ministers of the USSR issued 13 January 1987. See Konoplianik 54. About the first JVs, read Kriukov 95 and Gustafson 45-46.
210 Interview with Mikhail Kroutikhin, Partner and Analyst, RusEnergy, Editor-in-Chief, The Russian Energy Weekly, Moscow, 2 December 2009.
211 Heinrich, Julia Kusznir, and Heiko Pleines, 496-497.
212 See Gustafson, 161.
213 Haglund, 75. For additional discussion of the privileges foreign companies were awarded by the Russian government and implications, see Kriukov, 119-120.
214 Gustafson, 45-46.
Russian oil producers used the JVs as a tool for exporting. Some JVs, however, were clearly set up in order to maintain production as they focused on rehabilitation of idle or under-producing wells (mainly by service companies). Others leased entire fields and rehabilitated them. One JV attempted to develop a completely new field.215

Initially, the JVs were the only form of investment that could give foreigners access to Russia’s oil. The reforms in the oil sector left the “oil generals” with licenses for exploration practically without competition.216 Foreigners acquired only four licenses.217 At that time, Russian oil companies could not resell a license to foreigners even if they could not develop a deposit on their own.218

The Russian side had reasons to be disappointed in the JVs. A large number of foreign founders of oil JVs were small western companies that worked in finances and could not offer any technological “know-how” in the oil sector.219 These JVs were “low-budget affairs involving small companies.”220 One major exception was the Polar Lights JV, when Conoco invested over $400 million between 1992 and 1995 into development of a new oil field. On average, however, western partners invested $35 million into a JV. A large part of this sum was reinvested profit.221

For foreigners too, the JVs did not become a vehicle for attracting foreign investment since foreigners “considered the joint ventures too fragile a foundation for large multibillion-dollar projects.”222 Another obstacle was the unwillingness of the Russian partners to share control over projects. In many JVs, the sides did not clearly work out the details of who would exercise control over a JV and how, which led to conflicts later.223 In order to preserve the right to duty-free export, Russian partners sometimes substituted the initial foreign partner with a new

215 Gustafson, 156.
216 Interview with Mikhail Kroutikhin, Partner and Analyst, RusEnergy, Editor-in-Chief, The Russian Energy Weekly, Moscow, 2 December 2009.
217 Kriukov, 114.
218 Interview with Mikhail Kroutikhin, Partner and Analyst, RusEnergy, Editor-in-Chief, The Russian Energy Weekly, Moscow, 2 December 2009.
219 Konoplianik, 56-57.
220 Gustafson, 164.
221 Gustafson, 161.
222 Gustafson, 161.
223 Interview with an expert, Moscow, 2009.
“foreign” partner controlled by them.\textsuperscript{224} The Russian government and actors in the oil sector were unwilling to accept any capital if it came with strings attached.

To sum up, the JVs were short-lived because they satisfied the interests of domestic actors and foreign investors only for a limited time.\textsuperscript{225} They owed as much of their popularity to what the Russian government allowed them to do as to what their partners had to offer. The decline of the JVs was partly a consequence of their success. One of the main achievements of JVs was that they helped Russia stabilize its oil output.\textsuperscript{226} When the JVs began increasing production volumes, they began competing with the growing Russian oil majors for export volumes. After 1995, the terms of work for the JVs were tightened.\textsuperscript{227} Coincidentally, this was the year when Yeltsin and the growing oligarchs agreed on the loans for shares scheme. When the exporting privileges expired in September 1997, the JVs as a form of investment declined.\textsuperscript{228}

6.2. Production Sharing Agreements

The Production Sharing Agreements (PSAs) also failed to become a popular vehicle for FDI. Foreign investors promoted the PSAs as a way to mitigate the risk of investment into Russia. The PSAs offered to take the investment out of the jurisdiction of Russia’s unpredictable legal system and make each investment a matter of negotiations. In December 1993, Yeltsin signed decree 2285 that formed the legislative basis for signing of three PSAs in 1994-1995: Sakhalin-1, Sakhalin-1, and Kharyaginskoye.\textsuperscript{229} Adopting the Law on PSAs turned to be considerably more difficult because the Federation Council pushed for giving more power to the regions.\textsuperscript{230} When the Law on the PSAs was finally adopted in December 1995, it gave the parliament (and numerous interest groups working through it) a considerable say in signing the agreements. The Law required that federal law determine the list of fields eligible for PSAs, which made it more difficult to sign PSAs.\textsuperscript{231} Only one more PSA (on Samotlor) was concluded

\textsuperscript{224} Heinrich, Julia Kusznir, and Heiko Pleines, 497-498; Gustafson, 132.
\textsuperscript{225} For the list of selected JVs, see Heinrich, Julia Kusznir, and Heiko Pleines, 496.
\textsuperscript{227} Gustafson, 162.
\textsuperscript{228} Heinrich, Julia Kusznir, and Heiko Pleines, 497-498.
\textsuperscript{229} For a detailed discussion of Sakhalin-2 development, see Konoplianik, 241-246.
\textsuperscript{230} Heinrich, Julia Kusznir, and Heiko Pleines, 499.
\textsuperscript{231} Konoplianik, 372-373.
after the Law was passed, yet the development of the field was continuously postponed. In contrast to Russia, Azerbaijan and Kazakhstan did not require parliamentary approval for each individual PSA, which turned PSAs into a very popular form of investment.

The PSAs as a form of investment generally lacked support from government officials and societal actors. Russians treated them as a tool that was more appropriate for countries with less developed oil sectors. In Russia, PSAs were second-best solutions: only if an auction did not produce a winner could a field be offered for development through a PSA. PSAs could have allowed the Russian state to preserve its ownership over resources. However, it was not certain that a weak state would have been able to negotiate good terms and retain de facto control over projects. Reversing this loss would have been more difficult than reversing the loss of control to a local actor.

The Russian oil companies generally tried to prevent either foreign or domestic (state) actors from establishing themselves in the sector. Yukos’s “oil general” Muravlenko agreed to sign a PSA with Amoco to develop the technologically difficult Priobskoe oil field, which required $28 billion of investment. However, when he arrived at Yukos, Khodorkovskiy opposed the deal. By the time Yukos and Amoco reached an agreement, the latter was already in the process of being taken over by BP. For his part, Muravlenko had lost control over Yukos: the PSA was of little help to the company since it focused on the long-term development while the company needed money immediately. PSAs also did not appeal to Russian oil companies as the latter already had licenses for exploration. The attitude became more favorable after the 1998 financial crisis yet it changed again when Russian producers overcame the immediate effects of the crisis. PSAs with participation of foreigners presented competition: Khodorkovskiy

---

232 Konoplianik, 404.
233 Interview with an expert, Moscow, 2009.
234 According to the law, only if an auction had taken place to award the right to exploitation on conditions other than the PSAs and no participants took place could a field be offered for development through PSAs. See http://www.consultant.ru/online/base/?req=doc;base=LAW;n=117376. The Duma later adopted amendments to the law, according to which foreign investors could acquire no more than 20 per cent of Russia’s natural resources through PSAs and no more than 10 per cent of “strategic resources” (the list was still to be determined). “The revised law would require that production-sharing agreements be approved by regional legislatures as well as federal agencies.” The political economy of Russian oil 132 with reference to: RFE/RL Newsline, Vol.2, No.135, Part 1, 16 July 1998.
235 Interview with an expert, Moscow, 2009.
236 Gustafson, 135, 141.
237 See Heinrich, Julia Kusznir, and Heiko Pleines, 405.
launched a massive campaign aimed at discrediting the PSAs in the early 2000s. At this point Khodorkovskiy was planning to sell YUKOS to foreign companies and wanted to limit the number of ways in which foreign investors could gain access to Russia’s oil in order to raise the price of his company.

6.3. Privatization (Foreign Equity Investment) and Partnerships

Equity investment also did not become a successful form of FDI in Russia since it was more likely than other forms to lead to loss of control by domestic actors. During the late-Yeltsin era, the policy toward FDI in sectors such as oil was shaped by the influence of the oligarchs, who were largely against FDI. Foreigners could become donors, but they could not become investors with a real say over oil and gas assets in Russia. Maintaining control was the main factor influencing decisions on the entry of foreign capital into Russia at this time (and later too) for both political regimes and domestic business. Fear of competition during privatization that could raise sale prices was another factor that shaped the position of domestic private actors.

Decree 1403 that regulated privatization in the oil sector was reflective of these attitudes. It stipulated that foreigners could not own more than 15 per cent in a Russian oil company. This led the interested foreigners to have their own reservations about investing in Russia’s oil and gas industries. Due to vagueness of corporate governance, any share of ownership could have come without control over purchased assets. A share that was less than 15 per cent was not an attractive option for these reasons. Very few foreign companies were willing to take this risk. Also, very few Russian companies wanted to have foreign equity ownership in their company.

One of the exceptions was LUKOIL. Its head Vagit Alekperov opened up opportunities for foreign investment under his strict supervision. Alekperov had always been a very prudent manager who was able to identify the challenges his company would be facing long before they would become imminent on the agenda and far ahead of all competitors. This vision allowed him to successfully transform himself from a Soviet-era oil general into one of Russia’s most

---

238 Interview with an expert, Moscow, 2009.
239 The text of the decree is available here: http://base.garant.ru/100297/
successful businessmen. Three months after the voucher auctions of 1994, LUKoil announced that it would be selling 15 per cent ownership to foreign investor in the form of convertible bonds. In September 1995, ARCO, the seventh largest US oil company at the time, successfully bid $250 million in a tender for LUKoil’s convertible bonds.\footnote{Gustafson, 118.} At the end, ARCO was able to buy only 7.99 per cent of LUKoil’s shares. An additional .01 would have given ARCO a seat on board of directors but LUKoil’s management did not allow this to happen.\footnote{The political economy of Russian oil 30.} In contrast to Alekperov, Bogdanov of Surgutneftegaz, another successful oil general who retained his position in the sector, “refused any collaboration with foreign companies or foreign investors, except as contractors.”\footnote{Gustafson, 122.} In addition to ARCO, another foreign company that came to Russia was BP, which bought a 10 per cent stake in the oil company Sidanko in 1997. The purchase eventually led to the establishment of TNK-BP partnership in 2003.\footnote{For a good overview of BP’s presence in Russia, see, for example, “Timeline: BP’s Chequered History in Russia.” The Telegraph, 8 September 2011.} All success stories of foreign investment into Russia’s oil sector at the time had the same feature in common – if foreigners wanted to make an investment, they needed to work through a Russian partner, who could secure a political cover for the foreign company, help understand the Russian business culture and also “handle the bureaucrats, the police, the endless ‘consultants’ offering services that could not be refused, and the mafia.”\footnote{Gustafson, 177.}

In the gas sector, two decrees limited foreign ownership in Gazprom to 14 per cent while the Gas Supply Law limited foreigners’ holdings of shares in Gazprom’s charter capital to 20 per cent.\footnote{Stern, 171.} Foreigners could only purchase Gazprom’s shares outside Russia at a price that was at a minimum double the price of shares sold in Russia – the so-called “ring fence.” This “fence” had holes, however: Russian brokers often bought Gazprom’s shares at “domestic” prices and resold them to foreigners at a higher price. Such grey purchase schemes concealed the identity of Gazprom’s true owners and the size of their ownership. Only a minimal number of Gazprom’s shares ended up in foreigners’ hands: in 1998, Germany’s Rurhgaz purchased 2.5 per cent for
660 million and an additional 1 per cent in 1999 for 200 million. Rurhgaz controlled another 1.5 per cent through its JV with Gazprom.247

7. Mining and Metallurgy

Similarly to oil and gas, development of Russia’s mining and metallurgy sectors was heavily influenced by Soviet industrial policies and institutional reforms of the late 1980s. The 1987 Law on State Enterprises awarded managers of metals and mining enterprises considerable autonomy.248 During the late Soviet era, kontserny were created in the sector in order to transfer power from ministries to enterprises and isolate the latter from the instability of the late 1980s.249

The sector’s largest kontsern Noril’sk Nickel, a monopolist in the sphere of nickel and cobalt production, was established on a 1989 directive of the Soviet Council of Ministers.250 Noril’sk Nickel enjoyed privileged treatment by the Soviet authorities and was given autonomy from the Ministry of Non-Ferrous Metallurgy because it was a major generator of convertible currency.251 After the USSR collapsed, Soviet-era kontserny and production associations became JSCs. The Ministry of Metallurgy was converted into two corporations, Russian Ferrous Metallurgy (Roschermet) and Russian Non-Ferrous Metallurgy (Rostsvetmet).252 Along with kontserny and

247 Goldman, 102.
250 For the list of kontserns that were created before the USSR collapsed, including those working in the metallurgical sector, see http://bestpravo.ru/rossijskoje/eb-pravo/t5r.htm.
251 http://www.nornik.ru/about/history/. In early 1991, the Soviet metallurgical complex had fixed assets balance sheet value of 77.8 billion rubles, out of which 12.1 billion were Norilsk Nickel’s assets. The Soviet Ministry of Metallurgy had assets worth the remaining 65.7 billion. Industrial potential of Russia: analytical study based on fixed assets statistics to 1992, ed. A. Akopian (Commack, NY: Nova Science Publishers, 1992) 14. The kontsern united three enterprises that produced nickel at the time, which was an advantage for the future of the kontsern since this decision “secured the achieved high level of concentration in the sector and did not allow the sector to be dispersed in the course of privatization”. See S. M. Men'shikov, Анатомия российского капитализма (Moskva: Mezhdunarodnye otnoshenii, 2004) 102-103.
253 Barnes, 62-63.
production associations, these corporations leased the facilities of the former Soviet Ministry of Metallurgy and its units.253

Soviet industrial policies that aimed to promote development of defense production and heavy industry emphasized production volume rather than the efficient and effective utilization of inputs. As a result, the economy Russia inherited in 1991 was extremely metal-intensive.254 In its turn, the sector was very energy-intensive.255 The Soviet metallurgy complex disregarded republican borders and transportation costs: inputs often travelled thousands of kilometres and from one republic to another. The break-up of production chains after 1991 caused shortages of raw materials. For example, Russia’s iron and steel sector lacked critical inputs, such as ferroalloys, coking coal, scrap, pig iron, and rolling stock. The disintegration of ties with Ukraine hit the sector especially hard since the latter had been Russia’s important supplier of pig iron, manganese, ferroalloys, and other inputs.256 Production ties within Russia broke down too.257

Transition to a market economy created its own challenges. Domestic prices for metal products rose more slowly than prices for sector’s inputs and overall production costs.258 Domestic input prices sometimes exceeded those in Western states.259 Metallurgical enterprises faced constant shortages of funds. When the USSR fell apart, the demand for metal products fell dramatically. This was partly due to the decline of the military-industrial complex, which had been an important consumer of Soviet metallurgy’s products, and partly to the slowdown of the entire economy. The metallurgical enterprises faced difficulties getting payment from their customers and, as a result, were large debtors themselves.260 Many of them operated at a small share of their capacity or did not operate at all.261 Excessive production capacities were more a liability than an asset at this point as they had to be maintained despite a stall in production.

---

254 Haglund, 58-59.
255 In the late 1980s, the USSR consumed about four times as much steel per dollar of GNP as the US: Sagers, 197.
256 Sagers, 204.
258 Prices for most commodities were de-regulated in 1992. See Haglund, 88.
259 Sagers, 199.
260 See, for example, Frenkel', 56.
261 Sagers, 195.
At the same time, both ferrous and non-ferrous metallurgy did better than other industries. Despite the sector’s obsolete technology, some very limited modernization of equipment did take place during the late Soviet era.\(^{262}\) When the USSR collapsed, production fell less than in machine-building or light industry.\(^{263}\) The sector may have also fared better than the official numbers suggested because barter and informal payment schemes covered about 90 per cent of operations.\(^{264}\) Producers often sold goods for their personal benefit. This production likely escaped the official books.\(^{265}\)

A small improvement in production volumes was registered for the first time in 1995.\(^{266}\) Unfortunately, in 1996 a large-scale crisis hit ferrous metallurgy when world prices for rolled steel declined and Russia introduced a “currency corridor.”\(^{267}\) Within the sector, performance differed depending on access to markets and the cost of production.\(^{268}\) Many enterprises were surviving by relying on old production potential and postponing implementation of new projects.\(^{269}\) The Soviet era investment and the development the sector had experienced allowed them to do so.

Despite the poor financial state of the sector, enterprises did manage to complete a number of investment projects. For example, in 1995 the iron and steel sector mustered 6.5 trillion rubles ($1.4 billion) in investment.\(^{270}\) Even though input prices were increasing, the sector could compete at the global market due to, among other factors, a cheap labor force.\(^{271}\)


\(^{263}\) See, for example, Haglund, 92, Humphreys, 13, Komu prinadlezhit Rossiia: 10 let kapitalizma v Rossi. (Moskva: Vagrius, 2003) 303.


\(^{265}\) Humphreys, 13.

\(^{266}\) See, for example, http://minerals.usgs.gov/minerals/pubs/country/1995/9434095.pdf p 1. The improvement in ferrous metallurgy was due to increase in export and tolling (discussed below). See Frenkel’, 57-58.

\(^{267}\) "Currency corridor" meant fixing top and bottom levels of fluctuation of ruble’s exchange rate to US dollar. As a result, levels of profit in the sector dropped from 22% in 1995 to 5% in 1996 and 3.6% in 1997. Source: http://www.infomine.ru/otchets/en_rusteel.pdf


\(^{269}\) See Clark and Baglione, 935-936.

\(^{270}\) Sagers, 200. Another, much less significant source of capital was sales at the domestic commodity exchange. See, for example, Komu prinadlezhit Rossiia : 10 let kapitalizma v Rossi. 278.

\(^{271}\) Haglund, 87. Labor productivity was lower too, however.
Aluminum exports were particularly profitable.\footnote{Menshikov, 106.} Russia’s overall exports to international metal markets increased from $7 billion in 1992 to $13.1 billion in 1994. Their share of total export earnings increased from 16.4 per cent to 26.3 per cent.\footnote{Sagers, 201. Detailed data on the structure of Russia’s exports is available at: \url{Russia's post-communist economy}.}

Exporting abroad could help the sector in the short-term yet in the long-term, it was not a panacea.\footnote{For general discussion of important issues regarding exporting by Russian metallurgy and mining companies, see Haglund, 88-91.} Russian producers often faced protectionist markets. A sudden hike in exports from the former USSR threatened to undermine world metal prices.\footnote{Haglund, 82.} Russia made pledges to reduce its metals production in order to keep prices from falling, even if it did not always follow through on these pledges.\footnote{“Ottawa posle Brusselya: Osvezhaet!” Kommersant, 8 March 1994, available at \url{http://www.kommersant.ru/doc/9663/print} (last accessed March 15, 2015); Frenkel’, 59.} The “currency corridor” that aimed to maintain a stable ruble reduced export profits.\footnote{For an explanation, see Sagers, 203.} Metallurgy exports mostly consisted of raw materials and semi-finished products and therefore were unfavourable to long-term development.\footnote{For example, the share of raw materials in the export of copper in 1997 was 67 per cent, 96 per cent for nickel, 86 for aluminium. The numbers are 62, 96, and 82 per cent accordingly for 1998. See “Ekonomika I Zhizn,” 19 June 1999.}

7.1. Important, But Not Strategic

The metallurgical sector Russia inherited from the Soviet Union occupied second place in the country’s total export volume (after oil and gas) and third place in its industrial output (around 19.3 per cent).\footnote{A. Petros’ian, ”The Development of the World Metallurgical Complex and the Capital Market,” Problems of Economic Transition 49.10 (2007): 55.} The sector also employed millions. In many towns, a metallurgical enterprise was the biggest or even the \textit{only} employer. These towns were referred to as “\textit{grado-obrazuushchie predpriiatia}” in Russian (“town-creating enterprises”). Yeltsin’s regime considered metallurgy to be important yet viewed it as less significant than oil and gas since it brought less revenue for the budget.\footnote{Men’shikov, 102. For 2001 data, see \url{http://expert.ru/ratings/table_25495/}.} This attitude shaped the financing of the sector: in 1994, the government allocated two thirds of available funds for oil and gas exploration while precious metals and diamonds received only 12.4 per cent. Ferrous metallurgy and mining obtained a
Since the sector could survive because of the development it had achieved during the Soviet era, in the aftermath of the transition metallurgy stayed in domestic hands. Because the regime did not view metallurgy as strategic, it reduced formal state ownership to a minimum. State involvement took place mostly through administrative control, provision of subsidies, and facilitation of exports. Competition for sector’s assets took place among domestic private actors.

7.2. How Privatization Unfolded

Privatization of metallurgy proceeded very quickly. As of January 1995, 386 out of 407 metallurgical plants had been turned into JSCs or limited liability companies. Workers and management together usually owned 51 per cent of an enterprise by either purchasing or receiving shares free of charge. The state exchanged the remaining shares for vouchers. Soviet-era managers, who controlled the enterprises, later gained ownership by purchasing shares from employees. The state withdrew from metallurgy much more rapidly and to a fuller extent than from other sectors, including oil and gas. The remaining state ownership in the sector was “more the result of accident than of strategic planning.” By the end of 1995, the state retained significant ownership in only 12 companies. It still possessed the so-called “golden shares” giving it veto power in 55 companies. Some metallurgical assets were to be sold during the “loans-for-shares” auctions, yet management used all means available to be excluded from the list and was more successful in doing this than the oil generals, perhaps because these assets were less strategic and attractive to the bankers than the oil companies. The biggest winner of the auctions in metallurgy was Vladimir Potanin’s Interros group, which acquired 38 per cent of Noril’sk Nickel and 15 per cent in NLMK through its affiliated bank Oneksimbank.

---

282 See Levine, 729.
283 See Sagers, 208.
284 See, for example, data in Russia's post-communist economy 191. According to a large survey of 439 industrial enterprises that was conducted in summer 1994, the state was a full shareholder in 22.2 per cent of enterprises in metals and chemicals sector (for comparison: 52.4 per cent in fuel and energy). Outsiders to the sector owned only 19.1 per cent.
286 Sagers, 207; Komu prinadlezhit Rossiia: 10 let kapitalizma v Rossi. 280. For a sample-based comparative data of ownership by sectors, see Russia's post-communist economy 192.
287 Komu prinadlezhit Rossiia: 10 let kapitalizma v Rossi, 309.
288 This is in addition to the stakes it acquired in an oil company and a shipping firm. Barnes, 111-112.
7.3. Insiders – Managers: Their Interests, Power, Opportunities, and Challenges

Similarly to developments in other sectors, the institutional reforms of the late 1980s empowered managers vis-à-vis other actors in competition over their firms.\(^{289}\) The late Soviet-era trend toward decentralization certainly affected metallurgy and mining too. It empowered the industry generals when the Soviet system began crumbling down, but in no way secured their position under the new system as the enterprises faced a variety of challenges discussed above. In order to survive in the short term, managers tried to preserve Soviet-era paternalism through distribution of various benefits among the employees. At the same time, they lacked capital to finance social programs and maintain production. A major challenge was restoring the Soviet-era production chains or building new ones. As in the oil and gas sector, Soviet-era “generals” in metallurgy dealt with transition challenges in different ways. Some opposed changes while others showed remarkable flexibility. For example, the management of the Tulachermet ferrous metallurgy plant switched to production of “vacuum cleaners, television sets, home water heaters, and shoes; to roof tiles, patio bricks, and cinder blocks; and to construction, agro-industrial, and investment services.”\(^{290}\) Another challenge was fighting off their challengers: “every region had its own criminal group that exercised a serious influence over privatization.” This bid for ownership in Russia’s metallurgy sector resulted in many deaths.\(^{291}\) The majority of “red directors” lost control and ownership in their enterprises quickly in ways that were not unique to the sector. The two interrelated factors that determined the failure of managers to retain their positions were a) their inability to restore production chains and sell their products to world markets on their own and b) managers’ inferior political connections compared to those of their competitors.\(^{292}\)

\(^{289}\) Barnes, 131.

\(^{290}\) Clark and Baglione, 950. For discussion of other “creative’ ways to overcome the crisis among sector’s enterprises, see Frenkel’, 56.

\(^{291}\) Interview with Valeriy Zubov, a deputy of the State Duma, member of the faction “Just Russia: Motherland/Pensioneers/Life,” member of the Duma Committee on economic policy and entrepreneurship, Moscow, 11 December 2009.

\(^{292}\) Nechaev named another reason for the weakening of industry generals – liquidation of sectoral ministries. This should concern metallurgy too. Interview with Andrei Nechaev, president, “Russian Financial Corporation” Bank, former minister of economy (1992-1993), Moscow, 9 December 2009.
Soviet-era directors struggled to keep their enterprises running during economic restructuring when demand decreased dramatically. Industry generals also tried to increase sales by creating metals’ exchanges, yet these exchanges functioned poorly. Usually, the “way out” meant finding ways to export production abroad, yet exporting was not easy. Certain outsiders offered help. Some of them were the so-called “tsekhoviki” (“shadow capitalists”), who in the 1980s concluded agreements to produce a variety of goods at metallurgical enterprises. Unlike the managers, tsekhoviki had the trading experience and access to foreign credits. They could also solve transportation problems since they had experience in goods transportation and connections to authorities. Foreign trading organizations had operated in the late Soviet era. Some of them even the locals disguising themselves as foreigners. The outsiders offered managers “help” through “tolling,” a scheme where foreign (mostly trading) companies bought inputs from Russian suppliers or abroad, brought them to metallurgical plants for processing, paid any associated transportation and other costs, and shipped finished products for export. The government exempted the trading companies involved in tolling from paying any duties, value added, or any other taxes. Tolling allowed managers to obtain the much-needed inputs and pay for them. Managers of metallurgical plants also gained from tolling personally. Tolling became widespread. In the aluminium sector, 30 per cent of production went through “internal tolling,” where raw inputs were from Russia and the final product was sold in Russia. Seventy per cent of finished product went for export. While tolling allowed the plants to

---

293 In June 1991, more than 400 enterprises of the USSR’s metallurgical sector created Metals’ Exchange. Soon, there were more of such exchanges. See http://kommersant.ru/doc/98730; Komu prinadlezhit Rossiia: 10 let kapitalizma v Rossii, 304.
294 Fortescue, 51.
295 The other group Kommersant identifies is the so-called “clever boys,” who had good education and close connections to authorities, who in the 1990s discovered that metal trade could be very profitable. They were purchasing enterprise debts and using debt as a leverage to buy out shares. http://www.kommersant.ru/doc/607218
297 Sagers, 203.
299 Mukhin, 70. Tolling became more popular in non-ferrous (especially aluminum) than in ferrous metallurgy since it is easier to sell aluminum at an exchange (http://flb.ru/persprint/53.html). Another difference between ferrous and non-ferrous metallurgy that the literature notes is that ferrous metallurgy tends to be less criminalized since it requires more investment and does not bring profit that fast. Mukhin, 70. Therefore, the nature of the sector determines the intensity of struggle over ownership and control.
survive in the short term, it was a damaging strategy in the long-term since enterprises received only a small part of payment for what they produced. For example, aluminium plants that used tolling received only 40 per cent of the actual sales revenue for their products. Although production increased due to expanded export opportunities, the financial state of the metallurgical enterprises worsened: the number of unprofitable enterprises rose by 4 per cent to 14 per cent. Plants struggled to collect payment from their consumers. The lack of funds made enterprises even more vulnerable to hostile takeovers. The enterprise managers eventually effectively lost control to trading companies as the latter obtained control over enterprises’ cash flows – a crucial step in establishing subsequent ownership. By the late 1990s, very few owners were metallurgists by training and had worked in the upper management of the sector during the Soviet times.

Another reason the “red directors” lost ownership was their lack of adequate political patronage. The main government official in charge of the sector was Oleg Soskovets, who had become Minister of Metallurgy months before the USSR collapsed. Upon independence, Soskovets headed Roschermet – an association that became a successor of the former Soviet Ministry of Metallurgy. In 1993, Soskovets became chair of the State Committee on Metallurgy responsible for non-ferrous metals, iron, and steel production. Although the Committee presided over approximately 920 production units, it did not have a strong mandate. In 1993, Soskovets’s long-term ties to the industrial sector led Yeltsin to appoint the former as the first deputy head of the government. Yeltsin called Soskovets “essentially already the number-two man in the government.”

---

303 Frenkel’, 58.
304 For example, Fortescue, 51.
305 For a general article that discusses the role of the insiders in metallurgy, see: “Chernaia Metallurgiia,” Kommersant-Vlast’, 16 May 2000.
306 In October 1991, Russia’s Council of Ministers transformed the Soviet Ministry of Metallurgy into two separate corporations – Russian Ferrous Metallurgy (Roschermet) and Russian Non-Ferrous Metallurgy (Rostsvetmet). Barnes, 63.
307 Humphreys, 13.
308 Ties between the committee and individual enterprises and the exact hierarchy of their relations took time to establish. See Humphreys, 13. The Committee struggled to gain institutional importance and mostly remained a “coordinating and advisory body” vis-à-vis the sector. See Sagers, 207.
309 Petrov, Vladimir. “Oleg Soskovets Naznachen Pervym Zamestitelem Predsedatelia Pravitel’stva RF.” Krasnaia Zvezda, 5 April 1993. Soskovets had been the general director of the Karaganda Metallurgical Combine in Kazakh
Soskovets shared some similarities with Mintop’s Yuri Shafranik. Both started their careers in sub-sectors of Soviet industry. Throughout their tenure in the government, both worked to preserve state control and ownership in their sectors while lobbying on behalf of certain businesses. Soskovets successfully lobbied for tax exemptions for the sector, which, according to some estimates, amounted to 2 per cent of Russia’s GDP because, as he argued, metallurgy needed government help in establishing itself at the world market. Yet, despite his long-term career in the sector, Soskovets had closer ties to the rising FIGs and traders than to metallurgy generals. Vladimir Potanin, one of the main beneficiaries of loans-for-shares, characterized Soskovets as an “ideologist” of creating the FIGs. For example, Soskovets supported Potanin’s efforts to gain control over Norilsk Nickel and oust the long-term “red director” Anatoliy Filatov. In contrast, Shafranik’s institutional (as the Minister of Oil as opposed to Soskovets’ position as first deputy head in the government) and personal interests were more closely aligned with the interests of the “oil generals,” who relied and often could count on his political patronage.

Oleg Soskovets, one of the most powerful figures in the government, wanted to preserve significant state ownership in the sector. In 1996, he initiated creation of a new centralized entity, Russian Metallurgy, as “an alternative to selling off its remaining holdings in the sector during the second phase of privatization.” Selected JSCs were to transfer 10 per cent ownership to Russian Metallurgy, which was to be established as a holding company for the government’s remaining shares in 14 metallurgical companies. The government was to own 51 per cent of the holding company. The creation of Russian Metallurgy promised to strengthen Soskovets’s political position in the same way as Gazprom supported Chernomyrdin in power. However, after Soskovets lost his government position (because of his hard-liner views), Yeltsin

310 Soskovets was considered to be Yeltsin’s successor in 1996. See Boris Nikolayevich Yeltsin, Midnight diaries, 1st ed. ed. (New York: Public Affairs, 2000) 17.
312 Freeland, 166. In the government, Soskovets was considered to be a hard-liner who was prepared to defend power by using resolute (and undemocratic) methods. Freeland, 197.
313 Sagers, 208.
314 Sagers, 208.
315 Soskovets became a political burden for Yeltsin as the former was against holding the 1996 elections out of the fear that the Communists would win and, together with two more high government officials, “championed secrecy...
liquidated Russian Metallurgy in November 1997. There were other attempts to restore the role of the state in the sector. For example, in 1997, the Duma unsuccessfully tried to return Norilsk Nickel’s controlling package to the state. Evgeniy Primakov’s government also attempted to strengthen the role of the state in the sector (and the economy overall) but his efforts were not successful.

Overall, the regime guarded the remaining state property in the sector poorly. State representatives at boards of directors often did not participate in the board meetings. Whenever they did attend the general shareholders’ meetings to elect directors and members of executive boards, they usually automatically voted for whomever the majority already supported. However, similarly to oil and gas, even if “the levers of the state no longer work[ed] as well as they once did, they certainly still exist[ed].” The state remained an important source of various subsidies for enterprises. The directors who failed to adjust to the new economic system preferred to keep links with the state for all the support and protection by authorities. Whereas in the oil and gas sector state power resided in the state-owned pipeline system, in metallurgy the state derived power from its prerogative to issue export licenses. Any exporter needed to get these licenses as Western states imposed limits on the volume of metallurgical exports from Russia. Paradoxically, the withdrawal of the state as an owner from metallurgy and mining sectors left these plants more vulnerable to takeovers by outsiders and later forced them to build “partnerships” with each other more than was the case with oil. Significant state ownership status in oil and gas served as a “harbor” for packages of shares safeguarding them from immediate distribution.

316 Komu prinadlezhit Rossiia: 10 let kapitalizma v Rossii, 315.
317 Men’šikov, 104.
318 See Fortescue, 165.
319 Fortescue, 164.
320 Bim, 480.
321 Humphreys, 14.
322 Humphreys, 13.
323 Bim, 480.
324 There was a lot of “grey” exporting too. See Haglund, 91.
325 See, for example, p 231-232 http://www.ach.gov.ru/userfiles/bulletins/11-buleten_doc_files-fl-710.pdf. For discussion of differences with oil, see Dienes, 42.
7.4. Transworld Group

While in the government, Soskovets actively promoted the interests of the Transworld Group (TWG).\textsuperscript{326} Although formally TWG was a foreign investor, de facto it was run by shady figures of Soviet origin with close ties to Russian authorities.\textsuperscript{327} The founders of TWG and its predecessor Trans Commodities had emigrated from the USSR during perestroika.\textsuperscript{328} Sam Kislin, an American businessman of Soviet origin and a former manager of Odessa’s main grocery store, founded Trans Commodities. Kislin’s company initially supplied imported and domestic inputs to Russia’s metallurgy. Later, Kislin together with Vladimir Lisin actively engaged in tolling.\textsuperscript{329} Kislin and his Russian colleagues soon found new partners – Mikhail and Lev Chernoy. Trans Commodities became Transworld Group (TWG)\textsuperscript{330} and fell under control of the Chernoy brothers who had built their starting capital through appropriation of bank funds and clear fraud.\textsuperscript{331}

According to some sources, Soskovets himself presented Lev Chernoy as a “potential Western partner” at a meeting of kontsern Aluminiy to directors of aluminum enterprises. In March 1993, Yeltsin signed a decree initiated by Soskovets that allowed duty-free export of 520 thousand tons of primary aluminum.\textsuperscript{332} This decree benefitted TWG the most. At one point, TWG controlled 45 per cent of Russia’s aluminium exports.\textsuperscript{333} The methods TWG used to acquire property were not only illegal but also violent.\textsuperscript{334} The company stood at the centre of the so-called “aluminium wars” – struggles for property by organized crime groups during 1993-1996 that left 48 people dead.\textsuperscript{335} TWG invested its profits into ownership in a number of Russian

---

\textsuperscript{326} For more detailed information on the history of Trans Commodities, TWG, the Chernoy brothers and their business partners, see Mukhin, The Chernoys effectively took away Kislin’s business: \url{http://lenta.ru/lib/14177452/}

\textsuperscript{327} For example, when in August 2000 Mikhail Chernoy was extradited from Bulgaria and prohibited from entering the country for 10 years, Russian Ministry of Foreign Affairs issued a statement that Chernoy’s case had been blown out of proportions in order to “discredit Russian business.” See \url{http://flb.ru/persprint/53.html}

\textsuperscript{328} Mukhin, 70.


\textsuperscript{330} According to some sources, TWG consists of approximately 200 off-shores. Mukhin, 70.


\textsuperscript{332} Komu prinadlezhit Rossiya: 10 let kapitalizma v Rossii 280.

\textsuperscript{333} Fortescue, 51.

\textsuperscript{334} The Chernoy brothers at some point used the services of Anatoliy Bykov, a “businessman” from Krasnoyarsk (where a large number of metallurgical plants were located) with outright criminal connections in order to acquire control over plants. See Satter, 187; Mukhin, 67-68.

\textsuperscript{335} Mukhin, 70.
metallurgical enterprises. Ties to Soskovets proved to be both an asset and a liability for TWG: the decline of the company began after Soskovets’ was dismissed from power in 1996. Head of presidential administration Anatoliy Chubais and PM Victor Chernomyrdin did not favor the group. The group was also dealing with internal disagreements.

7.5. After TWG – redistribution of property continues

TWG did not manage to retain control over its assets in Russia’s metallurgy. However, the people who were once affiliated with TWG became owners of some of the biggest metallurgical companies in the country. For example, Iskander Makhmudov became Russia’s “copper king” with Mikhail Chernoy’s support. In 1998, Makhmudov and his business partners created the Ural Mining-Metallurgical Company. Oleg Deripaska, another powerful Russian metal magnate, rose through his ties to TWG. In the early 1990s, Deripaska traded metals. In 1994, he helped TWG establish control over Saianogorsk Aluminium Plant (SaAZ) and became the general director of the plant. In 1998, Deripaska began pushing the politically weakened TWG out of SaAZ. He initiated an additional issue of shares that dropped TWG’s stake and deprived TWG of veto power at the plant. In 1998, Deripaska became head of Sibirskiy Aluminium Group. In 2000, he headed Russian Aluminium group, which he had founded together with Roman Abramovich.

By the late 1990s, the owners of metallurgy assets were a diverse group of people. Those few who had worked in the sector during the Soviet times and survived used the same methods as the outsiders in gaining and maintaining ownership and control. For example, Vladimir Lisin, who at the end of the 1980s worked as deputy director general at Karaganda Metallurgical Combine in the Kazakh SSR, had strong ties to Soskovets. Lisin managed to secretly purchase

---

336 Satter, 188. According to Huskey, it was the General Aleksandr Lebed’, who was appointed as secretary of the Security Council after Yeltsin’s re-election in 1996 who pushed out of office the “powerful troika associated with presidential security and the military-industrial complex: Aleksandr Korzhakov, Mikhail Barsukov, and Oleg Soskovets, the first deputy prime minister.” See Eugene Huskey, Presidential power in Russia (Armonk, NY: M.E. Sharpe, 1999) 86.
337 Chubais was working for Deripaska, TWG’s competitor in 1998-1999. See Mukhin, 99.
338 Komu prinadlezhit Rossiiia: 10 let kapitalizma v Rossii 309.
339 Mukhin, 149-150.
340 Barnes, 138.
341 Barnes, 192.
342 Mukhin, 97.
shares in the Novolipetsk Steel Combine controlled by TWG at the time. He became an owner of a different plant from the one where he had worked as a manager during the Soviet times, which suggests that his political ties mattered more than his position as an enterprise insider. Aleksei Mordashev of Severstal (Cherepovets Metallurgical Plant before 1993) also began working in the sector in 1988 and gained control over the plant by outsmarting the “red director” Yuri Lipukhin. The position of the financial director put Mordashev in charge of Severstal’s privatization. In its efforts to gain control over the plant, Severstal’s management bought shares from the plant’s employees and accumulated them in the firm “Severstal’-Invest.” In 1999, Mordashev himself bought 17 per cent of the firm and gained an upper hand at the plant.

7.6. The Arrival of the Bankers

Besides tsekhoviki and metal traders, in the mid-1990s bankers also entered the sector. They soon replaced traders as the most influential outsiders in the sector. Occasionally, insiders who were desperately short of investment funds invited the banks in. Sometimes the banks forced their entry into plants, for example, in the case of ONEKSIMBank and Noril’sk Nickel discussed above. Similarly to oil and gas, some metallurgical enterprises had close connections to specific banks. For example, Aleksandr Mamut’s MDM bank was the financial operator of Iskander Makhmudov’s metallurgical enterprises. Makmudov in his turn owned a substantial part of the bank’s shares. Banks often acquired industrial assets without a particular strategy in mind. Yet, when they came, the first steps usually involved appointing their own managers, cancelling the existing supply and sales contracts and awarding new ones to firms from the banking group, and reestablishing centralized administrative control.

---

343 Read about his split with TWG, for example, Komu prinadlezhit Rossiia: 10 let kapitalizma v Rossii, 315; Barnes, 137.
346 For example, this was the case with the entry of Inkombank into the MMK and into SAMEKO, Europe’s largest plant producing rolled aluminum Komu prinadlezhit Rossiia: 10 let kapitalizma v Rossii, 286.
347 Before winning the struggle with the management of Norilsk Nickel, ONEKSIMBank had to fight off the attempts of TWG to win control of the plant. Komu prinadlezhit Rossiia: 10 let kapitalizma v Rossii, 291.
348 Mukhin, 156.
349 Fortescue, 176-177.
bankers promised to bring in more investment capital than the traders, yet these expectations were not always fulfilled. For example, after ONEKSIMBank took over Noril’sk Nickel’, the profits of the enterprise fell. A key factor determining the survival of the banks during the 1998 financial crisis was ownership of industrial assets. After the crisis, banks started to view assets in metallurgy and mining more as property rather than a venue for resource stripping.

7.7. Regional Authorities

Regional governments played an active role in sector’s privatization because, similarly to oil and gas sector, metallurgy, and mining enterprises were often the largest or even the only taxpayers in the regions where they were located. Regional authorities helped selected business groups acquire enterprises or maintain control over them. Some regional authorities gained ownership of sector’s assets located on their territory themselves. Regional governments could place representatives on boards of companies that were important for the region even after these companies had already become part of a FIG. Generally, regional authorities exercised their ownership rights as part of the board of directors and at shareholder meetings much more than central state representatives did. For business groups, the support of regional governments in a struggle for property was “not a formal requirement, but nonetheless a virtual necessity.” Regional governments enjoyed significant power especially vis-à-vis second-tier groups, such as Severstal, MIKOM, SibAL, which were registered in regions rather than in the capital in an effort to simplify bureaucratic procedures. Regional authorities were also “handy” whenever FIGs tried to acquire property through facilitation of bankruptcy as arbitration.

---

350 Fortescue, 51.
351 It reported losses of $257 million in the first half of 1998. Johnson names the following reasons: the enormity of the task of making these companies profitable; lack of experience, recalcitrant managers, and regional politicians, shortage of cash. See Johnson, 196.
353 See, for example, Barnes, 136. For a detailed discussion of their role, see Fortescue, 163-180.
354 Fortescue, 165.
355 Barnes, 125-126.
356 Fortescue, 165.
357 Barnes, 126.
courts were often dependent on regional authorities.\textsuperscript{358} FIGs and enterprise managers returned favors to regional authorities by supporting them in office.\textsuperscript{359}

8. FDI in Metallurgy and Mining

After the USSR collapsed, approximately two thirds of the sector’s equipment were technologically outdated and physically worn out. The sector needed capital for modernization. For example, Russia invested approximately $7-10 per ton of steel it produced, whereas the EU countries invested about $25-27 per ton. The majority of Russian investment went into maintaining the already existing facilities and equipment rather than modernization.\textsuperscript{360} The state played a limited role in providing funds. According to the federal program for 1993-2000, metallurgical enterprises were to begin large-scale modernization. Enterprises themselves were expected to finance 80 per cent of investment, 10 per cent were to come from loans, and 10 per cent were to come from the budget. At the end, enterprises financed 98 per cent of investment while the state gave a mere 2 per cent within this program.\textsuperscript{361} On the other hand, funds from the state for oil and gas were more easily available.\textsuperscript{362} Enterprises could not get bank loans due to extremely high interest rates. Still, the sector did not open up to FDI. There was a minimal presence of foreign investors specializing in metallurgy or mining outside Russia. No established international metallurgical or mining companies bought equities during privatization.\textsuperscript{363} As of 1995, only 3.5 per cent of ferrous metallurgy enterprises had foreign ownership. By the time

\textsuperscript{358} Adachi, 24.
\textsuperscript{359} For example, Oleg Deripaska helped Aleksandr Lebed’ become president of Khakassia while in return Lebed’ lowered taxes for Saianogorsk Aluminum Plant and favored the interests of TWG (Deripaska was part of the group at the time). Barnes, 138.
\textsuperscript{361} The government did try to ease the financial condition of the sector through a concession that allowed enterprises, including those with tax arrears, to reserve up to 30 per cent of funds that entered their accounts for paying salaries and meeting some other vital needs, which Sagers considers to be part of “electoral politics.” See Sagers, 200.
\textsuperscript{363} There were some attempts to form JVs in copper and gold sectors but they failed very quickly. See Haglund, 144. There were 15 JVs in mining as of April 1992: Haglund, 50 Some JVs, like Renova, were created together with Access Industries of Leonard Blavatnik, an émigré from the USSR. Mukhin, 110.
Yeltsin left office in 2000, metallurgy had attracted only 1.6 per cent of the FDI stock that had entered Russia.364

This lack of FDI in Russian metallurgy and mining cannot be explained by a lack of interest on the part of potential foreign investors. Rio Tinto showed interest but left Russia in the mid-1990s. The company characterizes this as an “unsuccessful period of involvement.”365 BHP also unsuccessfully participated in a tender to develop Udokan, Russia’s largest copper deposit.366 American Alcoa considered buying the Samara Metallurgical Company (Sameko) owned by Inkombank in the mid-1990s. Instead, Sameko was integrated into Sibirskiy Aluminiy. Alcoa acquired Samara Metallurgical Plant from Rusal (formed based on Sibirskiy Aluminiy) only in 2005.367 As a rule, foreigners could purchase assets in Russia’s metallurgy and mining only when domestic business was ready to sell their assets.

Even though the sector lacked capital for modernization, at the beginning of independence the main challenge for those who had gained control over the sector’s plants was retaining this control. That is why until 2002-2003, metallurgical companies preferred to accumulate debt rather than raise capital by selling stock.368 Initially, metallurgy stock was liquid, which enabled managers to purchase shares from plant employees.369 Yet later, when ownership was consolidated, owners began limiting the number of shares available for purchase (usually no more than 15 per cent were available). Sales of shares to outsiders, either foreign or domestic, made enterprises vulnerable to hostile takeovers. In their turn, foreigners were not interested in purchases that did not allow them to have control over an enterprise. The chances of getting any dividends were low.370 The nature of the struggle for property in the sector where one could easily lose one’s life also acted as a deterrent for the entry of foreign investors.

365 http://www.riotinto.com/documents/Media-Speeches/GRE-Russia_220606.pdf. The company only came back to Russia in 2006 when they formed a JV with Norilsk Nickel.
367 Mukhin, 99.
368 See “Pochemu metallurgicheskie kompanii ne vykhodyat na rynok tsennykh bumag?” Available at http://www.if.ru/upload/Pocemu_metallurgiceskie_kompanii_ne_vyhod_t_na_rynok_cennyh_bumag.pdf.
369 Petros’ian, 58.
370 See “Pochemu metallurgicheskie kompanii ne vykhodyat na rynok tsennykh bumag?” Available at http://www.if.ru/upload/Pocemu_metallurgiceskie_kompanii_ne_vyhod_t_na_rynok_cennyh_bumag.pdf.
The sector did see its share of purchases by “foreign” companies registered in traditional offshores.\textsuperscript{371} It is difficult to consider TWG a “foreign investor” due to its founders’ position inside the Soviet system. Swiss Glencore, an international commodities trading company, was one of the biggest foreign investors into Russia’s metallurgy.\textsuperscript{372} Similarly to TWG, Glencore had a murky reputation. It had traded with the USSR and participated in tolling.\textsuperscript{373} Its founder Marc Rich was a target of US law enforcement on multiple charges, including tax evasion. Glencore’s presence in Russia was significant.\textsuperscript{374} Most likely, the firm succeeded where others failed because it was better adapted to working in Russia’s business environment with its ambiguities and the prevalence of informal rules over formal regulations.

9. Conclusion

Russia’s oil and gas, and metallurgy and mining sectors did not attract a lot of FDI throughout the 1990s compared to some of its post-Soviet neighbors and Central European states. The high level of development that both sectors had achieved during the Soviet era allowed independent Russia to exercise the “default option” of retaining ownership and control in domestic (state and private) hands without inviting foreigners in, at least in the short-term when property rights remained insecure. In the struggle for property, political – and personal connections mattered much more than the offer of capital investment.

Russia’s oil and gas, and metallurgy and mining sectors needed investment to secure their long-term growth. The weakened state was in a poor position to provide or facilitate this investment, yet in the short-term, both sectors could survive without it. Besides, the regime used state resources to provide special privileges to its special friends. Among them were the “industry generals” who grabbed control of their sectors as the USSR began collapsing. At the

\textsuperscript{371} For example, the purchase of 15 per cent of Mechel by a Cyprus-based company Skironas. See Komu prinadlezhit Rossii: 10 let kapitalizma v Rossii, 317. Alisher Usmanov was behind one of the offshores: Valerii Igumenov, “Dobrosovestnye priobretateli,” Forbes, 3 March 2005, available at http://www.forbes.ru/forbes/issue/2005-03/18674-dobrosovestnye-priobretateli. \textsuperscript{372} See Adachi, 76. \textsuperscript{373} Valerii Igumenov, “Professiia – Posrednik,” Forbes, 3 June 2007, available at http://www.forbes.ru/forbes/issue/2007-06/12368-professiya-posrednik. Komu prinadlezhit Rossii: 10 let kapitalizma v Rossii, 278. \textsuperscript{374} For example, it participated in one of the fiercest battles for property in Russia’s metallurgy sector – over the Krasnoyarsk Aluminum Plant, where Glencore was TWG’s competitor. See, for example, Barnes, 139, Komu prinadlezhit Rossii: 10 let kapitalizma v Rossii, 290. Glencore also formed strategic partnership with Mechel (the Chelyabinsk Metallurgical Combine) and bought 36 per cent of Mechel’s stock. Sagers, 238.
same time, few of them managed to maintain their positions for long. In the oil and gas sector, they lost out to the bankers, who became politically powerful once Yeltsin turned them into his key allies to secure reelection in 1996 and opened up access to state resources. The political alliance between domestic business and the regime thus clearly drove Russia’s policy regarding FDI in this sector. Decentralization of oil and centralization of gas during the Soviet era also set these industries on different paths in the post-independence era. In metallurgy and mining, industry generals lost out to the traders, who were well-connected outsiders to the sector but still “insiders” to Yeltsin’s regime.

Both oil and gas and metallurgy and mining are important sectors for Russia yet the former was “more strategic” than the latter: it was the main source of revenues for the regime and rents for individual officials. The regime’s political survival itself depended on the sector and its performance. Although the state lost control over both sectors, its efforts to retain control over oil and gas were more visible (and more successful to some extent) than in metallurgy and mining. The latter ended up in domestic private hands. This suggests that the structure of the economy “matters.” However, as I argue, it does not unilaterally determine policy choices.

Formal categories of ownership and control do not have meaning if they are not contextualized. In Yeltsin’s Russia, ownership often came without control and vice versa. Domestic business needed the regime (working through the state) to establish both. Therefore, in the 1990s, the “weak” state had significant leverage over domestic business, which it did not always exercise. However, the state’s levers of power “remained intact.” Yeltsin was a poor manager of state resources as the state often lost ownership and control over its assets, yet in 2000 he made a wise (from the point of view of a weak autocrat) decision to step down before the state structures disintegrated beyond the point of no return and his regime crumbled on its own.

375 See Gustafson, 79.
Chapter 5. Russia Under Putin: Establishing Control Over Domestic and Foreign Investors

During the 1990s, the Russian state did not dissolve yet the political weakness of Yeltsin’s regime progressively undermined the power of the state. Even though in reality, the Russian state was stronger than the public perceived it to be, yet these perceptions of weakness mattered. Yeltsin’s regime was a poor manager of the state, which undermined the strength of the regime itself. On 31 December 1999, Yeltsin resigned and Vladimir Putin, who had been the prime minister for a year, became acting president. In 2000, Putin was elected as President of Russia.

The key difference between the two leaders was that Putin used his initial personal popularity to secure his own sources of legitimacy and solidify his power, including his control over the state. Whereas the Yeltsin era saw an erosion of state power, Putin managed to restore and expand the state’s formal and informal powers soon after assuming office. Although some saw Putin as an “appointed successor” with no adequate political experience, he was also viewed as young, fit, and resolute. That is why, in contrast to Yeltsin, Putin did not need to rely on the oligarchs to maintain his regime. His subsequent “tough” attitude toward them only reinforced his popularity with the broader public. Because Putin did not need big business to maintain his power, he was able to redefine relations with domestic business and put the regime in charge of the economy and the political life. Policy regarding FDI in its turn has been shaped by the regime’s desire to control exploitation of natural resources. Rising oil and gas prices allowed Putin to gain an upper hand over foreign investors too – those that had already come and those that wanted to come in. All FDI that entered Russia’s oil and gas during Putin’s presidency was able to do so only with the permission and under strong supervision of the regime. In metallurgy, little FDI has come as the domestic oligarchs, now under strict control of the regime, wished to retain control over a sector they could develop with their own efforts.
1. Main Political and Economic Challenges During Putin’s Presidency

It may be surprising how quickly Putin restored the power of the state vis-à-vis societal actors. However, the preconditions for making this turn had existed throughout the 1990s. Significant privatization took place in the 1990s, yet property rights remained insecure. The main threat came from business competitors and the state itself as “the most valued assets were … made into economic concessions, which the state did not fully relinquish its claim to.”¹ The state also retained its coercive powers. Therefore, the weakening of the state that occurred under Yeltsin was reversible. Restoration of state power in order to strengthen his own political power remained Putin’s key goal throughout his tenure as president.²

At the beginning of Putin’s presidency, two broad groups competed for dominance in Russia’s political life: the liberals and the siloviki. The former group consisted primarily of economists and lawyers who considered Russia’s economic transition to market economy to have been successful and accepted the existence of the private sector, yet felt that Russia needed a stronger and more competent state to oversee the economy. The latter consisted of representatives of security forces (former officers, policemen, and prosecutors) who were dissatisfied with Yeltsin’s economic policies and the empowerment of the oligarchs at the expense of the state.

In the informal division of labor that emerged, the liberals designed new fiscal policies, while the siloviki built a new structure of central political control.³ During economic policy-making, the liberals tended to win over the siloviki and the so-called dirigistas who were ideologically close to the siloviki but came from more diverse backgrounds and tended to work in sectoral ministries rather than security apparatus. For the siloviki and the dirigistas, a “strong state” meant a state with abilities to “command, control or coerce.”⁴

---

² Radygin notes that already in 2000-2001 the Russian executive started to expand the list of areas in which the state was involved: for example, cadre changes in the largest natural monopolies and strategic companies with the share of state ownership, such as Gazprom; return of former state assets that had been privatized or used as collateral (Sibur’s and Itera’s enterprises, which used to be owned by Gazprom); establishment of control over the main financial flows and concentration of financial flows in state banks, etc. Radygin 2004, 45-46. (http://www.iep.ru/ru/investicionnoe-povedenie-rossiiski-predprivati-nauchnye-trudy-65.html)
³ Gustafson, 234.
Development and Trade (known as MERT in Russian) under the liberal-minded German Gref was especially influential and acted as a “parallel government.”\textsuperscript{5} As a result, in the early 2000s, a number of legal codes were adopted, such as tax, land, labor, and customs codes, along with laws aiming to reduce bureaucratic interference into business. The liberals wanted to create an efficient state with new “capacities to tax, regulate and engage in rule adjudication.”\textsuperscript{6} The liberals and the siloviki both supported Putin in his efforts to restore the state because both groups believed that the weakness of the state undermined its long-term viability.

Putin seems to have realized early on that the power of his regime was dependent on the strength of the state. During his presidency, the state powers that had been largely latent during the 1990s manifested themselves clearly in all spheres of life. The regime explicitly tied the glory of the state, the regime, and the nation together in the eyes of the public. In order to restore state power, Putin strengthened his own power first. The executive branch came to dominate the other two. The President established a supreme position within the executive branch.\textsuperscript{7} The role of ministries in decision and policy-making declined.\textsuperscript{8} After Mikhail Fradkov became head of the government in March 2004, liberal MERT lost its influence while the role of security service became more important. The pro-Putin United Russia Party had a near monopoly over the political space in Russia yet lacked independence as an institution. Its role was limited to “ensuring the demonstration and staging of mass public support” for the regime.\textsuperscript{9} The Federal Security Service (FSB in Russian) became actively involved in parliamentary campaigns on behalf of United Russia, intimidating oppositional mass media and political parties.\textsuperscript{10} After 2003, when United Russia gained dominance in the Duma for the first time, the parliament’s role in policy-making declined and opportunities for lobbying that had been mostly used by big business dwindled.\textsuperscript{11} The regime also began neutralizing the governors as political actors who had often

\textsuperscript{5} Interview with Vladimir Milov, director of the Institute of Energy Policy and deputy minister of energy (2002), Moscow, 25 November 2009.
\textsuperscript{7} Pappe, 159.
challenged the power of the federal centre under Yeltsin.\textsuperscript{12} As the state was increasing its force, Putin’s authoritarian regime was also gaining strength.

\section*{2. Redefining Relations with Big Business}

During Yeltsin’s presidency, mutual dependence between the regime and the state had detracted from the legitimacy of both in the eyes of the public. Big business specifically was seen to have been heavily involved in corruption that undermined the state. As a newcomer to federal politics, Putin had an opportunity to build an image of a non-corrupt leader, whereas the oligarchs were mostly the “old faces” who had stripped the state of its resources during the previous decade at public expense. The new president with his own, growing sources of legitimacy had a chance to redefine the presidency’s relations with the big business. During a famous meeting with big business on 28 July 2000, Putin advised the oligarchs to stay out of politics. As long as they did so, he promised to abandon the Yeltsin-era favoritism and stick to the principle of “equidistance.” Until 2003, both sides generally observed this agreement.\textsuperscript{13}

The key event that signified this change of relations between business and the regime was the so-called Yukos affair, when the regime bankrupted Russia’s leading oil company Yukos in fall 2003 and imprisoned its owner, Mikhail Khodorkovskiy, on charges of tax evasion. The state subsequently purchased company’s “leftover” assets. After Yukos, the main battles over policy “took place mainly inside the state, rather than between the state and the private sector.”\textsuperscript{14} Some experts have argued that the attack on Yukos was intended to punish Khodorkovskiy for his defiance of Putin’s demand for all business to stay out of politics.\textsuperscript{15} Second explanation is that Yukos “went down” because Russian officials “regard[ed] profitable businesses or the real estate they occupy as fair game for their own economic interests.”\textsuperscript{16} During the 1990s, the primary threat to business had come from criminal groups and business competitors. Under Putin, the

\begin{itemize}
  \item \textsuperscript{12} Among other things, Putin changed Russia’s relations between the federal centre and the regions by creating seven federal districts and appointing a presidential envoy to each of them; he also changed the way the Council of Federation is formed. Its deputies are no longer directly elected by are proposed by chairs of assemblies. Deputies confirm them with secret ballots. For detailed discussion, see Cameron Ross, “Federalism and De-Federalization in Russia,” in Routledge handbook of Russian politics and society 144-150.
  \item \textsuperscript{13} Stephen Fortescue, “The Russian Economy and Business-Government Relations,” in Routledge handbook of Russian politics and society 278.
  \item \textsuperscript{14} Gustafson, 317.
  \item \textsuperscript{15} For a general overview of explanations, see Gustafson, 312-315.
\end{itemize}
main threat came from the state itself, in particular from three groups: highest-level officials, lower-level officials acting on behalf of certain private-sector clients, and lower-level officials and law enforcement agents acting independently.\textsuperscript{17} A related explanation is that an over-zealous bureaucracy may have acted on its own, even if with Putin’s general permission.\textsuperscript{18} In my view, the most credible explanation is that the regime saw opportunities to establish its presence in a sector that promised to generate increasing revenue (closest to the second explanation discussed above). In 2003, experts predicted that energy prices would rise over the long run. Powerful oil companies could then potentially over-power the regime and the state. The regime needed to gain control before it became too late. Also, as the former deputy minister of energy Vladimir Milov recalls, steadily rising energy prices made Russian government officials think they could now afford to go further than they could have ever gone before: “… they became more confident. In general, in this situation Putin and his team began pursuing the type of policy that they most likely had always wanted to pursue but the circumstances had not allowed them to do so.”\textsuperscript{19} This is the attitude that the regime had toward both domestic and foreign investors.

In the course of the Yukos affair, the state established its primacy over business and limited the autonomy of business.\textsuperscript{20} After Yukos, Russia’s big business took the attitude that “things were not good, but could have been worse.”\textsuperscript{21} Big business read the Yukos story as a lesson of what could happen to those who challenged the regime, either politically or economically. The regime itself revealed that it was not afraid to damage its international reputation if this was the cost of strengthening its positions at home.

The Yukos affair also changed the nature of the political involvement of the oligarchs. Whereas before 2003, they supported a variety of political projects to maximize the chances of getting decisions through, after Yukos big business mostly supported projects initiated by the executive branch.\textsuperscript{22} During Putin’s tenure, business continued to have close ties to the regime yet

\textsuperscript{17} Jordan Gans-Morse, "Threats to Property Rights in Russia: From Private Coercion to State Agression," Post-Soviet Affairs 28.3 (2012): 278.
\textsuperscript{19} Interview with Vladimir Milov, director of the Institute of Energy Policy and deputy minister of energy (2002), Moscow, 25 November 2009.
\textsuperscript{20} See Gustafson, 316-318.
\textsuperscript{21} Interview with an expert, Moscow, 2009.
the latter became clearly a more powerful actor in this relationship. Big business “with close
links to the political leadership ha[d] to be ready to serve.” It had to go along with the president
in fulfilling its social obligations, and most importantly, to pay taxes. A widely popular and
legitimate leader in charge of the state and its resources who could force the oligarchs to pay
taxes had more power than illegitimate business. The regime derived its popularity from its
reputation of “the regime that brings order independent of whether or not it actually brought
order” more so than on its actual economic performance. Even though the regime did not
always follow up on its “tough” rhetoric, big business had to accept the new rules of the game
imposed by the regime. According to one of my interviewees, Putin’s regime “treated domestic
business with almost the same suspicion as it has treated foreign investors, who [were] viewed as
threatening the foundations of Russia’s statehood.”

The state expanded the scope of its interference in the economic sphere and intensified it
too. As the former deputy minister of energy Vladimir Milov recalled, in 2002, one year before
the crackdown on Yukos when Yukos was considering selling off part of its shares to a foreign
company, “the dominating idea in the government was that, because we are the government, we
should be consulted.” No legislative provisions prohibiting such sale existed at the time. After
2003, business always had to consult the regime before making key decisions regarding its
development. Strategic sectors and public service monopolies came under Kremlin’s strict
control. In sectors such as oil and gas, the main decisions came to be …

made at the very-very-very highest level. When it comes to serious strategic investment questions, … it is
almost two-three people, maybe one, who are involved in that.

23 William Tompson, “The Political Economy of Contemporary Russia,” in Routledge handbook of Russian politics
and society 260.
24 Philip Hanson, "The Resistable Rise of State Control in the Russian Oil Industry," Eurasian Geography and
25 For example, William Tompson, "Putting Yukos in Perspective," Post-Soviet Affairs 21.2 (2005): 159. Also
Varieties of capitalism in post-communist countries, ed. David Stuart Lane and M. R. Myant (New York: Palgrave
Macmillan, 2007) 162.
26 Interview with Pappe Iakov, professor, Faculty of Economics, Higher School of Economics, 2 December 2009.
27 Routledge handbook of Russian politics and society 280.
28 Interview with an expert, Moscow, 2009.
29 Interview with Vladimir Milov, director of the Institute of Energy Policy and deputy minister of energy (2002),
Moscow, 25 November 2009.
30 Interview with Andrei Nechaev, president, “Russian Financial Corporation” Bank, former minister of economy
31 Interview with a foreign investor, 4 December 2009.
Ironically, the vulnerability of big business developed at the same time as business underwent a “fundamental shift”: key economic actors consolidated their assets and began trading shares at the stock market, participating in mergers and acquisitions, and building up their international reputation. They also enjoyed improved access to financial markets and began borrowing from abroad. The vulnerability of Russian big business vis-à-vis their home government undermined their effort to become full-fledged TNCs. In short, the post-Soviet Russian state played a key role in determining what was possible and what was not for Russia’s big business and the regime itself. And the internationalization of business came second. The 2008-2009 financial crisis further strengthened government’s position vis-à-vis big business since the state became the lender of the last resort. State support during the crisis largely targeted specific industries and often specific companies.

Throughout the 1990s, Russian big business lobbied the government individually and informally. Putin’s regime sought to replace more informal communication instead with business with formal procedures and to foster the institutionalization of business in a top-down manner. The most influential association of big business has been the Russian Union of Industrialists and Entrepreneurs (RUIE) established in 1991. Under Putin, RUIE became the tool used by the regime to exercise control over big business. The organization has increased its formal importance compared to the 1990s, yet it is still not a self-sufficient actor that speaks to the regime as an equal. For example, when RUIE’s previous head Arkadiy Volskiy was leaving the association, the membership elected Igor Yurgens. However, a phone call from the Kremlin followed and the association was asked to retake the vote. Aleksandr Shokhin became head of RUIE as a result. Under Putin, meetings between government officials and business became more regular and widely publicized. Even though the authorities could ask business for advice, they did not always follow it. Business could succeed in lobbying the government only

32 Pappe, 103.
33 Pappe, 87. Also Shokhin Alexandr, head of the Russian Union of Industrialists and Entrepreneurs, presentation at the HSE, 14 December 2009.
34 Routledge handbook of Russian politics and society 258.
36 Interview with Mikhail Kroutikhin, Partner and Analyst, RusEnergy, Editor-in-Chief, The Russian Energy Weekly, Moscow, 2 December 2009.
37 Presentation of Pavel Tolstykh, head of the GR Research and Consulting Centre, at the general conference of the Russian Association of Political Science, Moscow, December 2009.
38 Interview with an expert, Moscow, 2009.
regarding minor issues that did not concern personal interests of high-standing officials. Nonetheless, companies continued to seek direct contacts in the government and attempted to reach informal agreements before raising issues at business association meetings. The problem was that quite often “the level of distrust among the representatives of big business of each other was almost as large as their general distrust of the state.”

3. Essence and Implications of Statism for Russia

The key factor that gave Putin a possibility of becoming a “statist” was the rise of energy prices. Although energy prices had been rising since 1998, Russian officials began analyzing the long-term implications of this trend for Russia only around 2003. As Vladimir Milov recalled, he received a phone call from one of the ministers in the government the same day Alan Greenspan, Chairman of the US Federal Reserve, said in his speech in spring 2004 that the world had entered the period of steadily high energy prices. The minister was asking Vladimir Milov for his opinion on this statement (Milov had by then left the ministry of energy). As Vladimir Milov noted, “after this conversation I realized that the people on the top were critically preoccupied with this issue [whether or not energy prices will be rising].” As the oil sector began receiving super-profits, in the view of the regime, export duties became an insufficient mechanism for obtaining oil rents. Direct control over oil revenues would solve problems such as the repayment of debts and financing of social programs. When Putin came to power, many officials were worried about the so-called “problem of 2003” when Russia was supposed to repay approximately 17 billion USD of its external debt (in 1999, its entire federal budget was around 20 billion USD). Because the regulatory capacity of the state remained weak, the most direct way to establish control was to gain ownership. Increasing force to achieve these goals was much more feasible from the point of view of the regime than enhancing power, which would require long-term construction of institutional capacity and was not in the plans of the regime.

39 Interview with a former official of the Ministry of Energy, Moscow, 16 December 2009.
40 Yakovlev, 227.
41 Interview with Vladimir Milov, director of the Institute of Energy Policy and deputy minister of energy (2002), Moscow, 25 November 2009. Immediately after the 1998 financial crisis they were under 20 USD per barrel and began rising until they reached almost 100 USD per barrel in 2008.
Since 2004, state ownership of the economy increased from 25-30 to over 50 per cent.\(^{44}\) In 2007, state corporations became a new legal form of property. Their official goal was to promote international competitiveness. As Pappe noted, “the state corporation as a strange legal form of ownership was created based in certain illusions about the ability of the state to speed up development.” These companies held total state assets worth $86 billion and were eligible to receive $36 billion of budget funds. The state also obtained a controlling interest in 130 joint stock companies and a partial stake in 1,500 others.\(^{45}\) In July 2005, the state increased its direct stake in Gazprom to a majority (it had obtained de facto control earlier).\(^{46}\) The government also wanted to merge Gazprom and Rosneft’ into one giant company yet the plan failed because of disagreements between the leadership of these two companies.\(^{47}\) Instead, Gazprom bought a 75.68 per cent ownership package in Sibneft’.\(^{48}\) Rosneft’ in its turn purchased Yuganskneftegaz, Yukos’s leading production unit.\(^{49}\) The expansion of state ownership proceeded without any well-defined strategy. At the same time, “the process was neither random nor chaotic: there was a coherent approach towards resource sectors, where the Kremlin clearly wished to re-assert itself.”\(^{50}\) Direct ownership and control over strategic resources became the state’s chief instrument of political and economic influence and was one of the main elements of the force it applied: to paraphrase Charles Lindblom, it was the force of thumbs rather than the purposeful and sensitive power of fingers.\(^{51}\)

Expansion of state ownership and control in the economy has led some authors to suggest that after 2003, Russia witnessed the rise of “economic nationalism.”\(^{52}\) Some have even argued

\(^{44}\) Routledge handbook of Russian politics and society 279.
\(^{46}\) Hanson, 16; Gustafson, 266-268.
\(^{47}\) Detailed discussion in: Gustafson, 338-346.
\(^{48}\) It became Gazprom Neft’. Soon this package was increased to more than 95 per cent. See http://www.gazprom-neft.ru/company/history.php.
\(^{49}\) Rosneft’s head Sergei Bogdanchikov attempted to regain control over Rosneft’ long before the “statist turn” of the Russian leadership became evident. Initially he had little help from the Kremlin: Gustafson, 332.
\(^{50}\) William Tompson, “The Political Economy of Contemporary Russia,” in Routledge handbook of Russian politics and society 255.
that Putin’s Russia is an example of “post-Soviet developmentalism.”\textsuperscript{53} In the East Asian context, economic nationalism is defined as “a set of state practices, policies, and strategies … to protect and promote national economic interests.”\textsuperscript{54} States driven by economic nationalism often pursue such goals as fostering national competitiveness, inducing growth and structural change, and promoting “national champions.”\textsuperscript{55}

Putin’s Russia however is not South Korea or Japan. The state leadership has lacked political will to launch development. Instead, Putin’s regime treated its own survival and self-enrichment as paramount goals. According to one of my interviewees, the regime created “a specific form of corporation called ‘Russia’ where the ability to control financial flows was more important than ownership and where a large number of key companies are managed by a small number of people.”\textsuperscript{56} Another interviewee went as far as saying that “[t]here is no state in Russia but there are groups of people with their own interests that are managing financial flows.”\textsuperscript{57} This speaks to the need to differentiate between the state as an embodiment of public good and the regime that runs this state in its own political and economic interests. Second, relations between business and the regime have lacked “embedded autonomy.”\textsuperscript{58} The regime makes its decisions autonomously from the society yet meaningful connections to the society (what Evans refers to as “embeddedness”) are missing. The regime sets unclear goals in terms of economic development and lacks clear ways of evaluating progress toward meeting these goals.\textsuperscript{59}

Reconstruction of the “power vertical” under Putin strengthened coercive powers of the state while its legal base remained weak.\textsuperscript{60} Law has become a tool for power maintenance (“rule by law” rather than “rule of law”). Quite often, the regime has used the same questionable


\textsuperscript{55} Ibid.


\textsuperscript{57} Interview with Mikhail Kroutikhin, Partner and Analyst, RusEnergy, Editor-in-Chief, The Russian Energy Weekly, Moscow, 2 December 2009.

\textsuperscript{58} Evans,

\textsuperscript{59} Interview with Vladimir Milov, director of the Institute of Energy Policy and deputy minister of energy (2002), Moscow, 25 November 2009.

methods of acquiring property as the oligarchs did in the 1990s.\textsuperscript{61} State expansion brought about a new round of property re-distribution, which led to the creation of the so-called silovarchs: “industrial and financial capital has fused with secret police [the siloviki] to produce a new political and economic order.”\textsuperscript{62} Igor Sechin has been regime’s main raider, “sometimes to the benefit of the state, or sometimes to the benefit of companies that are friendly to him.”\textsuperscript{63} During the Yeltsin era, business tried to influence political power. Under Putin, “the [political] power itself informally became business.”\textsuperscript{64}

The state has invested considerably less in modernization of the production process than in the expansion of state ownership. Despite inflows of energy revenues, a large share of state ownership expansion was financed by loans from abroad.\textsuperscript{65} The state at the service of the regime expanded its ownership in both strategic and non-strategic sectors. Privately owned companies cannot expect a level playing field in sectors where gigantic state corporations or state-owned companies are present.\textsuperscript{66}

Putin’s authoritarian regime has become stronger (i.e., more stable). It relies on the support of a broad coalition of those benefitting from and supporting a larger, more forceful state, such as the siloviki, state officials, managers of state-owned and/or state-controlled companies. Putin and his regime were also widely supported by the population, who connected hopes for economic growth and credited the regime for any improvement of the economy that has taken place.\textsuperscript{67} This strength, however, undermined those institutions that in modern democracies interact with and are able to challenge the presidency. As one of my interviewees reflected, “[t]oday, there is no Duma [as an institution], there are no oligarchs [i.e., big business who could shape politics in its own favor]. There is only a bureaucratic organization that is fully

\textsuperscript{61} For example, by setting up shell companies and offshore bank accounts. The regime used a shady intermediary company, Baikal Finance Group, to purchase Yukos’s assets. See Peter Rutland, Putin’s Economic Record: Is the Oil Boom Sustainable? Routledge, 2008) 1058.

\textsuperscript{62} Treisman, 142.


\textsuperscript{64} Interview with Andrei Nechaev, president, “Russian Financial Corporation” Bank, former minister of economy (1992-1993), Moscow, 9 December 2009.

\textsuperscript{65} Pappe, 113. Hanson and Teague argue that obtaining capital is not a big problem for Gazprom: foreign banks feel safer lending to Gazprom than other, private borrowers. Varieties of capitalism in post-communist countries 157.

\textsuperscript{66} Institutions, ideas and leadership in Russian politics 81.

\textsuperscript{67} See, for example, Treisman Daniel, “What You Need to Know About Putin’s Popularity,” \textit{The Washington Post} (Monkey Cage), 7 February 2014.
tied by its officialdom and lack of understanding what is going on, which is called the state.68 The state and the regime in charge of it are likely to be “strong” in the short- and medium-term while Putin’s popularity remains high. They may survive in the long run if Putin’s eventual departure from power is smooth and Putin’s successor preserves state powers to interfere, dictate, and coerce. However, just like the Soviet state, the Russian state in the hands of Putin’s regime reproduces “power over” instead of increasing its “power to.”69 The institutions such as police, tax inspection, and customs service have filled in the niche previously occupied by organized crime.70 They have become convenient tools for the regime to neutralize its opponents and give lower-level bureaucrats sources of revenue to keep their allegiance to the regime. These bureaucrats are controlled but also empowered to do what they are doing from above, which in some ways is similar to how Nursultan Nazarbaev has maintained his power in Kazakhstan.

The state itself does not have adequate control over state corporations as these corporations lack transparency and public accountability. The law does not require state corporations to report on their activity.71 Other state institutions, such as the Ministry of Justice, tax inspection, and regional authorities, cannot interfere into the activity of state corporations. State corporations have access to state assets and budget funds while enjoying protection from bankruptcy and budgetary scrutiny.72 The criteria for evaluating their performance are unclear as the corporations are not supposed to be profit seeking.73

The story of Rosneftegaz suggests that the state as such did not gain control over the economy through state ownership. Rather, individual officials did. Rosneftegaz was created in 2004 as a structure that was supposed to temporarily hold state shares in Rosneft.74 These shares served as collateral for financing the purchase of Gazprom’s shares by the state. Yet, Rosneftegaz was not disbanded after the state had paid off the debt because keeping these shares off the state’s balance sheet allowed officials to manage or dispose of them without much

68 Interview with an expert, Moscow, 2009.  
69 Ledyaev, 32.  
72 Institutions, ideas and leadership in Russian politics 82.  
74 Igor Sechin has been the head of Rosneftegaz since 2006 (with a small break in 2011).
In 2013, it turned out that the State Property Agency and Rosneftegaz, which officially owned 75 per cent of Rosneft and 10.7 per cent of Gazprom, did not even have a formal agreement outlining the rights and responsibilities of these institutions toward each other. As a result, state representatives on boards of these companies delegated by Rosneftegaz could vote as they pleased.76

The state per se did not gain control over state-owned companies either. The former Minister of Natural Resources Yuri Trutnev recognized that the state did not have the means to control development of its offshore resources because they fell under direct control of Gazprom and Rosneft.77 Yet, the state was not the only shareholder in these companies. Russia’s highest officials are believed to own the state-owned and state-controlled institutions.78 Therefore, state institutions serve private interests, often through state-owned and state-controlled companies. Thus: “it is not the Kremlin that uses Gazprom in its own interests but the other way around.”79 Formal ownership matters less than ability of individual state officials to control financial flows of companies.80 Because state officials sit on company boards and often are unofficial owners who work for personal gain, “[a]s channels for the anonymous, unaccountable siphoning-off of rents, there may not be much difference, in current Russian circumstances, between private and state-controlled companies.”81 The most important difference, however, is that unlike the majority of private companies, Gazprom enjoys a privileged connection with the state. In order to provide these privileges, officials “spend taxpayers’ money to earn their own.”82 The meaning of state and private ownership is very blurred: for example, Gazprom is considered to be a state company (the state obtained minimal majority in the company in 2005-2006). The company possesses a number of privileges compared to companies with larger private ownership.

75 Institutions, ideas and leadership in Russian politics 83.
78 On Putin’s estimated wealth, see: Hanson, 25.
80 Nechaev, 179-180.
81 Hanson, 23-25.
same time, the company also has private owners. It is unclear what kind of control they have over company’s decisions.83

Access to state decision-making is also narrowing.84 Very few individuals in the presidential administration control a large number of companies on behalf of the state. This entanglement of interests in state-owned and state-controlled companies does not foster development since it makes these entities non-transparent and provides grounds for corruption. Public interests are sacrificed if their realization contradicts private interests of government officials. Dmitri Medvedev, Putin’s successor and pro forma president in 2008-2012, was initially viewed as more liberal than Putin. However, Putin’s premiership under Medvedev and the former’s popularity with the people ensured continuation of statist tendencies during Medvedev’s presidency too. In 2012, Putin returned to power as president once again.

4. Policy Regarding FDI during Putin’s Presidency

In the early 2000s, when Putin had just come into office, it seemed that Russia would finally become a major investment destination for foreign capital. First, having gained some strength and wishing to expand further, domestic business began showing interest in FDI. Second, the new president also initially treated foreign investment projects favorably.85 In 2005, capital inflows for the first time exceeded capital outflows.86 FDI came in too: in 2006, Russia received more FDI as a share of domestic investment than China.87 Overall, however, no FDI boom took place during Putin’s tenure. Whereas the dollar values of FDI rose by the mid-2000s, with 2007 and 2008 being the peak years, they began falling again by 2010 to the levels of 2005, even if they were still higher than in 2000. The share of FDI in the total foreign investment capital kept decreasing. For example, whereas in 2000 FDI constituted almost 40 per cent of foreign investment, this share plunged to 9.7 in 2011. In contrast, the share of foreign loans has grown from 43.2 per cent in 2000 to 73.4 in 2011.88

83 Interview with an expert, Moscow, 2009.
84 Interview with a foreign investor, 19 November 2009.
85 Pappe and Galukhina, 106-107.
86 Pappe, 111.
Putin’s regime adopted two different approaches to FDI. In “non-strategic” sectors such as retail and banking, Russia was open to FDI. Many foreign investors who came to work in these sectors were successful as long as they acceded to the terms set by the regime. The attitude was much more restrictive toward FDI in sectors that were deemed strategic due to their importance for the economy and provision of security. Even more importantly, such sectors also “mattered” politically as they helped the regime maintain its power and buy off the support of the key constituents. No less importantly, they provided rent-seeking opportunities to individual representatives of the political elite. The regime’s goal became centralization of control over sectors such as oil and gas. As one of my interviewees noted,

My view is that fundamentally, the government that has been here since 2000, does not want foreign investment. And to the degree it does, it wants it on very limited and very well-defined terms: where they [the Russian government] actually need technology, where they actually need capital, it’s [FDI] always in a junior role. And here you can trace the explicit statement of how warm or cold the Kremlin is to foreign investment by the price of oil. The higher the price, the nastier they are and more open about it.

The desire to formalize control over strategic sectors translated into the adoption of the Law on Strategic Sectors in May 2008 entitled “Procedures of Making Foreign Investment in Business Entities of Strategic Importance to National Defense and Security of the State,” which identified forty-two sectors as “strategic,” among them geological surveys of subsoil and/or prospecting for and extraction of minerals in subsoil plots of federal importance along with manufacturing, and sale of metals and alloys used for manufacturing of arms and military technology. Any foreigner who wished to invest in a strategic sector had to obtain prior authorization from the government. Therefore, the Law formalized the government’s control over these sectors. The Law became a “method of control” itself. Although it was intended to

---

89 Interview with a foreign investor, 4 December 2009.
90 Liuhto, 14.
91 Interview with an expert, Moscow, 2009.
92 Interview with a foreign investor, Moscow, 19 November 2009.
93 Putin invited the government to prepare this law in his annual address in April 2005 (Russian Federation: Strengthening the Policy Framework for Investment).
94 Russian Federation: Strengthening the Policy Framework for Investment 25
95 According to the Law, foreign control is defined when a foreign entity owns 50 per cent of voting shares and has a possibility to appoint half or more members of the managing body of a Russian company. If this Russian company is involved in geological survey of subsoil and/or prospection and extraction of minerals in subsoil fields of federal importance, the number drops to 10 per cent of shares. It drops to 5 per cent if a foreign company is also state owned. Russian Federation: Strengthening the Policy Framework for Investment 26
96 Interview with an expert, Moscow, 2009.
replace the case-by-case approval of foreign investment, the inter-governmental commission chaired by the Prime Minister had the power to make decisions that suited the needs of the regime. The Duma passed the Law with minimal discussion. In practice, the Law legalized informal practices that had existed long before its adoption, when foreign companies had to ask permission from the country’s top leadership to make an investment. Foreigners had almost no influence over the shape of final version of the Law. Crucial aspects regulating the entry of FDI remained vague, which gave the government some flexibility in using the Law but also undermined the goal of formalizing the entry of FDI.

The Law formally aimed to help the government protect national interests. “Toughness” on FDI also became regime’s strategy of legitimizing itself in the eyes of the population, part of the general strategy of demonstrating that Russia was “standing up from its knees” aimed primarily at the domestic audience and disregarding how this strategy affected Russia’s national interest. As one of my interviewees pointed out, out of 250 enterprises that were affected by the Law on Strategic Enterprises, 247 had been established before 1974. The Law used as a means of restricting foreign capital to these enterprises would delay modernization of these plants. There was little practical importance in adopting the law (one of my interviewees referred to it as “one big political slogan”) because the regime could always rely on one of the government agencies to deny access to foreigners before 2008.

The attitude regarding FDI reflected the change of relations between the regime and the oligarchs that occurred during Putin’s presidency. Whereas during Yeltsin’s era the oligarchs had the power to keep foreigners away from assets of interest, under Putin it was the political elite

---

97 Interview with an expert, Moscow, 2009. For detailed discussion of how approval process should look like as defined by the Law, see Russian Federation: Strengthening the Policy Framework for Investment 26.
98 Interview with an expert, Moscow, 2009. The main issues foreign investors were unhappy about were the difficulty of obtaining a license for a foreign company, even if it discovered oil; the thresholds for foreign companies that need to get governmental approval.
99 Even though the 2008 Law provided for a possibility of challenging the decision of the commission in courts, one could only challenge the formal procedure rather than the reasons for why a certain decision was made. Interview with an expert, Moscow, 2009.
101 Interview with Valeriy Zubov, a deputy of the State Duma, member of the faction “Just Russia: Motherland/Pensioneers/Life,” member of the Duma Committee on economic policy and entrepreneurship, Moscow, 11 December 2009.
first and foremost that did not want to share rents with either domestic or foreign companies. The political elite had become Russia’s economic elite. Similarly to Yeltsin, Putin did not rely on foreigners to sustain himself in power. Unlike Yeltsin, however, Putin did not need the support of the domestic oligarchs either. Rising energy prices led to competition among potential foreign investors interested in investing in Russia’s oil and gas sector, which gave the Russian government a choice about whom to let in and whom to deny access to. If one foreign investor left, even with a scandal, others would come to take his place. Even the Yukos affair did not cool the interest of foreigners in Russia. The majority of foreign investors treated Yukos as some sort of “atmospherics,” an isolated event driven by domestic politics that would not be repeated. FDI that came in was concentrated mostly in natural resources, the sector with the highest political risks but as long as energy prices were increasing, foreign energy majors were willing to take the risk.

To some extent, Putin’s “strengthening” of the state eased the work of foreign investors: the centralization of control meant that lower levels of bureaucracy were less likely to reverse a decision made at the highest level as it was the case under Yeltsin. However, under Putin, foreign investors have also been facing new challenges. First, it has become more difficult to gain access to decision-makers. Second, reaching mutual understanding has not been easy. Third, there is no guarantee that a promise will be kept. Whether foreign or domestic, investors in Russia need to know who will be making a decision in their case, and why an official may be interested in making a decision in favor of a foreign investor, the factor that usually concerns personal gain of a decision-maker. Important decisions are still pushed through personal contacts. Formal organizations such as the Foreign Investment Advisory Council (FIAC) have been more a “prestige factor” than a real agent of influence. FIAC provides foreign companies

---


104 See, for example, Vlast’ i Biznes: Leto 2003 Fond "Liberal'naia Missiia", 2003) 21.

105 Interview with a foreign investor, 4 December 2009.

106 Russian Federation: Strengthening the Policy Framework for Investment 14. In 2007, for example, mining and quarrying was responsible for 48.6 per cent of all Russia’s FDI. Russian Federation: Strengthening the Policy Framework for Investment 16.

107 Interview with a foreign investor, Moscow, 19 November 2009.

with an opportunity to interact face to face with the highest decision-makers, yet the majority of investors are afraid to go publicly against Russia’s political leadership.\footnote{Interview with a foreign investor, Moscow, 19 November 2009.}

Upon their entry into Russia, foreign investors have not gained greater protection vis-à-vis the government compared to domestic business. At the end, if there is a conflict between a foreign investor and the government, the former has to negotiate and compromise since “anything that [was] based on threat and trying to get the [foreign] government to lobby for you rather than doing it the “Russian way” has proved to be very ineffective.”\footnote{Interview with a foreign investor, Moscow, 4 December 2009.} Some foreign investors prefer to work with Russian partners (in some sectors, such as oil, they are often forced to\footnote{Interview with a foreign investor, Moscow, 19 November 2009.}). However, having a Russian partner does not mean that the government will not put pressure on a foreign investor because the government does not trust either foreign or domestic businesses.\footnote{Interview with an expert, Moscow, 2009.} The main way to ensure the safety of investment for both has been to demonstrate that your company’s goals are aligned with Russia’s “national interest,” the essence of which is interpreted by the government, and that the government will not lose control over the project and personal interests of government officials will be satisfied too.\footnote{Interview with a foreign investor, Moscow, 4 December 2009.}

To some extent, Russia modified its attitude regarding FDI during the course of the 2008 global financial crisis. The Minister of Economy at the time, Elvira Nabiullina, noted that Russia would replace foreign capital that came into Russia in the form of loans with FDI.\footnote{Elvira Nabiullina’s interview, Russian economy minister. \textit{Financial Times}, October 28, 2009.} In 2011, Russia passed a new Law that lifted some restrictions on foreign investment imposed by the 2008 Law.\footnote{See, for example: “Inostrantsam Stalo Legche Investirovat’ V Strategicheskie Otrasi Rossi.” Dp.ru, 17 November 2011. Available at http://www.dp.ru/a/2011/11/17/Medvedev_smjagchil_zakon_ob2/ (last accessed February 18, 2015).} In 2012, Putin issued a decree that tasked Russia with improving its ranking in the World Bank’s Doing Business report by 100 positions within six years, which would move the country from the 120\textsuperscript{th} position to the 20\textsuperscript{th}.\footnote{“Investitsionnaia privlekatel’nost’: pryzhok na 100 pozitsii,” Promyshlennik Rossii, December 2012, available at http://www.promros.ru/magazine/2012/dec/investicionnaya-privlekatelnost-pryzhok-na-100-pozicij.html (last accessed March 12, 2015).} Continuously high oil prices would not help Russia achieve this goal. Also, it appears that in 2014 in the course of Russia’s confrontation with the
West, Putin has been prepared to jeopardize all these goals for the sake of asserting his position vis-à-vis Ukraine and gaining additional legitimacy at home.

### Table 8. Foreign Investment by Selected Sectors (FDI and other forms)

<table>
<thead>
<tr>
<th>Sector</th>
<th>2005, mln USD and % of the total</th>
<th>2007, mln USD and % of the total</th>
<th>2008, mln USD and % of the total</th>
<th>2009, mln USD and % of the total</th>
<th>2010, mln USD and % of the total</th>
<th>2011, mln USD and % of the total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign investment</td>
<td>53,651 (100%)</td>
<td>120,941 (100%)</td>
<td>103,769 (100%)</td>
<td>81,927 (100%)</td>
<td>114,746 (100%)</td>
<td>190,643 (100%)</td>
</tr>
<tr>
<td>Fuel and mining</td>
<td>5,164 (9.6%)</td>
<td>15,860 (13.1%)</td>
<td>9,868 (9.5%)</td>
<td>8,294 (10.1%)</td>
<td>11,880 (10.4%)</td>
<td>14,861 (7.8%)</td>
</tr>
<tr>
<td>Mining only</td>
<td>839 (1.6%)</td>
<td>1,533 (1.3%)</td>
<td>2,528 (2.5%)</td>
<td>2,033 (2.5%)</td>
<td>1,978 (1.7%)</td>
<td>3,773 (2%)</td>
</tr>
<tr>
<td>Metallurgy</td>
<td>3,420 (6.4%)</td>
<td>15,229 (12.6%)</td>
<td>14,499 (14%)</td>
<td>4,494 (5.5%)</td>
<td>7,627 (6.7%)</td>
<td>9,235 (4.8%)</td>
</tr>
</tbody>
</table>


### Table 9. Russia’s Sectoral Distribution of FDI Stock, 2005 and 2010 (US million)

<table>
<thead>
<tr>
<th>Sector</th>
<th>2005</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Sectors</td>
<td>49,751</td>
<td>116,199</td>
</tr>
<tr>
<td>Mining and quarrying</td>
<td>12,872</td>
<td>20,406</td>
</tr>
<tr>
<td>Extraction of crude petroleum and gas only</td>
<td>12,200</td>
<td>16,807</td>
</tr>
<tr>
<td>Basic metals and metal products, except machinery and equipment</td>
<td>6,601</td>
<td>21,154</td>
</tr>
</tbody>
</table>

Source: Columbia FDI Profiles

---

117 According to the author, Goskomstat began publishing sectoral data only in 2005.
118 [http://ccsi.columbia.edu/files/2014/03/Profile- Russia IFDI 5 August 2012 - FINAL.pdf](http://ccsi.columbia.edu/files/2014/03/Profile- Russia IFDI 5 August 2012 - FINAL.pdf)
5. The Relationship between Putin’s Regime, Business, and Foreign Investors in Oil and Gas Sectors

5.1. Political Importance of Oil and Gas For Putin’s Regime

Skyrocketing energy prices strengthened Putin’s regime vis-à-vis the oligarchs and foreign investors. At the same time, rising prices made the regime dependent on the revenue the sector generated.\(^{119}\) Oil and gas came to dominate Russia’s exports. In 2008, they accounted for almost 70 per cent of export revenues.\(^{120}\) Whereas in 2001 oil revenue accounted for 6 per cent of Russia’s GDP, by 2005 this figure rose to 14 per cent.\(^{121}\) Oil generated more than half of all budget revenues.\(^{122}\) Even though the entire oil and gas sector became formally defined as “strategic” for the first time in 2008, the sector has been important politically and economically throughout Russia’s post-independence era. With the rise of energy prices, however, the level of “strategicness” only increased. As Soviet “legacy” oil and gas reserves are being exhausted, this dependence threatens Russia’s economic future.

Putin’s regime has been facing what Gustafson calls “Russia’s modernization dilemma”: although the officials view oil as a source of capital for transitioning to a high-tech innovation-based economy, they also view oil as a danger in itself. They are aware that energy dependence can be a “curse” and consider an economy based on oil and gas exports to be a sign of backwardness. Yet, it is very unlikely that Russia will be able to diversify its economy and overcome its dependence on oil in the near future. Putin’s regime has been unwilling to recognize that hydrocarbons will remain Russia’s main comparative advantage in the global economy.\(^{123}\)

Another problem has been regime’s reluctance to introduce the needed changes in the administration of the sector. Because the sustainability of Putin’s regime depends on the performance of oil and gas sector, the regime has been unwilling to “rock the boat.” At the same

\(^{119}\) For numbers on gas and its role in Russian economy, see Rudiger Ahrend and William Tompson, "Unnatural Monopoly: The Endless Wait for Gas Sector Reform in Russia," Europe-Asia Studies 57.6 (2005): 801-802.

\(^{120}\) William Tompson, “The Political Economy of Contemporary Russia,” in Routledge handbook of Russian politics and society 254. For every $1 per barrel increase in world oil prices, Russia’s export duties and production taxes yield an additional $1.9 billion to the state per year. See Gustafson, 360.


\(^{122}\) “Deputy Minister: Oil and Gas Sector Gives More than Half of Budget Revenues of the RF”. Nef’ Rossii, 21 June 2011.

\(^{123}\) Gustafson, 496.
time, the regime’s highest officials have regularly compromised the long-term future of Russia’s energy sectors for personal benefits obtained through direct state intervention. For example, the authorities have been unwilling to make the much-needed changes in the way Gazprom is managed due to their desire to exercise control over the company.\footnote{Interview with Andrei Nechaev, president, “Russian Financial Corporation” Bank, former minister of economy (1992-1993), Moscow, 9 December 2009.} The regime has been ignoring the task of expanding the resource base of the sector. It lacks an understanding of how the sector may develop in the long-term and is much more focused on solving the most immediate tasks on the agenda.\footnote{Interview with an expert, Moscow, 2009.} Instead of focusing on gas extraction, which has become increasingly expensive, the regime has been focusing on construction of pipelines that guarantee “uninterrupted chain of rent generation.” Pursuit of the regime’s political survival and of officials’ personal enrichment shape the present and the future of Russia’s oil and gas.

The regime’s unwillingness to take the problems of oil and gas sectors seriously jeopardizes the future of these sectors. Without substantial investment, oil and gas are unlikely to continue to generate the revenues needed for Russia’s economic development. In the future, oil and gas will need more and more capital since this investment has decreasing returns.\footnote{Interview with Kroutikhin Mikhail, Partner and Analyst, RusEnergy, Editor-in-Chief, The Russian Energy Weekly, 2 December 2009.} LUKoil’s vice president Leonid Fedun estimates that Russia’s oil sector will need about USD 1 trillion of investment in order to maintain the daily production of 10 million barrels during the next 20 years.\footnote{Oilru.com, 21 April 2010. For detailed analysis of the investment needs of Russia’s oil sector, see Woiciech Kononczuk, “Russia’s Best Ally: The Situation of the Russian Oil Sector and the Forecasts for Its Future,” OSW Studies 39, Warsaw, April 2012, 49-51. Available at \url{http://www.osw.waw.pl/sites/default/files/PRACE_39_en.pdf} (last accessed March 17, 2015).} In order to meet the demand for gas, Russia will need to invest approximately USD 18 billion into the sector annually until 2030.\footnote{Orttung, et al, 28.}

The regime so far has been unsuccessful in both providing investment to the oil and gas sectors and creating favorable conditions for investment by private companies. Gazprom has been buying assets with existing production rather than investing in new projects. The company’s gas production has been growing by less than 1 per cent annually.\footnote{Orttung, et al, 28.} Recent growth in gas production mostly took place due to efforts of independent gas producers and private oil...
companies. Rosneft’ faces a similar situation. After acquiring TNK-BP in 2013, it announced that it would take a $10 billion loan from TNK-BP – hardly a boost to the oil sector. Immediately after this announcement, TNK-BP’s shares dropped by 25 per cent.131

5.2. Private Companies and the Regime

As the purchase of TNK-BP by Rosneft’ suggests, control comes first for Putin’s regime. The regime is not concerned with the creation of value for a company, whether state- or privately- owned. Compared to the 1990s, private oil companies have become considerably less dependent on the Ministry of Energy. However, they are now even more dependent on the highest officials, whose view is that “the first obligation of the oil companies is to the state and the state budget, not to their shareholders.”132 This attitude limits companies’ growth and takes away incentives to invest.

The overwhelming presence of the state in the sector established an unequal playing field. Both officially and unofficially, the regime has been privileging state-owned and state-controlled companies.133 Gazprom and Rosneft’ have been the main beneficiaries of the 2008 Law on Strategic Sectors that effectively excluded all other players from working in the offshore.134 Gazprom and Rosneft’ are the most important players and the regulators of the sector at the same time. For example, Gazprom, which is set up as a JSC, has tight control over the sector’s infrastructure and information flows within it.135 The government eventually began considering changes to the legislation that awarded Russia’s offshore resources to Gazprom and Rosneft’ when it became clear that these companies would be unable to develop resources on their own. A resource in the hands of state-owned companies without the actual development of these resources would not be able to generate revenues for the regime.136 Private companies also cannot expect to compete on equal terms with those companies that are owned, as rumored, by the highest officials. For example, since approximately 2002, Surgutneftegaz, one of Russia’s

132 Gustafson, 493.
133 Read, for example, about the battles between LUKoil and Rosneft’ for Arkhangel’skgeodobyche, a company formed to develop the oil-rich province of Timano-Pechora. LUKoil lost out when it became clear that Putin was on the side of Rosneft’. See Gustafson, 333-336.
135 Ahrend and Tompson, 801.
key oil producers, has become less transparent, but also suspiciously favored by the regime. According to some sources, the head of the company Vladimir Bogdanov, who had acquired control over the company during loans for shares, “easily agreed to exchange his ownership for the role of hired general manager” as the company was too vulnerable to hostile takeovers at the time.\footnote{Vlamimir Milov, “Chastnyy Stabfond. Chto Stoit za Slukhami o Prodazhe Paketa ‘Rosneftii’ ‘Surgutneftegazu,’” \textit{Slon.ru}, 13 May 2015.}

Although initially the 2008 Law on Strategic Sectors was supposed to limit the activities of foreign investors, “by the time the final draft was approved it had turned into a weapon directed against all non-state actors,”\footnote{Gustafson, 434.} including domestic business. Companies such as Lukoil and TNK BP could not develop “strategic” fields offshore because the law reserved these for the state companies. For example, the Law made it difficult for Lukoil to extend its license for exploration of the Tsentral’noe field in the Caspian Sea because they are not a state company.\footnote{Interview with Vladimir Milov, director of the Institute of Energy Policy and deputy minister of energy (2002), Moscow, 25 November 2009.} In 2010, Sechin stated that LUKoil would be allowed to keep its right to explore the field at the same time as LUKoil agreed to create a JV with Gazprom and Kazakhstan’s Kazmunaigaz.\footnote{“Sovmestnoe rossiysko-kazakhstanskoe predpriyatie zaymetsya razrabotkoy mestrorozhdeniiia Tsentralnoe na Kaspii,” \textit{Vestnik Kavkaza}, 17 May 2012.} Another problem for domestic oil companies has been the fact that, according to the 2008 Law, Russian companies were considered “foreign” because they had foreign shareholders, whether or not those foreigners had any meaningful control over the company.\footnote{A.V. Stepanchenko, “Inostrannye Investitsii v Strategicheskih Inostrannykh Investitsiyakh,” \textit{Biznes, Management, I Pravo}, available at \texttt{http://www.bmpravo.ru/show_stat.php?stat=929} (last accessed in March 17, 2015).} Even the close friendship

\begin{itemize}
\item Access to the state-owned pipeline gives the regime a powerful source of leverage over oil companies. While oil producers have some limited independence, Gazprom continues to be the dominant player in the gas sector. Russia’s second largest gas producer Novatek unsuccessfully tried to challenge Gazprom’s monopoly over the export of Liquefied Natural Gas (LNG): the presidential administration stated that elimination of Gazprom’s monopoly over exports would endanger gas supplies to the domestic market.\footnote{“Gazprom Perekrivaet Gaz Novateku,” \textit{Izvestia}, 5 February 2013.}
\end{itemize}
between Gennadiy Tymchenko (who controls Novatek), and Putin did not help. Other independent gas producers have to cooperate with Gazprom or its regional subsidiaries.\textsuperscript{143}

Taxation remains one of the most contested issues between private oil companies and the state. The Russian taxation system consists of export and production taxes (the latter known as NDPI in Russian), both of which depend on world oil prices and are based on gross revenues rather than profits. A weak state with underdeveloped bureaucracy adopted this taxation system in order to capture maximum export revenue. Yet, this system removes incentives to invest in new production since increasing production costs have no effect on the amount of tax a company has to pay. A series of half-measures aimed at stimulating investment into upstream that followed consultations between the government and private oil companies are also unlikely to create favorable investment climate for domestic and foreign oil producers.\textsuperscript{144}

Both the fiscal and regulatory systems of the hydrocarbons sector “originated in a policy environment in which state bureaucrats believed the oil industry enjoyed an unlimited resource base and inexhaustible rents and that the central imperative of state policy was therefore to re-establish control – of the rents and of the industry’s practices.”\textsuperscript{145} The regulatory system is very complex as it developed over time and without one vision. Streamlining did take place as part of the regime’s efforts to regain control: now only one, federal, level of government makes decisions as opposed to both federal and regional, as was the case before. Overall, however, the system suffers from poor coordination, interagency conflicts, and resistance to change. The three main ministries that regulate the sector – the Ministry of Natural Resources, the Ministry of Economic Development, and the Ministry of Energy – have swollen in size along with Putin’s “strengthening” of the state. Their powers to “investigate and prosecute” increased in order to ensure state control, yet to little positive effect.\textsuperscript{146} In reality, these ministries do not have the power to decide. Putin and Sechin make the most important decisions regarding the sector.\textsuperscript{147} The highest officials have resisted changes to the sector even when there is consensus about the need for changes. For example, the licensing system requires reform as the 2008 Law took away incentives from private companies, both Russian and foreign, to look for new fields. Even if a

\textsuperscript{143} Ahrend and Tompson, 804.
\textsuperscript{144} Gustafson, 379-381.
\textsuperscript{145} Gustafson, 409.
\textsuperscript{146} Gustafson, 390-391.
\textsuperscript{147} Interview with a foreign investor, Moscow, 19 November 2009.
company discovers a new field with “strategic” reserves, current legislation does not guarantee
the right to develop the field.\textsuperscript{148} The company that discovered the field is entitled to
compensation from the state yet usually this sum is too small to cover the cost of exploration.\textsuperscript{149} The
strengthening of the state has served to strengthen the power of the regime and to enrich the
political elites personally, yet there is little trace of “post-Soviet developmentalism” in the
making.\textsuperscript{150}

6. Policy Regarding FDI in Oil and Gas

After energy prices began rising, international energy companies considered Russia the
place to be since the country had abundant resources that needed extensive capital investment
and technological upgrade. Many Western oil companies required access to these deposits in
order to maintain long-term growth.\textsuperscript{151} In Russia, there have been both successes and failures,
which were to a large extent determined by Putin’s regime’s attitude toward FDI and, at least
initially, by the interests and ambitions of domestic Russian companies and their power vis-a-vis
their domestic government.

For Russian business owners, the main appeal of integration with western oil companies
has been the possibility of exposure to global markets. Many needed foreign partners for access
to capital and technologies, especially those companies that planned to pursue new projects in
remote areas with poor infrastructure.\textsuperscript{152} Integration with Western oil companies also served as a
form of legitimization – Russian companies have been striving to become more “normal” outside
Russia even if still facing legitimacy issues at home. However, as the “Yukos affair”
demonstrated, global integration cannot compensate for lack of legitimacy at home.

After the first decade of independence, marked by the struggle for acquiring assets,
domestic Russian companies began discovering that in order to grow, they needed not only to
increase production but also raise the price of their shares by making their companies more
attractive to global markets.\textsuperscript{153} Some showed interest in attracting foreigners as partners. One of

\textsuperscript{148} Interview with Kroutikhin Mikhail, Partner and Analyst, RusEnergy, Editor-in-Chief, The Russian Energy
Weekly, 2 December 2009.
\textsuperscript{149} For detailed analysis of the problem, see “Konfiskatsionnoe Investirovanie,” Kommersant, 21 November 2012.
\textsuperscript{150} See Wengle, 75-114.
\textsuperscript{151} Interview with an expert, Moscow, 2009.
\textsuperscript{152} Interview with a former senior official from the Ministry of Energy, Moscow, 16 December 2009.
\textsuperscript{153} Gustafson, 417.
the first partnerships was the TNK-BP JV between BP and the Russian consortium AAR, which employed approximately 50,000 people and worked in almost all Russia’s regions that are rich in hydrocarbons. The JV became the third largest vertically integrated oil and gas company. From 2003 to 2012, it generated over $55 billion of net profit. The use of advanced technologies allowed TNK-BP to increase its own production by 40 per cent. 154 The long-term partnership ended however because the two sides fought for control over decision-making. They also disagreed about the JV’s long-term development: BP wanted TNK-BP to focus on projects within Russia (it was not interested in growing a competitor externally). In contrast, Russian co-owners of TNK-BP were interested in expanding the JV abroad. 155 ConocoPhillips also bought the government’s remaining 7.6 per cent of shares in LUKoil for $2 billion in 2004. The two companies then created what they referred to as a “strategic alliance.” ConacoPhillips increased its stake to 20 per cent in 2006. As a result, Conaco gained a foothold in the Russian oil sector while Lukoil welcomed integration with a global company. These are the relative success stories of FDI in Russian energy sector. Both of them were initiated when oil prices had just begun rising. However, after the regime bankrupted Yukos and policy changed, the cooperation between Lukoil and ConacoPhillips in some sense stalled too. 156

Putin’s regime gained the upper hand over both domestic business and foreign investors. As one of my interviewees put it, “the higher the [energy] price, the nastier they [Russian government] are and more open about it.” 157 A number of my interviewees spoke about the oil and gas price as the main factor shaping the attitude of Russian government towards foreign and domestic investors. In the early 2000s, when oil and gas prices began to grow, the government was reluctant to let foreigners in since they were afraid to under-sell the resources. 158 Policy toward FDI was based on the desire “to put up a fence and keep stealing behind it.” 159 Until the global financial crisis hit Russia in 2008, Putin’s regime “behave[d] as if did not need investment and to the degree it did, it wanted it on very limited and well-defined terms.” 160 The regime not

---

155 Interview with an expert, Moscow, 2009.
156 Interview with an expert, Moscow, 2009.
157 Interview with a foreign investor, Moscow, 19 November 2009.
158 Interview with an expert, Moscow, 2009.
160 Interview with a foreign investor, Moscow, 19 November 2009.
only defined the general terms of investment for these sectors but also interfered in the daily operation of projects. Gaining and (re)-gaining control over natural resources has been the main goal. A large portion of foreign capital entered Russia in the form of loans, which left control over projects in domestic hands. Because of this restrictive attitude toward FDI, Western MNCs have so far played a minor role in oil exploration and development. Foreign companies have been responsible for only 12 per cent of Russia’s oil production. Whereas the developmental states of East Asia helped those countries to establish their private companies, the Russian government has been undermining its privately owned companies. Paradoxically, interest by a state-controlled company like Gazprom or Rosneft in a project often leads to a reduction of its value as it increases the risk that a company will be pressured to let Gazprom or Rosneft “in.”

The state itself became an investor in the sector: between 2003 and 2007, its share of overall investment grew from 24 to 43 per cent. The government considered ownership to be the best means of control. As a result, state-owned and state-controlled corporations forced themselves into projects with foreign investors. Sometimes they pushed foreign investors out. Foreign investors could only be project operators and minority partners, who served as financial donors and brought in technology but did not make important decisions about development of a resource. The 2008 Law on Strategic Sectors put Russian state companies into the best position to form partnerships with foreigners. These companies have the political connections that are crucial for the success of a project. This is similar to Kazakhstan where Nazarbaev’s regime pushed the state oil and gas company into projects with foreigners.

Although initially Putin supported PSAs as “strategic priority,” rising oil prices ended the long-term debate about the benefits of PSAs for Russia. Oil money could come much faster if the state was a direct participant in a project and if it did not have to wait for foreign investors to recoup their costs. PSAs also did not allow the regime to establish effective control over a

---

161 Pappe, 111.
162 Gustafson, 415.
164 Routledge handbook of Russian politics and society 299.
166 Interview with an expert, Moscow, 2009.
For example, Gazprom had been initially considering allowing one of the five leading Western energy companies to obtain a 49 per cent share in the development of the Shtokman gas field but in the end decided to do it all alone. This was a large surprise to these companies, which were not even informed officially that none of them would be able to take part in the project. The management explained that they considered development on Shtokman on the terms of the PSA to be highly un-attractive as they did not want to share gas with foreigners. At the same time, a number of experts pointed out that Gazprom was unfit to develop the field on its own.

The government put continuous pressure on Shell, the operator of Russia’s first PSA Sakhalin-2, over environmental violations and escalating costs of the project. These two issues subsequently served as a pretext for redefining the terms of other foreign-operated projects. The initial PSA stipulated that the Russian government would receive its first share of oil after the consortium had recovered development costs and gained a 17.5 per cent return on its investment. Shell’s announcement that its project costs doubled from $10 bln to $21 bln was thus not received well. Oleg Mitvol, deputy head of Rosprirodnadzor, the Environmental Watchdog of the Ministry of Natural Resources (Minprirody), threatened to levy a $50 bln fine, jail the project’s managers for up to seven years, and file a lawsuit against the consortium in international courts for environmental damage. The pressure campaign worked: Shell’s share in the project was eventually reduced from 55 to 27.5 per cent. The shares of Shell’s partners also decreased. Gazprom received 50 per cent plus one share in the project. In the meantime, the government’s environmental concerns subsided. Total and StatoilHydro, the two foreign companies working on the Kharyaga PSA, also had tense exchanges about cost overruns with the

---

167 Interview with an expert, Moscow, 2009.
172 Mitsiu’s share declined from 25 per cent to 12.5 and Mitsubishi’s share fell from 20 to 10 percent.
government. The Minprirody publicly contemplated the possibility of revoking their licence. In the end, state-controlled Zarubezhneft’ obtained a 20 per cent stake in the project.174

Another way to establish control was to make a project economically unsustainable. The most effective means was to deny or limit access to the export pipeline, i.e. the same source of leverage that has been used against domestic companies. For example, TNK-BP had to sell Rusia Petroleum, which had a license to develop the promising Kovykta gas field in 2011 for $770 million, considerably below its estimated market price.175 For years, Gazprom had refused to grant TNK-BP access to its export pipeline insisting that gas from the field go to the local market instead. TNK-BP argued that the local market was too small to justify production and wanted to export gas to China. When the conflict led to a stall in production, TNK-BP risked losing its license because of the failure to meet production targets. After the sale of Rusia Petroleum, Gazprom officials boasted that the reserves of the field were big enough to single-handedly satisfy the world’s gas needs for eight months.176 It is not clear why they expected TNK-BP to limit themselves to providing gas to scarcely populated Siberia. Similarly, the government also pressured Exxon-operated PSA Sakhalin-1 to sell all of its gas to Gazprom at fixed domestic prices in order to fill in the newly built pipeline from Sakhalin through Khabarovsk to Vladivostok.177 Exxon had been planning to sell this gas to China instead. As a result, Sakhalin-1 did not sell any gas for years – hardly a win for the Russian government.178

High oil prices have been the main factor keeping foreign oil majors in Russia despite the unfavourable investment climate. Their resources elsewhere were close to depletion and many of them had no choice but to work in Russia on the conditions offered by the Russian government if they wanted to maintain production.179 The head of BP’s Russian division David Peattie noted that he was “…optimistic [that] we will have a future here. I just don’t know yet what that future

174 Despite all the threats and negative publicity about the Kharyaga PSA, the actual fine was minimal – the government presented Total with a fine of $1,150 for minor safety violations. See Krysiek, 6.
175 Some analysts have estimated the value to be $2 billion. See “Gazprom Wins Long Kovykta Battle Over TNK-BP Gas,” The Telegraph, 2 March 2011.
178 “Minenergo Zastavlyet ‘Gazprom’ Prodats Gaz s Sakhalina-1,” Izvestiia, 14 December 2012. Sakhalin-3 had its share of problems. See, for example, Barnes, 54.
179 Interview with an expert, Moscow, 2009.
looks like.”180 After all, BP’s Russian JV was very successful: once the company had made its initial investment of $8 billion in 2003, BP received $19 billion in dividends, which accounted for a quarter of BP’s production and a fifth of its reserves.181 Investment into Russia has not been equally successful for all foreign companies. For example, Statoil had to write off its $336 million investment into the Shtokman gas field and transfer its 24 per cent share to Gazprom after it failed to agree on the field’s development with the Russian government.182 The whole project was put on hold since it lost its original European market to US gas producers and became economically non-viable.183

Given that energy prices tend to fluctuate, Russia cannot rely on maintaining its leverage over foreigners in the long-run, which makes the regime economically and therefore politically vulnerable.184 The tone of the government changed over the course of the 2008 financial crisis that resulted in a temporary drop in oil prices. Although initially offshore fields were to stay out of foreigners’ reach,185 officials began discussing legislative changes needed to give foreign investors a stake in the development of the shelf.186 In 2011, in the presence of Vladimir Putin French Total and Russian NOVATEK agreed that the foreign investor would acquire 12 per cent of Russia’s gas producer with the possibility of acquiring total 19.4 per cent of shares within three years.187 This deal would give Total a seat in NOVATEK’s board of directors and a 20-per cent share in the Yamal gas project in the Arctic – a way to have a modest say in the control of the strategic sector that sustains it in power as long as possible.

In 2014, Putin’s regime annexed Ukraine’s Crimean peninsula and began supporting rebels in Eastern Ukraine, which led to Western-imposed sanctions that hurt Russia’s oil and gas sector. Until then, foreign investors could remain optimistic that Russia would remain moderately open to FDI for two main reasons. First, in the long-term Russia needs foreign investors as a source of capital, technology and expertise as it begins to tap energy resources

180 Guy Chazan, “BP Faces End of Road In Russia,” The Financial Times 1 June 2012.
185 Gustafson, 403.
located in distant and undeveloped territories. In 2012, Gazprom formed a partnership with Shell to develop the Russian Arctic. Rosneft’ signed its own deal with ExxonMobil, Statoil, and Eni to explore offshore fields in the Arctic. A “statist,” Igor Sechin played a key role in fostering this alliance. As the Soviet-era “legacy oil” and “legacy gas” are coming close to being exhausted, Russia will need to involve foreigners if it wants to raise extraction levels and tackle resources in under and un-developed areas.

Second, cooperation with foreigners and foreign ownership in Rosneft’ and Gazprom is likely to raise the stock value of these companies. If indeed the highest officials own these companies, they may be interested in seeing this happen. At a meeting with heads of energy companies in St. Petersburg in 2012, Putin stated that Russia would attract foreign investors into its oil sector in return for Russian companies’ investment abroad “on an equal footing and without discrimination.” Swapping of assets, foreign investment into Russia and Russian investment abroad would “strengthen global energy security and stability.” Cooperation with foreigners could also help the silovarchs cash in on their investments. Russian officials did not object to foreign ownership per se as long as foreign investors entered on the terms defined by the former and Russian officials did not have to surrender control to the outsiders. Regaining control over strategic assets of Russia’s economy has been the main achievement of Putin’s regime.

A number of examples suggest that Russia, in fact, was cautiously open to foreign investors under Putin. In 2006, Rosneft had its IPO: 15 per cent of shares were offered on the Russian Trading System and the London Stock Exchange. In 2013, Rosneft’ bought out BP’s half in TNK-BP for nearly 55 billion USD. It had acquired the remaining 50 per cent from the Russian owners of the JV. Rosneft had to borrow almost 40 billion USD from Western banks to finance the deal with BP. The remaining 15 billion it owed to BP were paid for by giving BP a

---

189 Gustafson, 493.
191 For example, Igor Sechin pointed out that he was disappointed by the fact that, according to him, Rosneft’ was undervalued by the markets in the aftermath of its purchase of TNK-BP. See Ekaterina Skobitskaya, “Sechin: “Rosneft”’ Ivano Nedootsenivaut,” DP.ru, 23 April 2013.
193 21 per cent of these issues shares were bought by BP, the China National Petroleum Company, and Petronas. International portfolio investors bought the rest. See Russian Federation: Strengthening the Policy Framework for Investment 30.
nearly 20 per cent ownership in Rosneft. The deal made Rosneft the largest (in terms of production volume) oil company in the world.\textsuperscript{194} The regime likely calculated that this goal was worth the price of foreign ownership in Rosneft.\textsuperscript{194}

In the gas sphere, German E.ON. had been Gazprom’s most important foreign investor. It began acquiring Gazprom’s shares in 1998 yet did not have any meaningful control over the company at the time.\textsuperscript{195} The Gas Supply Law that limited Gazprom’s foreign ownership to 20 per cent created obstacles to Gazprom’s capitalization. The removal of the “ring fence” promised to turn Gazprom into one of the largest companies in the world (in terms of market capitalization) and also to make some influential Russians very rich.\textsuperscript{196} As soon as the regime gained control over Gazprom by obtaining 50.002 per cent in the company, it lifted restrictions on foreign ownership in Gazprom.\textsuperscript{197}

As the war between Russia-supported rebels (and, according to numerous accounts, Russian troops) and Ukrainian soldiers is still going on and sanctions have been imposed, including those that target specifically the oil and gas sector, it is difficult to explain with certainty why Putin’s regime decided to go forward with the war despite the political and economic costs. Energy prices have been falling since 2014 and have significantly affected the Russian economy. Some experts have suggested that Putin launched the war against Ukraine and the (ideological) war against the West to compensate for the inadequacies of economic policy-making under Putin that have now put Russia’s economy under significant strain and have endangered the regime. If so, and given that the sanctions significantly hurt the interests of Russia’s oil and gas sector, the regime has been willing to exchange the long-term future of the sector for its political survival.

\textsuperscript{194}“Rosneft’ Pays Out In Historic TNK-BP Deal Completion,” Reuters, 21 March 2013.
\textsuperscript{196} Gustafson, 339.
\textsuperscript{197} Pappe, 170-171.
7. The Relationship between Putin’s Regime and Domestic Business in Metallurgy and Mining Sectors

Metallurgy and mining is a key economic sector responsible for approximately 5 per cent of Russia’s GDP, 18 per cent of industrial production, and 14 per cent of exports. Metallurgy accounts for 5 per cent of tax revenues in federal and regional budgets. The government officially refers to it as “bazovaia otrasi’” (an essential sector) that gives Russia an advantage in the global distribution of labor. Russia produces approximately one third of the value of all European metals and mining. The 2008 Law on Strategic Sectors identified geological surveys of subsoil and/or prospecting for and extraction of minerals in subsoil plots of federal importance as strategic. The Law restricts foreign investment into production of metals and metal alloys that are used by the army. Although very important, the metallurgy and mining sector has lower political significance than oil and gas since it brings in considerably less budget revenue. This factor has shaped the government’s attitude toward the sector.

By the time Putin came to power, Russia’s metallurgy sector was largely in private hands. Drastic changes to ownership patterns did not immediately follow. Even in 2007, when expansion of state ownership had long been underway in other sectors, the state still owned only 3 per cent in metallurgy and mining (compared to 47 per cent in oil). After fierce competition for assets in the sector of the 1990s, ownership became consolidated. In 2006, RUSAL and SUAL created the giant Russian Aluminium, the world’s leading producer of primary aluminium. Most certainly, “this [deal] would have not happened if it had not been sanctioned from above.” The official attitude of state officials toward metallurgy and mining was

198 Within the mining and metallurgy sector, iron and steel in 2009 were responsible for 58.5 per cent of the sector’s value; precious metals and minerals were responsible for 15.3 per cent; coal – 12.3 per cent; base metals – 8.6 per cent, and aluminium – 5.3 per cent. See “Metals and Mining in Russia.” 2010. Available at www.datamonitor.com
199 See, for example, Strategia razvitiia metallurgicheskoy promyshlennosti Rossiiskoy Federatsii na period of 2015 goda adopted in July 2007.
203 These are the numbers based on capitalization. See Liuhoto, 9.
204 Interview with an expert, Moscow, 2009.
rejection of interference while also provision of some assistance in solving international issues.\textsuperscript{205}

After 2001, metal prices began rising, mostly due to China’s spectacular growth accompanied by investments in infrastructure, which in turn created demand for metallurgical products. The sector was booming.\textsuperscript{206} Production increased by 10-35 per cent for a whole range of products compared to 2000. Profits and exports more than doubled.\textsuperscript{207} Unlike the 1990s, shortage of capital was no longer an issue. A large number of enterprises began drawing funds from the Initial Public Offerings (IPOs). The oligarchs’ personal fortunes grew too. Out of 33 Russians who made it to Forbes’ list of billionaires in 2006, 15 came from metallurgy and mining. By comparison, oil and gas produced 12. By 2008, mining and metals had 20 billionaires.\textsuperscript{208}

After a decade of asset stripping, owners began investing in production. During 2000-2008, annual investments in reconstruction and modernization increased by nine times.\textsuperscript{209} As a result, the level of depreciation of the main funds decreased from 54 per cent in 2000 to 43 per cent in 2010.\textsuperscript{210} Although Putin praised metallurgy for investing in modernization,\textsuperscript{211} the regime itself did not actively facilitate it. As with oil, state officials were primarily concerned with collection of tax revenues from the sector, not with fostering the sector’s growth.\textsuperscript{212}


\textsuperscript{208} Rutland, 1063.

\textsuperscript{209} “Metallurgiya v novykh usloviakh.” Promyshlennik Rossi, March 2012. Available at \url{http://www.promros.ru/magazine/2012/mar/340.phtml}.


\textsuperscript{212} As Vladimir Lisin pointed out during the 2012 meeting between representatives of the sector and the government, representatives of the state tax administration used to tell metallurgical companies in 2005 that the companies would be investing no matter the tax rate. Any tax reductions would simply mean less revenue for the state. See “Soveshchanie o sostoyanii i perspektivakh razvitiia chernoi metallurgii.” 16 June 2012. Transcript available at \url{http://www.kremlin.ru/transcripts/16000} (last accessed February 13, 2015).
The prospects for Russia’s mining and metallurgy seemed so good that after 2000 the sector began internationalizing by purchasing assets all over the world. Evrazholding acquired Vitkovice Steel in the Czech Republic and several plants in Italy, the USA, Canada, and South Africa. Severstal’ bought Technologie Buczek in Poland and a number of steel plants in the US, which made it one of the largest steel makers in the US. Three Russian companies (Noril’sk Nickel’, Alrosa, and Metalloinvest) made it into the list of the world’s thirty largest companies in the sector. Expansion abroad led some to believe that “[t]he metals sector may see some assertion of state control, but it contains rising multinationals that are—whether deliberately or not—acquiring a role beyond Russia’s borders that the state could not easily take over.” Internationalization of oil companies did not protect them from their own government, yet metallurgy, at least for some time, seemed to be different: due to its less “strategic” status and excellent prospects for international growth, it seemed to have had more room to maneuver. The regime gave metallurgy over to selected domestic oligarchs, allowing the latter some visibility of decision-making in exchange for political loyalty.

Similarly to oil and gas, metallurgy and mining are highly dependent on world market prices that tend to fluctuate. A steep decline followed years of rising metal prices as demand for almost all metals shrank due to the 2008-2009 economic crisis. The effect of the crisis became evident immediately. All expansion that took place before the financial crisis suddenly became a burden. Purchases of assets abroad before the crisis meant heavy indebtedness. Russian companies struggled to pay back these loans, many of which were short-term. Some even had to subsidize the work of foreign affiliates through their production within Russia: for example, Severstal’ North America reported an after-tax loss of $373 million whereas the domestic

---

215 Mechel struggled the most since it had short-term credits to pay back: “Mechel nameren privlech’ kredit bez pomoshchi gosudarstva,” RBC.ru, 30 January 2009.
division had a profit of $1.9 billion. It became evident that for many Russian metallurgists, the only way to survive was to turn to the state for help.

Although the regime did not intervene in metallurgy before the crisis to the same extent as it had in oil and gas, big business in the former did not have much freedom. Metallurgy and mining has been “one of those sectors where you know that in reality don’t even dream of doing anything unless a firm blessing or approval from the very top.” Even though there is some variation in terms of the political importance of the sector across its subsectors (steel may be less sensitive while precious metals are highly sensitive; other metals are in somewhat of a grey area), overall the sector has been under the strict control of the regime. Its big companies do not make any steps without consulting the government. Even though there are no state companies operating in the sector, the “level of government influence over large companies of the sector is absolute.”

The government also undermined the companies indirectly: the ambiguous relationship between Russian business and the regime hurt companies in their quest for global status since outsiders doubted the ability of Russian companies to make independent decisions about their development. According to one interviewee, none of those companies make their own decisions on big strategic foreign investment questions.

In the course of the 2008 crisis, the state became the sector’s most important source of capital, which intensified its dependence on the regime. In October 2008-2009, the government offered $9.78 trillion as assistance to the largest companies. The power of the regime increased even more than before the crisis: it could now provide assistance and “save” the companies or it could declare liberalization and let the “market” (or rather, pure luck) decide who would survive.

---


217 According to Vedomosty.ru, the final list of companies to receive state assistance during the crisis included 32 companies from metallurgy and the primary sector. See Ivatinskaia Nadezhda, “The List of Companies Guaranteed Assistance from the State Is Published,” Vedomosti, 26 December 2008 (taken from David Johnson’s Russia List).

218 Interview with a foreign investor, Moscow, 4 December 2009.

219 Interview with a foreign investor, Moscow, 4 December 2009.


221 Shokhin Aleksandr, President of the Russian Union of Industrialists and Entrepreneurs, presentation at the Higher School of Economics, 14 December 2009.

222 Interview with a foreign investor, Moscow, 4 December 2009.
and who would not.\textsuperscript{223} The main vehicle for delivering assistance was the state corporation Vneshekonombank, which provided state guarantees for loans acquired by Russian companies from international lenders.\textsuperscript{224} The government promised to prioritize assistance to companies that re-focused their work from external to domestic market and reduced export dependence.\textsuperscript{225} In exchange for emergency assistance, the regime strengthened control by sending its representatives to companies’ boards. For example, in December 2008, Nornickel’ expanded its board of directors from nine to thirteen people. The four new seats were offered to state representatives, which gave the regime substantial control over the company.\textsuperscript{226}

Owners of metallurgical companies contemplated (on their own or with prompts from the government) the possibility of merging some of the sector’s main assets into a single holding with state ownership in order to reduce their indebtedness to the state. This deal would have turned the state into a major owner in the sector. Interros’s Vladimir Potanin presented the proposal at a briefing with deputy PM Igor Sechin in early 2009. Mass media reported that Sechin supported the idea.\textsuperscript{227} Noril’sk Nickel, Metalloinvest, Evraz, Mechel, and Uralkaliy were to participate in the project.\textsuperscript{228} The debt owed by Russian metallurgical companies to the state was to be converted into state shares in the holding company giving the state control over it.\textsuperscript{229} As the \textit{New York Times} put it, the oligarchs were essentially “voluntarily proposing to reverse the contentious loans-for-shares privatizations that birthed [them] in the mid-1990s.”\textsuperscript{230} To some of them, partial surrender of control to the state likely seemed a better option than losing full

\textsuperscript{224} For discussion of other measures of state assistance to the sector, see http://v2009.minprom.gov.ru/activity/metal/news/87.
\textsuperscript{226} Oleg Deripaska and Vladimir Potanin put 45 per cent of Norilsk Nickel’s shares as collateral for loans from the state-affiliated banks (the VTB and VEB). The state in its turn put its representatives on board of the company. See: “Sozdanie metallurgicheskogo kholdinga razmoet doli minotariev GMK.” Rbc.ru, 14 January 2009. Available at http://top.rbc.ru/finances/14/01/2009/274005.shtml (last accessed February 13, 2015).
\textsuperscript{227} “Sozdanie Metallurgicheskogo Kholdinga Razmoet Doli Minotariev GMK,” RBC.ru, 14 January 2009.
\textsuperscript{228} Hanson offers a detailed discussion of how this was to be done: \textit{Russia as a network state: what works in Russia when state institutions do not?}, ed. Vadim Kononenko and Arkadi Moshes ([Helsinki, Finland]: Ulikopoliittinen Instituutti, 2011) 126. There were different lists of participants, neither of them final.
\textsuperscript{229} Hanson offers a detailed discussion of how this was to be done: \textit{Russia as a network state: what works in Russia when state institutions do not?}, ed. Vadim Kononenko and Arkadi Moshes ([Helsinki, Finland]: Ulikopoliittinen Instituutti, 2011) 126. There were different lists of participants, neither of them final.
Another possibility is that the companies that promoted creation of the holding wanted to use this structure as a channel for receiving state money, subsidies, and other forms of preferential treatment by the state. Essentially, the holding was to function similarly to state corporations. For some companies, the debt was too big to allow long-term development.

The idea of creating a state holding was abandoned by summer 2010. After the worst crisis was over, the regime declared that private metal companies needed to solve their problems on their own. The cash-strapped government may have become “wary of investing in troubled industries” or simply did not have enough resources. Many analysts and some government officials pointed out that the creation of a metallurgical giant made no economic and technological sense since it would have combined a large number of various assets into one structure. Since metallurgy was not “strategic” politically, the government may have considered it not worth it to take an enormous risk upon itself. What is clear is that the current regime lacks a coherent policy towards metallurgy and mining, not just oil and gas. Instead, the “policy” is heavily influenced by “alliances between particular officials and particular tycoons … [which are likely to be] competing above all for control of assets.”

Besides provision of capital, the government has exercised control by shaping the cost of inputs. In this respect, metallurgy is not very different from other sectors. For example, state-subsidized prices for railroad transportation, electricity, and gas decrease production costs for metallurgy. According to Severstal’s Vadim Makhov, Western-level prices of electricity, transportation and human resources would have made Russian companies uncompetitive due to lower production efficiency.

Oligarchs’ dependence on the state and the nature of the sector make it a good setting for the regime to demonstrate its “human face” and score additional points with the population. Since the metallurgical sector is a large employer, and often the only employer in Russian towns,

---

233 Russia as a network state: what works in Russia when state institutions do not? 127.
236 Interview with an expert, Moscow, 2009.
decisions by metallurgical companies have serious social repercussions. For example, in May 2009, workers shut down the federal highway in Pikalevo, a small town close to St Petersburg, because Oleg Deripaska had stopped production at his concrete-producing plant. Deripaska blamed high input prices for the closure. In a widely broadcast meeting in Pikalevo, Putin reproached Deripaska and the head of Fosagro, the supplier of Deripaska’s concrete-producing plants, for “excessive ambitions, lack of professionalism, and perhaps simply greed” and forced them to sign an agreement about supplies in his presence. The most memorable moment of the meeting was when Putin reminded Deripaska to return the pen the latter had borrowed from the President, yet again reinforcing the image of the oligarchs as thieves. This was perhaps metallurgy’s very light version of the “Yukos moment” when the regime publicly asserted itself against a specific oligarch. However, unlike Khodorkovskiy, Deripaska quietly obeyed. In exchange for the “sticks” in public, Deripaska received “carrots” from the Kremlin in the form of generous assistance during the crisis. Public humiliation of the oligarch “worked” for the regime: according to anecdotal evidence, after Putin’s interference in the conflict, presidential portraits were sold out across the town’s shops.237 The move reinforced Putin’s popularity more broadly, especially because Deripaska is regarded as Putin’s “favourite” among the oligarchs. The New York Times reported that the majority of Pikalevo’s population hoped that Putin would announce the nationalization of the plant, which underscores the on-going problem Russian oligarchs have with obtaining legitimacy in the eyes of the Russian population and securing their property.238 In another well-known case, in July 2008 Putin publicly mentioned that Mechel, one of Russia’s leading metals and mining companies, could face problems with the Federal Anti-Monopoly Agency and the Prosecutor’s Office because of its pricing policies.239 The value of Mechel’s stock at the New York Stock Exchange immediately went down by 38 per cent – an indication that international investors took the threat seriously.240 Putin’s regime continues to reap the fruit of the Yukos affair, which demonstrated that the regime could and would destroy a company in order to assert its strength. In doing so, it relied on force rather than power. Therefore, Putin’s Russia is hardly a developmental state in the making.


239 Similarly, Igor Sechin managed to reduce Uralkaliy’s value by 60 per cent by threatening the company with hefty fines, which could mean change of ownership: Levy, Clifford J. “In Hard Times, Russia Tries to Reclaim Industries.” The New York Times, 7 December 2008.

8. Policy regarding FDI in Metallurgy and Mining

During Putin’s presidency, metallurgy and mining attracted a fair share of FDI. In 2010, the inward FDI stock into basic metals and metal products (except machinery and equipment) was USD 21,154 million, or approximately 18 per cent of the total FDI stock. Foreign companies, such as ArcelorMittal, BHP, and several Chinese companies expressed interest in investing. Both the government and domestic metallurgical companies have been shaping Russia’s policy regarding FDI. Whereas the government wants to retain control over an important sector, the oligarchs aim to preserve maximum ownership and control over assets without the involvement of foreign investors whenever they can afford to do so.

After consolidation of ownership and the rise of metal prices, Russian metallurgical companies did not need FDI because they could now finance modernization and technical re-equipment from other sources. In 2005, their export revenue was double the level of 2000. In 2007, export revenues were already three times higher than in 2000. During 2005-2012, fifteen metallurgical companies underwent IPOs, which was more than in any other sector. These IPOs were not very successful as a means of raising money since companies were unwilling to offer substantial packages of shares for public trading fearing loss of control. The IPOs became more of a “status factor” that helped to build up the companies’ image rather than provided capital. Many companies preferred to acquire debt rather than sell shares in order to retain control. For example, Deripaska’s Rusal borrowed $11 billion; Mechel borrowed $9.5 billion, and Severstal’ borrowed $9 billion. Even after the crisis, Russian companies were issuing bonds instead of letting FDI in.

---

242 Humphreys, 9.
245 Norilsk Nickel’ was probably an exception when it had a free float of around 45 percent, with approximately half of these shares being traded in western markets. Humphreys, 16
246 Interview with an expert, Moscow, 2009.
The ability and determination of Russian metallurgical companies to develop without inviting foreign partners in limited the amount of FDI that went into the sector, where there were even fewer equity purchases than in oil and gas. Opportunities to buy assets only became available when Russian owners wished to sell the assets they had acquired in the 1990s. For example, Alcoa purchased two plants from Oleg Deripaska in 2005. ArcelorMittal bought three Siberian coalmines from Severstal’ in 2008. Before that, ArcelorMittal had tried to enter a number of projects yet lost out to Russian competitors.  

Negotiations with the government have been the first step for interested foreign investors. For example, during a meeting with Russia’s Minister of Natural Resources Yuri Trutnev, BHP Billiton representatives expressed interest in every area where the Russian authorities would allow them access. Trutnev responded by offering foreigners to develop the Udokan copper field if they formed a JV with a Russian company. The JV that was formed with Nornickel’ gave BHP Billiton 50 minus one share. Those who were willing to leave control over a project to Russians could come and work in Russia.

Whenever Russian mining companies could not ensure development on their own, they formed JVs. Mining is similar to oil extraction in that it requires advanced technologies and high capital investments upfront if a resource is not yet developed. This is different from metallurgy where the infrastructure has been in place since the Soviet times. In April 2006, Noril’sk Nickel’ and Rio Tinto formed a JV, RioNor Exploration, to examine opportunities in Southern Siberia and in the Far East. Noril’sk Nickel received 51 per cent in the JV while Rio Tinto obtained 49 per cent. Afterwards, Noril’sk Nickel’ formed a JV with Rio Tinto’s competitor BHP Billiton to extract resources in the North West of Russia and Western Siberia. The JV between Noril’sk Nickel’ and BHP gave foreigners 50 per cent minus one share leaving control in the hands of the Russian company. Russian analysts suggested that Noril’sk Nickel’ needed cooperation with BHP in order to secure technologies and expertise to develop new projects. The level of sector’s development therefore continues to influence policy choices toward FDI. The JV with Rio Tinto ended in four years after the Russian company declared that it wanted to focus on their

“local concerns.” Plans to explore the Syradasaiaskoye coal deposit in the Arctic through a JV with BHP also came under review. While closing off opportunities for foreigners within Russia, Nornickel’ agreed to cooperation with BHP in Australia. Similarly, although Russian Magnitka eschewed foreign capital at home, it established a JV in Turkey and a greenfield shield plant for the car industry in the US. While cooperating with foreign companies outside Russia, within Russia the goal of retaining control seems to be paramount.

An example of a bigger-scale project with foreigners was the attempted merger of Russia’s Severstal’ and Luxemburg-based Arcelor. In 2006, two companies reached a preliminary agreement that would have given Severstal’ and Arcelor respectively 32 and 68 per cent in the new entity. At the end, Arcelor rejected the deal and merged with the steel giant Mittal (now ArcelorMittal). The Luxemburg company may have used Severstal’ to enhance its negotiating position with Mittal. It is interesting, however, that Severstal’ was willing to go ahead with the merger and that the Russian government officially welcomed the merger. Although the government has not interfered with the work of domestic metallurgical companies to the same extent as with oil, its approval has been mandatory for any major deal involving foreigners. In the case of Severstal’s merger with Arcelor, the Russian side would have had significant control over the company. Severstal’s Mordashov was to become a non-executive president of Arcelor’s board and would have had the right to nominate six out of eighteen directors. Severstal’ would have retained its “Russian citizenship” and would have continued to pay Russian taxes. The government would have been able to influence Severstal’s decisions even after the merger. This stood in stark contrast with Yukos, where in early 2000s Khodorkovskiy considered selling the entire company to foreign investors.

---

253 Interview with an expert, Moscow, 2009.
256 Pappe, 140.
259 Interview with an expert, Moscow, 2009.
Some Russian analysts have argued that the government provided financial assistance to metallurgical companies during the crisis in order to prevent foreign ownership in the sector. Yet, the “threat” of foreign ownership in metallurgy for the government is significantly lower than in oil. Metallurgy matters politically because it employs a large number of people. The Russian government ran into a similar problem with Mittal as it did with Deripaska in Pikalevo back in 2009. When ArcelorMittal contemplated the layoff of workers as a cost-saving measure, the local government threatened to confiscate property without compensation. According to media reports, ArcelorMittal wanted to sell the mines. ArcelorMittal, like other companies working in Russia tries to avoid raising conflicts to the political level whenever possible.

One foreign company that has been present in Russia during the last two decades is the giant Swiss-based trader Glencore. In 2006, it joined Deripaska’s Rusal and Vekselberg’s SUAL to create Russian Aluminium. Glencore acquired 8.75 percent of United Company RUSAL. Glencore has seen good and bad times in Russia, staying in the country when many other foreign investors left. It has also been working in the oil sector. It is not entirely clear why Glencore succeeded where others failed. As a trading company, Glencore “makes its money at the margins, but Glencore, even more so than its competitors, profits by working in the globe's most marginal business regions and often, investigators have found, at the margins of what is legal.” Usually, the company gains access to resources by working through “gatekeepers” who provide access to senior officials. At present, Glencore has increased its political importance in Russia as it has concluded a deal with Rosneft’ for long-term supplies of oil, which helped Rosneft’ pay acquisition of TNK-BP.

---

261 Interview with an expert, Moscow, 2009.
264 In Russia, Glencore’s gatekeeper was has been oilman Mikhail Gutseriev, who in 1995 was elected to the Duma as a member of right-wing party of Vladimir Zhirinovsky. Silverstein, Ken. “A Giant Among Giants.” Foreign Policy, 23 April 2012.
9. Conclusion

The evolving relations between the regime and domestic business reflected and in some ways shaped Russia’s policy regarding FDI during Putin’s presidency. In oil and gas, the regime established control by re-acquiring assets that had slipped into private hands in the 1990s. In metallurgy and mining, the regime strengthened its control over domestic business without acquiring ownership. In both cases, Putin redefined the relationship between his regime and domestic business by reducing the political influence of Yeltsin-raised oligarchs and bringing the state “back in” by strengthening the state force. He was able to do this for two main reasons. First, an alignment of interests within Putin’s circles together with the increased public legitimacy the president enjoyed gave him autonomy from the oligarchs and made the restoration of state power possible. Second, the increase in energy prices – largely an external event – provided Putin’s regime with both an incentive and the possibility to re-gain control over the sector to brought lucrative individual rents and revenues for the budget.

The relationship between the regime in possession of rich energy supplies and resource-seeking foreign investors thus shifted in favor of the former. My dissertation demonstrates clearly that this relationship is not static.266 The level of a sector’s development (initially the level that was achieved during the Soviet era) and the way the regime sustains its power at home continue to matter in explaining not only the origin of initial policy choices but policy change too. Although rising oil prices empowered the regime vis-à-vis foreigners, the sector’s need for long-term capital investment and advanced technologies did not allow Russia to unilaterally dictate terms to foreign investors (at least, Putin’s regime showed evidence of self-restraint until 2014). Russia is not dependent on foreign investors to the same extent as Kazakhstan because its oil and gas sector is more developed, yet over the long-term this dependence is likely to grow as Soviet “legacy fields” in Russia are quickly coming to exhaustion.

Under Putin, the state has become more visible in the economy, yet it acquired more force than power. Paraphrasing Lindblom, the thumbs of the Russian state grew disproportionately larger than the fingers. The state as an embodiment of public interest has not become a player in its own right. Instead, Putin prioritized his regime with its needs for survival.

266 The possibility of weakening of the “accord that originally existed between the foreign investor and the host country when, trapped by their heavy capital expenditures, foreign investors are in a weak position to resist new demands from government” (the “obsolescing bargain”). Raymond Vernon, In the hurricane's eye: the troubled prospects of multinational enterprises (Cambridge, Mass.: Harvard University Press, 1998) 65.
and the satisfaction of officials’ personal interests. That is why, as I argued in this chapter, Putin’s Russia has not become a “developmental state.” The regime has used the state as a means of enhancing its own power. It has given force to the state in order to use it as a tool to assert its own interests. Putin’s regime is committed to development only to the extent that that development sustains regime’s legitimacy. “State capitalism” is capitalism through the state and in favor of particularistic interests rather than for the state serving the public good.267

In Russia, capital often brings with it power. The metallurgical companies that were severely hit by the 2008-2009 crisis were willing to accept greater government control in return for payment of their bills. However, in political capitalism such as Russia’s, the proposition “capital equals power” does not always work in straightforward ways. The power of the regime in charge of the state is strengthened even further when it provides capital to private actors. However, it is not the same for private actors who bring in capital. For example, rising energy prices turned the oil and gas sector into the main source of budget revenues to the state. Yet, the power of oil companies vis-à-vis the state did not increase. On the contrary, increasing revenues flowing towards the sector became an invitation for the regime to take over the sector. The regime used the coercive powers of the state to establish ownership and control over these resources. The power of the state trumps the power of private capital. Foreign capital also cannot expect to be welcomed unconditionally, especially when it threatens to undermine regime’s control over a strategic resource, such as oil. The forceful (but not powerful) state will continue to define what private (domestic and foreign) actors can and cannot do in Russia.

---
267See, for example, Easter, 225.
Chapter 6. Kazakhstan: Using FDI to Consolidate the Nazarbaev Regime

One of the former Soviet republics, Kazakhstan is yet to see a transfer of political power. Its first president Nursultan Nazarbaev has won every presidential election with astonishing support. It is difficult to determine to what extent Nazarbaev’s regime is actually popular with the people because the elections are unfair. It is possible that the majority of the population would have supported him even if elections were free and fair. At the same time, Nazarbaev’s regime is clearly an example of consolidated authoritarianism. To a great extent, it owes its stability to FDI that came into the country throughout independence and to Nazarbaev’s ability to turn the opportunities FDI created to his own benefit.

The republic’s political elite and Nazarbaev personally began establishing relations with foreign oil companies during the late Soviet era in hopes of strengthening the republic’s role within the USSR. Kazakhstan continued to court foreigners after gaining independence in 1991. The newly born state was rich in hydrocarbons yet could not develop them on its own and required foreigners. The second factor was the strategy the regime chose to maintain its power and the political role it assigned to an economic sector. In Yeltsin’s Russia and Kuchma’s Ukraine, *collusion* between the regime and domestic business that was supposed to sustain the regime in power resulted in restrictive policies regarding FDI in key economic sectors. In Kazakhstan, especially in the case of oil and gas, the interests of the regime by contrast converged with those of foreign investors. Whereas the former needed FDI to sustain its power and enrich the political elite, the latter needed Kazakhstan’s natural resources to grow their companies. Foreigners helped Nazarbaev maintain political power through invested capital that resulted in increased revenue and rent-seeking opportunities rather than through direct support for his reelection.¹ FDI also helped Nazarbaev strengthen his power vis-à-vis domestic business. Foreign investors entered metallurgy and mining too. However, in contrast to oil and gas, in many cases the investors in metallurgy and mining were “foreign” only nominally: Kazakhstan

¹ In some ways, we could argue that foreign investors in Kazakhstan had more “structural power” than domestic business in any of the three cases, since economic performance of the country and regime’s power were dependent on FDI. At the same time, foreigners shared ownership and control with Nazarbaev’s regime, so the “structural power” argument alone does not account for this fact.
could develop this sector on its own due to the high level of development the sector achieved during the Soviet era; foreign-registered companies served here as a disguise for ownership that in reality remained in domestic hands, mostly those of the highest political elite itself.

1. Main Challenges before Nazarbaev’s Regime

The USSR fell apart without Kazakhstan’s participation. Nazarbaev supported the idea of preserving the Union in one form or the other until the moment of its dissolution because he had been promised a senior position in the Soviet power hierarchy. As late as in 1989, Nazarbaev expressed concerns that free market reforms would only bring the USSR “back to capitalism” by causing inflation that would push the republic down. In summer 1991, Nazarbaev granted a number of Soviet ministries the right to manage enterprises on the republic’s territory. At this time, the RSFSR and other republics were already appropriating enterprises on their territories instead. Because of Nazarbaev’s reluctance to leave the USSR, some scholars have referred to Kazakhstan as an “accidental country.”

After gaining independence, Kazakhstan avoided significant institutional ruptures at the republican level. Nazarbaev’s overwhelming focus on maintaining his personal power defined political and economic transformation in the 1990s. The three major challenges that shaped the nature of Nazarbaev’s regime were the challenges of economic transformation, solidifying statehood, and consolidating power within the country.

Kazakhstan underwent significant industrialization during the Soviet era, yet its economy was very vulnerable after the USSR had collapsed. First, the end of direct financial transfers from Moscow hit Kazakhstan hard. Kazakhstan now had to pay for its own defence and honor its foreign debt obligations. During 1991-1994, the country’s GDP fell by around 60 per cent. In 1994, gross domestic investment constituted only 17 per cent of the 1990 level.

---

3 Power and change in Central Asia, ed. Sally N. Cummings (New York: Routledge, 2002).
6 Cummings, 33.
the Soviets focused on building large industrial complexes, production often took place on the territory of several republics. Kazakhstan’s industry needed inputs from other republics but also sent production for processing elsewhere. The “brain drain” of ethnic Russians from the industry had a significant impact on the economy given that the Russians constituted a disproportionate number of well-educated and skilled workers. Lack of a unified electrical system threatened interruptions of electricity supplies. Third, even though Nazarbaev had served as the First Secretary of the Communist Party of the Kazakh SSR (he converted this post into a presidency in March 1990), the republic had little formal control over its own economy. Central ministries controlled more than 75 per cent of industrial enterprises on its territory. Moscow also fully controlled Kazakhstan’s monetary policy and external economic activities. There was continuity in leadership yet this leadership lacked policy-making experience and had very limited experience of interacting with the outside world.

The second challenge was to solidify Kazakhstan’s new and “accidental statehood.” According to Nazarbaev himself, Kazakhstan needed to “qualify as a state.” After obtaining independence formally, Kazakhstan still had to establish de facto independence, especially given its economic dependence on Russia and the presence of a substantial Russian minority within its borders. Kazakhstan was largely unknown in the West at the time and could not count on external support of its sovereignty.

Nazarbaev’s third challenge was to consolidate state power within the country. Kazakhstan is a territorially large country with relatively small population. Building a nation out of citizens promised to be a difficult task since neither a state (Kazakhstani) nor an ethnic national (Kazakh) identity was easily available. Kazakhstan was the only post-Soviet state where the former tsarist and Soviet-era policies had left the Slavs in a relative majority. Only 39.5 per cent of the republic’s population were ethnic Kazakhs. Russians constituted 37.7 per

---

12 It has the territory of Western Europe yet only 15 million population. See Bhavna Dave, Kazakhstan: ethnicity, language and power (New York: Routledge, 2007) 1.
13 Cummings, 34.
cent. Together with ethnic Ukrainians (5.4 per cent) and Belarussians (1.1 per cent), Slavs accounted for 44.2 per cent of the population. During the Soviet era, ethnic Kazakhs were extensively russified: many did not have basic writing and readings skills in Kazakh because they had been educated in Russian during the Soviet era. Many so-called “red directors” – managers of large industrial enterprises – were ethnic Russians. There was fear that the Slavic-populated north and northeast would secede. Energy-rich Western Kazakhstan also made secessionist threats. Soviet policies that established administrative units based on location of pre-existing sub-ethnic groups “inadvertently imbued regional identity with political meaning.” Local elites had consolidated their power in the regions during the Soviet era and were unwilling to give it up. The challenges were thus considerable.

2. Nazarbaev’s Response to These Challenges

In contrast to Yeltsin, who surrendered prerogatives to the regions and undermined his power in this way, Nazarbaev refused to delegate any official territorial or financial autonomy to the regions. He also resisted demands for direct elections at the regional level but allowed regional heads substantial de facto control over economic resources. In the long run, retaining formal powers while offering informal opportunities to regional elites proved to be a good strategy for maintaining the power of the centre and Nazarbaev’s personal power. Local regional elites had to curb their political ambitions in order to be appointed by the president to a lucrative position. Nazarbaev fostered and then exploited the dependence of different social groups on him for access to state resources. For ethnically non-titular elites, this dependence was even stronger than for ethnic Kazakhs. Frequent relocations of akims (regional leaders) from one region to another and from regional to central governments and back prevented akims from gaining political power. Cooptation into the system turned them into reliable pillars of the regime.

The Russian “threat” did not materialize in Kazakhstan. The regime may have also purposefully exaggerated its extent. Ethnic Russians began losing their economic power even

---

14 See Power and change in Central Asia 61.
17 Dave, 145.
18 Junisbai, 256.
before the USSR collapsed. Nazarbaev ensured that after the collapse, most prominent ethnic
Russian politicians and business representatives “owe[d] their political success to their personal
loyalty to the regime, rather than to an ability to forge independent ethnic or financial
networks.” For example, Nazarbaev appointed an ethnic Slav (born in Russia) Sergey
Tereshchenko as the first PM. By making reference to the threat of ethnic Kazakh chauvinism,
Nazarbaev gained the upper hand over ethnic Russians in charge of industrial assets (those who
stayed in Kazakhstan) and turned them into his dependents. Even though officially Kazakhstan
pursued the policy of multi-ethnic civic nation-building known as Eurasianism, in practice, the
regime ensured that ethnic Kazakhs dominated political institutions. The success of
Eurasianism became a cornerstone of Nazarbaev’s legitimization strategy. Nazarbaev capitalized
on the fears of both groups – the Kazakhs and the Slavs – and secured his own position at the
top. The regime promoted the idea that only Nazarbaev could prevent Kazakhstan from turning
into Yugoslavia. This threat of imminent ethnic conflict after Nazarbaev’s departure from
office helps him maintain power today too.

3. The Nature of the Regime

When the USSR began collapsing, representatives of the Soviet nomenklatura easily
transformed themselves into “democrats” across all republics. Later, leaders like Nazarbaev
consistently undermined establishment of democratic institutions while solidifying control over
the political process. In Russia, Yeltsin openly supported democracy because pro-democracy
rhetoric had brought him to power. He had to be a “democrat” at least pro-forma to maintain his
domestic and external legitimacy. In contrast, Nazarbaev came to power without questioning the
nature of the old regime. That is why “further development of the revolution was dangerous to
him, fraught with the rise of new, charismatic-revolutionary leaders.”

Instead, Nazarbaev’s regime emphasized that Kazakhstan needed to focus on fostering
economic growth. Political freedoms would come whenever the country was “ready.” Nazarbaev

---

19 Dave, 145-146.
20 E-mail correspondence with an anonymous Kazakhstani journalist.
21 Cummings, 84.
argued that he needed strong presidential power in order to end the political crisis and avoid “protracted discussions and quests for compromises and half-measures.” This rhetoric put his regime on a particular path of power maintenance. Because the regime did not claim to be democratizing, this took away the grounds for evaluating it based on whether it fostered political freedom, protected rights, or built democratic institutions. In many ways, the development-based claim to legitimacy made Nazarbaev a “strong” autocrat from the beginning.

Because Nazarbaev had neutralized or eliminated his potential competitors for power early into independence, his regime emerged much stronger than Yeltsin’s or Kuchma’s at this time. Nazarbaev’s regime had attributes of soft authoritarianism – a regime that relies more on “means of persuasion than on the means of coercion, although coercion remains a part of the ruling elite’s arsenal.” In such regimes, political elites successfully frame political debates, define the agenda and in this way influence political outcomes. In some ways, soft authoritarian regimes are better at maintaining power than “hard authoritarian” regimes since they focus on preventing the rise of challengers rather than destroying them afterwards. This makes soft authoritarian regimes also stronger than weak democracies, such as Yushchenko’s Ukraine.

Kazakhstan’s “soft authoritarianism” has been built around the presidency. Whereas Yeltsin created a super-presidential republic mostly on paper, Nazarbaev came close to establishing it in reality. The formal transformation from a parliamentary to a presidential republic in 1995 gave the president virtually unlimited formal powers. Nazarbaev quickly sidelined the parliament, which at the time consisted of representatives of the former communist organizations, state enterprises, and institutions. Unlike Yeltsin, whose attempts to tame the legislature led to major bloodshed in 1993, Nazarbaev acted cautiously. When parliament resisted the IMF-backed stabilization program that threatened to undermine the entrenched interests represented in the legislature, Nazarbaev “invited” the parliament to dissolve itself in December 1993 on the grounds that independent Kazakhstan had not had democratic parliamentary elections. The new legislature elected in 1994 became a rubber-stamp institution.

---

24 Nazarbaev, 8.
25 In fact, he got rid of some of his opponents with Moscow’s support even before the USSR collapsed. See Dave, 162.
27 Furman, 25.
Unlike Yeltsin and Kuchma, Nazarbaev put consistent effort into the creation of top-down parties. The regime co-opted individual parliamentarians too. The oversight of candidate lists by akims and presidential administration prior to 2007 elections further weakened the power of legislators. Since 2007, loyalty to the presidential party has served as a key precondition for obtaining seats in the parliament.

Despite Kazakhstan’s authoritarianism, even the regime’s critics agree that the majority of population has been voting for Nazarbaev and his party Nur Otan during elections. Unlike Yeltsin’s Russia or Kuchma’s Ukraine, Nazarbaev’s regime has had its own sources of legitimacy and therefore did not depend on domestic businesses for power maintenance. Nazarbaev’s declared goal of maintaining stability genuinely appealed to a population that was suffering from economic disruption, political uncertainty, and ethnic tensions.

4. Regime’s Relationship with the State

The regime-state relationship in Kazakhstan in the 1990s was characteristic of the post-Soviet space where political regimes used the state to maintain their power. Nazarbaev stood out however in how successful he was in maintaining control over the state, its institutions and the market reforms that were launched after independence.

Even though Nazarbaev was initially hostile to some components of market reforms, such as price liberalization, he looked favorably at privatization from the very beginning. Speaking at the meeting of the Communist Party of the Kazakh SSR in 1991, Nazarbaev urged the communists to lead the process of privatization. When Kazakhstan became independent, it initially released control over privatization to the regions, yet quickly took it back by 1993. From 1993 to 1997, extensive privatization took place under the careful watch of central authorities. In 1994, Nazarbaev appointed Akezhan Kazhegeldin as the new PM and tasked him with speeding up the case-by-case privatization of large enterprises and enterprises “with a special status.” Kazhegeldin was considered to be a “reformer,” but also “an outsider, one who constituted a good buffer zone between Nazarbaev and the powerful groups whose interests were to be upset

---

28 Cummings, 27.
29 Junisbai, 259-260
30 Nur Otan’s predecessor, the Fatherland party, was established in 1999. Nazarbaev officially headed it in 2007.
31 Furman, 38.
during privatization.” Privatization became a highly political process designed to give different
groups access to state resources in return for political loyalty.

The 1991 Law on Destatization and Privatization differentiated between federal and
regional property, when regional councils made decisions regarding the latter. Strategic sectors
were to remain state-owned. Land and natural resources were defined as the exclusive property
of the state. At this time, Kazakhstan followed the “Russian model” of privatization in that it
prioritized worker buyouts. Soon, the central elites became dissatisfied with the first phase of the
privatization program because it was seen as benefitting the incumbent regional political and
economic elites. Nazarbaev later complained that enterprise managers were “deliberately
slowing down privatization and fraudulently creating the right conditions to make personal
fortunes for themselves and their close associates by bleeding the enterprises and accruing
enormous credit debts.” Prıkhvatizatsiia benefited ethnic Russians since they constituted a
large share of managerial elite. Ethnic Kazakhs feared that they would lose out. The central
elites were concerned they would not be able to retain control over the process. Because
Kazakhstan’s economy was built on large enterprises – often the only employers in town –
Nazarbaev needed to obtain control over these enterprises, which the politically disloyal “red
directors” could otherwise use to blackmail the government. That is why by fall of 1992, the
decentralized privatization program was temporarily suspended. In March 1993, Nazarbaev
announced that “we made a mess of the first stage of privatization, but without doing serious
harm.” He promised to re-centralize the process. In order to gain the allegiance of the industry
generals, he also declared that it would take 25-30 years for the share of the state sector in the
economy to fall below 50 per cent.

Privatization was re-launched in April 1993. In its new form, privatization focused on
preserving regime’s control over the process. The new program granted decision-making powers
exclusively to the centre. There was no longer any separation of federal from municipal property.
The government reserved the right to have a ‘golden share’ in some companies. The new

33 First steps toward economic independence : new states of the postcommunist world, ed. Michael Louis Wyzan
(Wesport, Conn.: Praeger, 1995) 93.
34 Nazarbaev, 179.
35 Olcott, 137.
36 Dave, 143.
37 First steps toward economic independence : new states of the postcommunist world 93.
privatization program provided for creation of the holding companies, which were to control networks of subsidiaries in the key sectors. The state would retain a controlling package of shares for at least five years. Paradoxically, the second stage of reforms aimed to “restore some of the state control over industry that was lost in the last years of the Soviet regime.”

Privatization itself was very extensive. The private sector grew from representing 25 per cent of GDP in 1995 to 65 per cent in 2002. Privatization revenues increased from an annual average of $400 million in 1992-1994 to $1,140 million in 1995-1997. At the same time, Akezhan Kazhegel’din’s “technocratic” government faced severe criticism for its policies. The privatization program lacked clear goals beyond selling as much property as possible. Enterprises were sold even when they had worked well under the previous management. It was not clear why in some enterprises 100 per cent ownership was sold while in others only a bare majority (yet in no case did the government sell a minority stake). Besides, the management contracts with an option of future purchase were “little more than a means to allow the new investor to become familiar with the actual operation of the enterprise and then to keep virtually all subsequent negotiations private.” Kazhegeldin faced criticism from Nazarbaev himself even though the president was privately benefitting from privatization. In an effort to pre-empt criticism and personal blame for privatization, Nazarbaev ousted Kazhegel’din’s government in 1997.

Kazhegel’din’s dismissal was also an early sign of changes in policies. Kazhegel’din’s successor Nurlan Balgimbaev favored strengthening the formal role of the state in the economy. However, Balgimbaev was inconsistent: his government terminated some sales and cancelled some management contracts but also concluded new deals depending on the political needs of the regime and personal interests of its officials.

Kazakhstan’s formal focus on creating “free markets” left a strong role for the state to play. While the formal focus on free markets would appeal to the West, the focus on the strong state would tie Kazakhstan’s economic transformation to the successful East Asian model of

---

38 First steps toward economic independence: new states of the postcommunist world 94.
39 Richard Pomfret, "Kazakhstan's Economy since Independence: Does the Oil Boom offer a Second Chance for Sustainable Development?" Europe-Asia Studies 57.6 (2005): 867.
40 Peck, 70.
41 Peck, 46.
42 Nazarbaev, xiii.
development. Nazarbaev promised to turn Kazakhstan into “a Central Asian snow leopard.”

The idea of a strong state helped legitimize the regime since it suggested to the population that the state remained in control of economic transformation as opposed to the “chaos” that took place in Russia and elsewhere in the former USSR. Indeed, the capacity of the state for control (exercise of force) grew much faster than general “state capacity” (state power). The regime was able to exercise control on behalf of the state yet it did not do so in the broader public interest. Also, similarly to Russia, the formal course at radical economic reforms stopped short of creating institutions of market economy. Whereas in Russia capitalists emerged before the emergence of capitalist institutions, in Kazakhstan, one main capitalist emerged – Nazarbaev himself. The regime implemented reforms because their post-Soviet interpretation corresponded to the interests of political elites, in particular the president.

Whereas Yeltsin and Kuchma tried to solidify their power by handing control and ownership over property to their political allies, Nazarbaev essentially put up every state post for negotiation in exchange for political loyalty. The difference between the two methods of maintaining power may not be that significant on the surface since in Ukraine and Russia weak property rights made control and ownership of property dependent on the regime. At least initially, though, Nazarbaev’s choice in favor of patronage through appointment gave fewer resources over into the hands of potential opponents for challenging the regime in the future. Patronage also made every state official personally dependent on Nazarbaev, as they could never be certain where they would end up during the next “big shuffle” of personnel that happened regularly. State officials benefited from patronage as long as they did not engage in unapproved economic or political activities. Nazarbaev tolerated and even fostered corruption and used “blackmail politics” to maintain his regime. In Kazakhstan too, the state, its resources, and powers were “captured” not by business elites but by the political regime itself. The strengthening of Nazarbaev’s regime came at the price of weakening the power of the state,

---

44 Pomfret, 42.
45 I use the plural, even though their number was limited and their origin strictly conditioned by their connections to the state.
46 Furman, 39.
which became effectively de-institutionalized. Policy-making effectively meant drafting an official policy based on presidential directives to the ministry or parliament.

While the regime used the state for its own purposes and destroyed it along the way, it also reformed it to some extent. Since performance became the measuring stick for the regime’s effectiveness and the main source of its legitimacy, political elites could not exclusively predate on the state. Besides patronage, the other side of Nazarbaev’s neo-patrimonialism is that the regime “combine[d] personal or patrimonial use of authority to procure loyalty and compliance with emphasis on an efficient, Western-style system of administration.” 49 The majority of state officials were appointed based on their personal loyalty. However, Nazarbaev also appointed others for their technocratic skills. Often, these were also the people who had the potential to challenge president’s power in the long run, for example, the so-called “Young Turks” who formed Akezhan Kazhegeldin’s government. Comprehensive economic reforms pursued by this government (1994-1997) created “[p]ockets of reliable business infrastructure, notably the banking sector, pension reform and foreign investment law.” 50 Whether Nazarbaev encouraged rent-seeking or was modernizing the country, he strove to retain control over all these processes.

5. FDI Comes to Kazakhstan

Foreign investors became key actors in Kazakhstan’s political and economic transformation. The country was the largest recipient of FDI per capita in the CIS. 51 The highest priority sectors for attracting FDI were oil and gas, food processing, gold mining and refining, other non-ferrous mining and processing. 52 From 1995-2004, the annual average of FDI was US $1,898 million, rising to US $6,456 million in 2005-2007. 53 From 1993-2000, the oil sector alone attracted more than 80 per cent of cumulative FDI. 54 From 1993-2002, non-ferrous metallurgy attracted US $1,592.9 million of gross FDI while US $795.9 million went into ferrous

49 Dave, 141.
50 Cummings, 141.
52 Olcott, 144.
metallurgy. FDI allowed oil and metallurgy sectors to avoid the severe investment crisis that affected other economic sectors.

**Table 10. FDI Stock by Sector (as of June 2011, in USD millions). Data for selected sectors of Kazakhstan’s Economy**

<table>
<thead>
<tr>
<th>Sector</th>
<th>USD millions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>88,950</td>
</tr>
<tr>
<td>Extractive industries</td>
<td>64,348</td>
</tr>
<tr>
<td>Mining and quarrying</td>
<td>14,692</td>
</tr>
<tr>
<td>Exploration and prospecting</td>
<td>49,654</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>8,592</td>
</tr>
<tr>
<td>Basic metals</td>
<td>6,977</td>
</tr>
<tr>
<td>Finance</td>
<td>5,266</td>
</tr>
</tbody>
</table>

Source: National Bank of Kazakhstan.

6. Why Foreigners

Why did Kazakhstan so overwhelmingly focus on attracting FDI? In this section, I will concentrate on FDI into oil and gas since this is where the majority of “real” (not offshore) FDI came in. I will discuss metallurgy and mining in the subsequent section, even though some propositions I make here apply there too.

The decision to act quickly – to privatize and let foreigners in – was driven by both structural and political factors. The primary structural reason was that Kazakhstan was unable to develop its hydrocarbons on its own. The regime could foresee the opportunities stemming from FDI: as a source of revenue, the hydrocarbons sector developed through FDI would allow the regime to face the most imminent economic and political challenges and therefore strengthen the regime while also maintaining its power. As one of my interviewees noted, “[W]e had some

---


57 Interview with an expert, Kazakhstan, 2010.
kind of euphoria that the contracts with foreigners will bring in constant flows of big money.”

President Nazarbaev realized at the onset of independence that he needed foreigners and needed them immediately in order to consolidate his power. The prospect of attracting significant FDI shaped the nature of the regime even before the massive influx of FDI began. FDI allowed the regime to make claims for more power and to make a more extensive use of this power from the very beginning of independence.

In addition to structural and political reasons for pro-FDI policy, it “helped” that Kazakhstan began establishing contacts with foreigners during the Soviet times, when Gorbachev opened up the Soviet economy to foreign investment. Already then, Nazarbaev courted foreigners in hopes of gaining more economic powers for the Kazakh SSR and enhancing his own position in the republic. At this point, he did not yet have political control over the republic. During his 1990 visit to US as chief of the Kazakh communist party, Nazarbaev acted as a “one-man chamber of commerce” hoping to convince the US oil companies to do business in the republic. By 1991, Kazakhstan’s elite had been negotiating with foreigners for two years and had signed its first deal with Chevron on development of Tengiz, one of Kazakhstan’s main oil fields.

The President and his PMs made key decisions regarding privatization. The weakness of the parliament and the president’s power to issue decrees allowed Nazarbaev to pass legislation on FDI almost unilaterally. Deals were concluded in a rush and behind closed doors. In November 1996, the government established the State Investment Committee (Goskominvest) as a one-stop shop for potential foreign investors accountable exclusively to the President. Established in 1998, Foreign Investors’ Council offered the most significant foreign investors (mostly in the energy sector) a chance to meet face-to-face with the President – the key

---

58 Interview with an expert, Kazakhstan, 2010.
59 I am grateful to Ed Schatz for helping me articulate this point.
60 Yelena Kalyuzhnova, *Economics of the Caspian oil and gas wealth: companies, governments, policies* (New York: Palgrave Macmillan, 2008) 78.
63 Interview with an expert, Kazakhstan, 2010.
64 Interview with an expert, Kazakhstan, 2010.
65 See, for example, Peck 2010, 102.
decision-maker in the country. Kazakhstan as a consolidated authoritarian regime succeeded in providing a good climate for foreign investors: “foreign investors may be more confident that a deal signed by the government of Kazakhstan would actually be brought to fruition.”

6.1. Source of Revenue and a Tool for Improving Economic Performance

FDI was to play an important political role in maintaining the regime in power. Because the regime claimed the economy, not democracy, to be its key focus, it had to deliver some tangible economic results to the population. Yet, the economic situation was dire. Kazakhstan needed revenues to reverse economic decline and maintain social peace. Nazarbaev announced that Kazakhstan would follow South Korea’s example of gradual state-controlled opening to FDI. The President promised to re-direct some of the capital obtained as FDI into resource industries to other sectors, which would eventually enable Kazakhstan to offer high value-added products to the world market. Part of FDI capital would finance the purchases of consumer goods. This promise appealed to the population. Some even argued that Nazarbaev “was saving the country from hunger” by letting FDI in.

Focus on FDI also allowed the regime to shift responsibility for the financial and technological revival of enterprises onto foreign investors. In the early 1990s, state budget funds became the sole source of investment, yet they were insufficient for financing any large project. Foreigners’ purchases of enterprises were usually tied to conditions regarding social development, such as maintenance of daycares, hospitals, and apartment buildings for workers. This policy relieved the government of its fiscal burden and helped build local support for reforms. FDI also eased the task of financing social programs. At the same time, not all capital that came in as FDI reached the budget. Many projects, especially the PSAs, stipulated

---

67 First steps toward economic independence: new states of the postcommunist world 91.
69 Interview with an expert, Kazakhstan, 2010.
70 Interview with Magbat Spanov, Institute of Development of Kazakhstan, president, Almaty, 3 June 2010.
71 Economic transition in Russia and the new states of Eurasia 150.
72 For example, when Canadian Hurricane Hydrocarbons Ltd bought Yuzhneftegaz in 1996, it also acquired “a wide range of supporting operations, including a road building company, a form covering some 2,500 square miles … with 25,000 sheep, 450 camels, and a number of cattle, horses, pigs, and goats which provided food for employees, a transportation company responsible, among other things, for transporting employees from Kyzyl Orda (sic) to Kumkol…” Peck, 159.
73 The Caspian: politics, energy and security 208.
74 Pomfret 2005, 861.
that Kazakhstan would receive revenue much later after the contract was signed. For example, according to the agreement between Chevron and Kazakhstan on Tengiz, the latter would receive payment only when the field produced more than 12 million tons per year. The field reached this production level only in 2001. This suggests that obtaining budget revenue was not the only factor driving the authorities towards opening up to FDI. At the same time, the need to earn “quick cash” in order to maintain the support of the population often facilitated the sale of shares to foreigners. For example, the “political factor” certainly was behind the sale of Kazakhstan’s share in the Kashagan project in 1998. The presidential elections were coming up in early 1999 and salaries and pensions needed to be paid.

6.2. Strategy of Legitimization
For political elites, the focus on the development of the domestic oil industry was clearly the best way to tackle challenges of economic transition. FDI became part and parcel of the strategy of external legitimization through Westernization that was then “broadcast inward to domestic audiences.” Kazakhstan had to succeed where others failed – dissolving the potential for inter-ethnic challenge by adopting “Western,” civic-based nation-building, by establishing good relations with the West at the price of voluntarily giving up its nuclear arsenal, and by becoming a “success story,” attracting FDI. Oil developed by international oil majors would also help solidify Kazakhstan’s statehood vis-à-vis external actors, Russia in the first place. Allowing FDI in was clearly a political choice that promised to maintain the regime’s power and served as “great aid” to Kazakhstan’s independence. Letting Western companies in would create a number of influential stakeholders in Kazakhstan’s independence and Nazarbaev’s regime. Nazarbaev himself characterized the signing of the Tengiz contract with Chevron as an event that was important both politically and economically: [t]hat a Western company had decided to conclude such a deal with us, on purely commercial grounds, showed to the world the seriousness of Kazakhstan’s intentions to work with the world business community.”

---

75 Peck, 153-154.
76 Interview with an expert, summer 2010.
79 LeVine, 344.
80 Nazarbaev, 168.
a sign that “investors trust[ed] us and believe[d] in Kazakhstan.” Nazarbaev promised not to betray their trust.

6.3. Solidifying Power within Kazakhstan

The state as such did not have effective control over FDI since the regime attracted it based on what suited its own interests. Initially, foreigners received very advantageous terms for their investments. This was partly because they were more experienced negotiators than Kazakhstani officials and partly because the latter were negotiating deals for themselves rather than for broader national public (I discuss the issue of corruption in detail below). At the same time, the development of oil and gas by foreigners rather than domestic business strengthened the regime vis-à-vis domestic actors and helped Nazarbaev solidify his power.

First, FDI helped Nazarbaev neutralize regional elites. After the de-facto decentralization of the early 1990s, the scope of provincial powers was enlarged. However, the centre did not allocate sufficient funding to use these powers. In some ways, the infusion of international capital into the regions made this informal decentralization meaningful because it “provided regional leaders with alternative sources of income and therefore alternative patrons.” In the early 1990s, those who had been involved in the management of the industry before (various federal government officials, regional administration heads, and heads of oil enterprises) began to obtain licenses and contracts for subsoil development without consulting the Ministry of Geology and Subsoil Protection. As a result, by 1995 “no one knew how many signed contracts existed in the country, much less what their terms might be.” However, in contrast to Yeltsin’s Russia, in Kazakhstan the centre retained control over the distribution of benefits associated with the entry of FDI. Deals with foreigners helped the regime establish its control over the sector. Foreign investors still approached the centre first and only then went into the regions. Local governments in their turn insisted on contributions to the development of their regions and financing of social obligations by foreign investors. From 1993-1998, for example, TengizChevroil gave $50 million in support of local community development programs in the

---

81 Nazarbaev, 109.
82 Cummings, 128.
83 Ostrowski, 39.
In practice, the two most common demands put forward by local authorities were for investors to hire “friends” of the local government and to take on a certain local company as a subcontractor. This centrally administered patronage helped Nazarbaev maintain his power. Since regional elites were appointed, placement in an FDI-rich region with better infrastructure and lower unemployment rates, better salaries, and available social programs increased dependence of regional elites on the regime.

Secondly, FDI also allowed Nazarbaev to neutralize ethnic and clan challenges by moving the capital city from southern Almaty to provincial northern Astana in 1997 and turn the latter into a modern city. The move helped Nazarbaev solidify Kazakhstan’s statehood vis-à-vis Russia since Astana became a centre of “Kazakhness” next to the Russian border. The bureaucrats hired in Astana tended to be ethnic Kazakhs. They were more likely to be personally loyal to Nazarbaev than to clans, which weakened the Soviet-era clan-based patronage networks. Foreign companies were “routinely pressed” to make donations for construction of Astana. The regime claimed that it cost the state “nothing” to move the capital because only extra-budgetary funds helped build Astana. Foreign investors, in particular those working in oil, involuntarily and indirectly became key players in Nazarbaev’s strategy of power maintenance.

6.4. Personal Interest

Foreign investors quickly realized that investment in oil and gas sectors in Kazakhstan “required blurring the lines between what was due to the country and what was due to its leaders.” Even respectable foreign energy companies generally agreed to play by these rules. Approximately $800 million and $450 million that Mobil and Chevron respectively paid for entering the Tengiz partnership were reportedly missing from the budget. Nazarbaev’s personal gains from the sector are said to have exceeded $1 billion. As one of my interviewees noted,

---

86 Peck, 156.
87 Interview with an expert, June 2010.
88 Junisbai, 241.
89 Challenges of the Caspian resource boom: domestic elites and policy-making.
90 Schatz, 126. According to some accounts, Nazarbaev asked if Chevron would build a stadium in new capital. See LeVine, 260-261.
91 LeVine, 288.
93 Energy, wealth and governance in the Caucasus and Central Asia: lessons not learned 143.
There is one well-known rule that in the East, one needs to share. No matter how principled were the fellows who came here, they were forced to pay later. This concerns anyone from large companies to small servicing companies. It is difficult to foresee these costs, because everyone has their own. However, in our country if you are starting any kind of project, I would recommend obtaining the approval of the influential people first. This simplifies things, but does not free you [from the potential problems] fully. I have not seen an example where someone would come here [to invest] and everything would have been marvelous.  

A number of sources point out that Nazarbaev and his closest circle had personal stakes in contracts with foreign oil companies. The so-called Kazakhgate scandal is the most credible evidence of this allegation. In an effort to discredit his presidential rival, President Nazarbaev accidentally revealed that he and the ex-oil minister Nurlan Balgimbaev, who publicly criticized FDI, had received kickbacks from international oil companies. The US courts investigated these allegations because US companies were involved. Nazarbaev and Balgimbaev reportedly placed $78 million in overseas accounts through James Giffen, who acted as an intermediary between the government and foreign investors. The government of Kazakhstan had hired Giffen’s company Mercator to negotiate deals with foreign oil companies. Mercator charged foreign investors a fee on behalf of Kazakhstan. According to the indictment, the funds collected went into the personal bank accounts of several high-standing Kazakhstanis. During the 1999 elections, Giffen hired foreign political advisors “to persuade the outside world that Kazakhstan was a democracy in the making” and therefore helped Nazarbaev sustain his power at the time when the Kazakhstani president was tightening his grip on power.

Even though the US court could not charge Nazarbaev himself, the president had to return some of the money from his private account in order to improve his domestic and foreign image. In 2002, the new PM Imangaly Tasmagambetov announced that the President had temporarily simply placed the money into his personal account and intended to use it as a reserve fund during an economic crisis or if national security came under threat. After the Kazakhgate scandal broke out, the president promised to transfer the funds into the National Fund. This story clearly demonstrates the blurred distinction between the president’s personal accounts and

---

94 Interview, Kazakhstan, 2010.
96 Pomfret, 866.
97 LeVine, 364-365.
state funds. In a rare development, due to the diligence of foreign courts this time the funds were to be transferred from Nazarbaev’s personal into the state account, as opposed to the other way around, which was much more common.

Foreign companies had to be prepared to deliver both big and small things that “mattered” to Nazarbaev. For example, when Mobil’s CEO Lucio Noto asked Nazarbaev about how much half of the state-owned shares of Tengiz would cost, “the Kazakh leader made a series of extravagant demands. Apart from undisclosed sum of money, he asked for a new Gulfstream jet aircraft, four trucks equipped with satellite dishes for his daughter’s television network, and new tennis courts at Nazarbaev’s home in Kazakhstan.”99 Even though Mobil denied that it had fulfilled these requests, it later turned out that Mobil had paid hundreds of millions of dollars to bogus companies in Russia and Kazakhstan.100 In the end, Mobil bought a 25 per cent share of Tengiz for $1.05 billion. James Giffen as the intermediary collected a $51 million fee for concluding the deal on behalf of Kazakhstan, out of which $22 million reportedly went to Nazarbaev, 2 million to Balgimbaev, and 2 million to Giffen’s “trusted ally” at Mobil, Bryan Williams.101

7. Origin and Role of Domestic Business

In Kazakhstan, domestic business received no preferential treatment over foreign investors during privatization. In fact, the reverse was often the case. Even though ethnic Kazakhs were privileged over the Slavs in the process of privatization, key industrial assets remained out of the reach of both.

In the industry, the government made a limited effort at restructuring, which mostly consisted of bureaucratic reorganizations. The existing management was temporarily left in place. According to Nazarbaev, “we really did try to carry out privatization independently, but that made matters even worse” as the locals lacked management skills and funds.102 When management failed to restore production, the regime began searching for other solutions. Nazarbaev argued that giving ownership to the locals was dangerous because they were mostly

100 Kleveman, 81.
101 LeVine, 288-289.
102 Nazarbaev, 171-172.
interested in property embezzlement.\textsuperscript{103} Foreign investors purchased 57 out of 94 big enterprises offered for privatization during the second and third stages of privatization.\textsuperscript{104} Nazarbaev argued that the overwhelming presence of foreigners in the economy by the late 1990s reflected an “objective” fact: those companies that had capital and competent management got the assets.\textsuperscript{105}

In reality, the entrance of FDI into key economic sectors was much more subjectively determined than Nazarbaev suggested. In difference to Russia and Ukraine, foreigners often received preferential treatment over domestic producers, especially in key sectors such as oil. Nazarbaev’s regime neglected (if not undermined) the establishment of domestic business in key economic sectors for two main reasons. First, Nazarbaev feared that domestic oligarchs (especially if formed out of ethnic Russians) would challenge his power. At the beginning of the transition, the central elite partly lost control over the process of privatization yet managed to restore it after the power of regional elites (first and foremost, enterprise managers) was weakened.\textsuperscript{106} A substantial share of industrial assets at the time was in the hands of ethnic Russians. Ethnic Kazakhs too had long-standing clan divisions. If awarded economic power, they could threaten Nazarbaev.\textsuperscript{107} That is why Nazarbaev often empowered ethnic minorities (and not only Russians), who were unlikely to build a strong support base among ethnic Kazakh population due to their “foreignness.”\textsuperscript{108} Nazarbaev’s close associate Alexander Mashkevich is Jewish. Vladimir Ni, an ethnic Korean, had long-term unconditional access to Nazarbaev through posts in presidential administration and later through his board membership in Kazakhmys.\textsuperscript{109}

Secondly, because Nazarbaev had legitimacy of his own (as with Putin), he did not need domestic business to the same extent as Yeltsin or Kuchma did in order to maintain power. Through systematic efforts, Nazarbaev managed to solidify his power before he faced the need for reelection. The regime claimed it needed to be effective and efficient – and therefore (implicitly) authoritarian – in order to foster growth. Democracy would come later. The strategy

\textsuperscript{103} Nazarbaev, 171-172.
\textsuperscript{104} Nazarbaev, 180.
\textsuperscript{105} Nazarbaev, 177.
\textsuperscript{106} Challenges of the Caspian resource boom: domestic elites and policy-making 75.
\textsuperscript{107} Dave 2008, 146.
\textsuperscript{108} Interview with Dosym Satpaev, Risk Assisment Group, director, Almaty, 31 May 2010.
\textsuperscript{109} “Umer Vladimir Ni, chelovek iz okruzhenia prezidenta Nazarbaeva.” Radio Azattyk, 10 September 2010. Available at \url{http://rus.azattyq.org/content/vladimir_ni_kazakhmys/2153880.html} (last accessed February 13, 2015).
worked, at least for some time: the regime faced very little pressure to hold competitive elections or reform its political institutions. Media under the control of Nazarbaev’s daughter Dariga helped him effectively deliver his message of “economy first, politics later” to the population.¹¹⁰ This is in contrast with Yeltsin, who relied on oligarchs’ media resources to win the 1996 reelection.

The mass entrance of FDI slowed down, but did not completely prevent domestic private business from emerging. Even though market reforms were controlled and limited and came with top-down distribution of resources, they eventually created local economic actors.¹¹¹ Six to eight business groups established themselves by the end of the 1990s. They were associated with the people who headed them: Alexander Mashkevich, Oleg Ni, Nurzhan Subkhanberin, Abliazov, Nurlan Balgimbaev, and Rakhat Aliev.¹¹² The president’s son-in-law Timur Kulibaev also accumulated assets in key sectors through his ties to Kazkommertsbank.¹¹³

Some of the domestic Kazakhstani businesses formed out of the Soviet nomenclature, while others developed more sporadically through trade and acting as intermediaries at the market. People with a business background entered Kazhegel’din’s government for the first time. Their mission was to undercut the power of the old Soviet party members.¹¹⁴ Based on Nazarbaev’s “compartmentalized strategy of recruitment,” loyalty to the political leadership was the main criterion for hiring. However, sometimes, professional qualifications mattered too.¹¹⁵ The second round of appointments took place in 1997-1998. Unlike those business representatives who joined the government during the first round, these people were already prominent figures in the country. Most of these appointments lasted less than a year as business representatives were considered to be politically unreliable.¹¹⁶

Despite his meticulous effort at power preservation that slowed down and also established control over formation of domestic business, even Nazarbaev did not manage to avoid challenges to his power. Market reforms produced an intra-elite conflict over allocation of power and resources because one could only benefit from market reforms with the “permission”

¹¹⁰ Cummings, 27.
¹¹¹ Junisbai.
¹¹² Cummings, 124.
¹¹³ Peck 2002, 55.
¹¹⁴ Challenges of the Caspian resource boom: domestic elites and policy-making 77.
¹¹⁵ Cummings, 127.
¹¹⁶ Cummings, 51.
of the autocratic ruler or through the patronage system that favored people who were closest to
the president.\textsuperscript{117} Such a system significantly narrowed the space for competition and therefore
intensified this competition. Those who fell outside the privileged “inner circle” had incentives
to defect because they were not benefiting to the same extent as others.\textsuperscript{118}

In 2001, high-ranking government officials and business elites who had defected from the
regime formed an opposition movement named the Democratic Choice of Kazakhstan (DCK).
DCK became arguably the most serious attempt to challenge Nazarbaev’s power. The movement
called for the decentralization of political power through direct election of regional governors, a
strong legislature, and independent judiciary that could restrain presidential power.\textsuperscript{119} It fell short
however of making pro-democracy demands.\textsuperscript{120} Similarly to Ukraine’s Orange Revolution, the
DCK represented the opposition of the millionaires to the billionaires. The DCK formed in the
aftermath of a conflict when the president’s son-in-law Rakhat Aliev tried to gain a stake in Bank
Turan Alem that had been successfully developed by Mukhtar Abliazov. Both Aliev and
Abliazov were “part and parcel” of the system of business-regime relations the President had
constructed.\textsuperscript{121} Aliev at the time worked as Deputy Head of the National Security Committee.
Abliazov himself had served as a Minister for Energy, Industry, and Trade. Nazarbaev resolved
the tension by sending Aliev into an “exile” as Kazakhstan’s ambassador to the OSCE in Vienna,
which suggested that Nazarbaev was willing to sacrifice the interests of his relatives in order to
preserve his own power. He also created many bureaucratic hurdles that prevented the DCK
from registering as a party.\textsuperscript{122} The DCK’s two most prominent leaders, Abliazov and
Zhakiyanov, were imprisoned, leading to a split of a more moderate wing of the DCK, which
later became the pro-business Ak Zhol (Bright Path).\textsuperscript{123}

The victory of the president over the DCK and the fact that Nazarbaev has faced such a
major challenge only once since 1991 underlies the supreme position that Nazarbaev occupies in

\textsuperscript{117} Junisbai 2009, 5.
\textsuperscript{118} Barbara Junisbai, "Market Reform Regimes, Elite Defections and Political Opposition in the Post-Soviet States:
Evidence from Belarus, Kazakhstan and Kyrgyzstan," PhD, Indiana University, 2009, 204-206.
\textsuperscript{119} Azamat Junisbai and Barbara Junisbai, "The democratic choice of Kazakhstan: a case study in economic
\textsuperscript{120} Barbara Junisbai, "Improbable but Potentially Pivotal Oppositions: Privatization, Capitalists, and Political
\textsuperscript{121} Junisbai, 251.
\textsuperscript{122} “Political Freedoms in Kazakhstan.” Human Rights Watch Report, April 2004. Available at
\textsuperscript{123} Ostrowski, 56.
his relations with business. While the nature of ties between a particular business and the regime varied – some relied on ad hoc government contacts while others had a more permanent political patron in the government\(^{124}\) - personal connections to the president have always mattered the most. The circle of privilege and the extent of favouritism have been changing over time.\(^{125}\) Business in Kazakhstan is nonetheless even more dependent on the regime than in Russia or Ukraine. As President Nazarbaev once put it during a meeting with business representatives, “I can at any moment have all of you taken to court and put behind bars.”\(^{126}\) The bigger the business, the more it is dependent on the regime.\(^{127}\) Domestic business depends on Nazarbaev not only for acquiring assets but also for protecting them from competing business groups. However, the most important economic elite (which partially coincides with the groups listed above) have been the top-level bureaucrats themselves, first and foremost President Nazarbaev himself, who obtained significant ownership in key sectors yet conceals this ownership from the public. This elite has a strong foot in both political and economic spheres – the key to success in a political capitalism.

8. Strengthening the State

The story of DCK taught the regime that it was not enough to control business in an environment where external actors and a narrow circle of domestic elites received state resources. Even if controlled, business could present a threat to his political power. The regime needed to be more effective at cooptation of businesses.

By 2001, the “soft authoritarian” regime abandoned its formal position of neutrality with respect to the origin of capital in favor of promoting domestic business. This was an effort to hijack business agenda and prevent dissatisfied representatives of business from challenging the regime.\(^{128}\) This change of attitude was one of the reasons why Kazhegeldin’s government was dismissed in 1997.\(^{129}\) The change of the PM was to signify a change of policy and boost presidential legitimacy. Foreigners were now the “evil” that needed to be neutralized.


\(^{125}\) Interview with an expert, Kazakhstan, 2010.

\(^{126}\) Quoted in: Junisbai, 256.

\(^{127}\) Interview with Dosym Satpaev, Risk Assessment Group, director, Almaty, 31 May 2010.


\(^{129}\) Furman, 44.
As elsewhere in the post-Soviet region, business in Kazakhstan depends on the regime for its survival. Therefore, business cannot expect to fully control the private property it officially owns. Property is only secure so long as until business maintains good relations with the regime, which means that business generally has to stay out of politics.\footnote{Interview with Dosym Satpaev, Risk Assessment Group, director, Almaty, 31 May 2010.} The “heavily staticized [Russian: \textit{ogosudarstvenny} – state-affiliated, dependent on the state] business supports the president.”\footnote{Interview with an expert, Kazakhstan, 2010.} For example, Nazarbaev made it clear that domestic companies from the oil sector that engaged in unsanctioned political activities would not receive state subsidies.\footnote{Challenges of the Caspian resource boom: domestic elites and policy-making 113.} Conflicts regarding distribution and re-distribution of property within business community have remained intense and prevented business from organizing to challenge the president.\footnote{Interview with Dosym Satpaev, Risk Assessment Group, director, Almaty, 31 May 2010.} Instead, business groups “constitute the main pillars of the regime.”\footnote{Dave 2008, 151.} The regime makes sure that key economic groups are represented during ministry appointments and therefore has been balancing their interests.\footnote{Olcott 2010, 171.} Nazarbaev has also initiated a top-down institutionalization of business where business associations that serve more as a means of control than as institutions for representation of interests. They do not create opportunities for a meaningful dialogue between business and the regime.

Similarly to Russia, after a decade of independence in Kazakhstan the state became a more active player in the economy. It increased official ownership and control in key sectors by renegotiating most important contracts with foreign investors in oil and gas and strengthening state presence in metallurgy and mining. Creation of the National Welfare Fund “Samruk Kazyna” in 2008 helped Nazarbaev consolidate state power in the economy and strengthen the regime’s control over domestic business.\footnote{Tashimov, Tulkin, Svetlana Gribanova. “Industrializatsiia. Izdanie vtoroe, ispravlennoe.” Expert Online, 15 June 2009. Available at http://en.expert.ru/kazakhstan/2009/23/reforma/ (last accessed February 13, 2015).} Samruk-Kazyna manages shares in more than 400 companies that represent approximately 65 per cent of the economy.\footnote{OECD investment policy reviews 53.} Greater presence of the state in the economy has left business even less room to maneuver. Formal strengthening of the state is the most direct and effective way to maintain control. Informal mechanisms proved to be
insufficient at the time when business was undergoing differentiation and further development while energy prices continued to rise and offer lavish opportunities for rent-seeking.

The strengthening of the state has been mostly about establishing force (vis-à-vis other societal groups, such as business) and therefore empowering the regime than about the development power as a resource that serves the public good. As in Russia, state institutions in Kazakhstan have not gained strength. The ability of the state to command has been much stronger than the state power to set goals that serve the public interests and achieve these goals.

9. Kazakhstan’s Oil and Gas Sector

There is broad agreement in Kazakhstan that when the former Soviet republic gained independence, it did not have sufficient capital or technologies to develop oil and gas, the most promising economic sector, on its own. The Soviets knew about Kazakhstan’s hydrocarbons (Kazakhstan had 115 reserves with an extractable volume of 2 billion tons of oil and 1,500 billion cubic meters of gas per annum) but could not develop them due to lack of capital and advanced technologies. According to Nazarbaev, he concluded that Kazakhstan could not develop its resources on its own after the failure of the Soviets to extinguish the Tengiz fire in 1985. After gaining independence, Kazakhstan did not have the $10 billion (according to Chevron’s estimations) that were necessary to develop Tengiz. The same was true for gas. The Karachaganak gas field was discovered in 1979 in Western Kazakhstan, yet both the Kazakh SSR and the USSR in general lacked capital to develop it. According to some estimates, the oil sector required imports of equipment worth $270 million in 1993 alone in order to sustain expansion and some $400-600 million per year thereafter. By comparison, the state invested a mere $90 million in 1994 and $110 million in 1995. Independent Kazakhstan also lacked a reliable pipeline system to deliver oil to western markets, which was a very important factor

---

139 Economic transition in Russia and the new states of Eurasia 152.
141 Nazarbaev, 90.
142 LeVine, 115.
143 First steps toward economic independence: new states of the postcommunist world 83.
144 See Economic transition in Russia and the new states of Eurasia 150.
affecting Kazakhstan’s decision regarding the future of the sector. Oil exports were completely dependent on transportation quotas imposed by Russia. Therefore, as Nazarbaev concluded, “[t]he only real solution would have been foreign investors.”

Because Kazakh oil and gas remained underdeveloped during the Soviet era, there was no substantial indigenous class of oil workers in the republic. During the Soviet era, Atyrau was a “dirty little town without decent water supply.” Now it forms the hub of the oil industry located in Western Kazakhstan. Some oil workers who were ethnic Russians left Kazakhstan in the early 1990s. In contrast to Russia, where the “oil generals” became important economic and political actors in the early 1990s, Kazakhstan’s “oil generals” did not have sufficient power to influence policies that concerned the sector. Nazarbaev provided them with rent-seeking opportunities, often through appointments to lucrative posts, such as ministries, presidential administration, and state oil companies (in particular, Kazmunaigaz) in exchange for political allegiance. Once some of the “oil generals” became too successful and began acquiring resources, they were moved away from the projects.

9.1. The Arrival of Foreigners

For Kazakhstan, oil was to become “the foundation of economic independence.” Given the sector’s potential, Kazakhstan made a political decision to focus on development of large oil fields as opposed to small ones, which it could develop on its own. During the first decade of independence, Kazakhstan attracted US $13 billion of FDI into oil and gas sectors. As of 1995, oil and gas hosted 99 per cent of incoming FDI.

---

145 Nazarbaev, 171.
146 Interview with Zhassulan Kuzhekov, RFE/RL correspondent in Astana, founder of the website Atyraunews.com, Astana, 18 June 2010.
147 Interview with an expert, Kazakhstan, 2010.
149 Interview with an expert, Kazakhstan, 2010.
150 Nazarbaev, 93.
152 Economic transition in Russia and the new states of Eurasia 152. This share has been declining since then, likely because other industries have been catching up with oil and gas. In 2000, the share of oil and gas in FDI total amount was 72 percent. It declined to 16 per cent in 2010. At the same time, the total FDI has been rising – from 2.8 billion in 2000 to 17.4 billion in 2010. The share of oil and gas in GDP has also risen considerably – from 10.9 per cent in 2001 to 28.3 per cent in 2010. See Kazakhstan Oil and Gas Tax Guide. 2011. Ernst and Younge.
investors discovered Kashagan, Kazakhstan’s major oil field today. Oil production increased from 530,000 b/d in 1992 to 939,000 b/d in 2002. Since 1998, output has been rising by approximately 15 per cent annually. After the oil prices began steadily rising, Kazakhstan accumulated $70 billion of financial reserves in its National Oil Fund, which only fortified Nazarbaev’s position.153

In the early 1990s, Kazakhstan was completely unknown to the West and therefore was considered a “risky” investment destination. The country “felt like it needed to do something special” to compensate for those risks.154 In sectors like oil, foreign companies were clearly interested and many of the offered concessions were excessive.155 For example, it is unclear why Kazakhstan gave up the Korolovsky field as a “small concession” during negotiations over Tengiz, yet this move doubled the area offered for exploration.156 That is why while there is general agreement that Kazakhstan could not develop its oil and gas sectors on its own, Nazarbaev’s regime has faced criticism of how it opened up its key sector to foreigners.

Kazakh representatives had very little experience at conducting negotiations. For example, during talks over Tengiz, the Kazakhstani delegation initially did not have a single lawyer in its team. Chevron’s lawyer drafted the agreements.157 Foreign lawyers represented Kazakhstan itself.158 The government at the time usually “simply signed the text offered by a foreign investor.”159 The US embassy provided technical assistance on the contracts. Coincidentally, some of the biggest foreign investors at the time came from the US, which left room for conflicts of interest.160 In the 1990s, Kazakhstan “gave away much more than necessary” to foreigners.161

The fact that the two sides sat down to negotiate suggests that Kazakhstani officials had made their initial choice regarding FDI. Perhaps an even bigger problem than lack of experience was the fact the interest of the regime predominated over public (state) interest during the

154 Interview with an expert, Kazakhstan, 2010.
156 Nazarbaev, 100.
157 LeVine, 137.
158 Interview with an expert, Kazakhstan, 2010.
159 Interview with an expert, Kazakhstan, 2010.
160 Interview with an expert, Kazakhstan, 2010.
161 Interview with an expert, Kazakhstan, 2010.
negotiations (I already discussed Nazarbaev’s personal interest in the deals above). During negotiations, Nazarbaev himself “was inexperienced, but not unschooled.” When negotiating his personal interests, Kazakhstani officials turned out to be “tough negotiators with few illusions.” Even if the deals were bad for Kazakhstan, they were not necessarily bad for Nazarbaev and his regime.

Chevron was the first Western company to show interest in Tengiz. After long negotiations, on June 2, 1990 Chevron and representatives of the Kazakh SSR signed a contract that awarded the US company exclusive rights to develop the field. However, after the collapse of the USSR Nazarbaev backed off from the deal. Using BP’s growing interest in the field, Nazarbaev re-negotiated the deal with Chevron: the profit share of the latter would drop to 19 per cent from the initial 29 per cent. According to Nazarbaev, he presented Chevron with an ultimatum: the latter either had to take Kazakhstan’s new offer or leave it.

In reality, neither side wanted the negotiations to fail. Kazakhstan needed foreign companies to develop its key sector while Western oil companies needed new oil deposits to maintain production. In 1993, Chevron and Kazakhstan finalized the deal and created a JV TengizChevroil based on equal partnership. The deal that became known as the “contract of the century” paved the way for the entrance of other foreign companies into Kazakhstan. Chevron agreed to pay $450 million for a 50-per cent stake, out of which $420 million would be payable on completion of a dedicated pipeline system that would allow exporting 260,000 barrels of oil per day or TCO’s production capacity. Not only Kazakhstani officials but foreigner investors made mistakes. Chevron left it up to Kazakhstan to construct the pipeline and soon “made the rueful discovery that [by releasing control over construction of the pipeline] he [the company head] had inadvertently agreed to let the Kazakhs run Tengiz.”

Besides Tengiz, foreigners also developed Kashagan and Karachaganak based on PSA agreements. A total of 14 PSAs were signed. The procedure for signing them was rather easy.

---

162 LeVine, 113.
163 LeVine, xiii.
164 LeVine, 139.
165 Nazarbaev 102.
166 Quoted in Peck, 153.
167 LeVine, 140.
Not a single PSA had to go through parliamentary approval. Foreigners merely had to deal exclusively with the president. Intentionally or unintentionally, Kazakhstani negotiators made some serious mistakes. When the Kashagan PSA was signed in November 1997 and the AgipKCO North Caspian consortium was created, the Kazakhstani government adopted the text of the PSA offered by foreign consultants without major discussion. The PSA was to be valid for 40 years, without further subdivision into the stages of exploration and extraction.\textsuperscript{169} James Giffen ensured that this time Kazakhstan got its money up front rather than having to wait for it in installments, as Chevron had so purposefully negotiated for Tengiz.\textsuperscript{170} The content of these PSAs remains undisclosed up to today.

In the 1990s, Kazakhstan did not help local oil companies establish themselves. Not only did Kazakhstan avoid developing its own version of “Lukoil” as an example of a company run by former “red directors” that successfully adapted to new circumstances, but the regime deliberately excluded domestic actors from privatization.\textsuperscript{171} Domestic enterprises that worked on oil projects in the 1980s could not compete with foreign subcontractors that began arriving in the 1990s. Kazakhstani oil producers were small and were unable to pay large cash bonuses to the officials. Many domestic actors working in the sector could not even make the pre-qualification payment for major oil assets.\textsuperscript{172} In 1995, the Subsoil Law and Petroleum Law stipulated that foreign companies could choose their own partners on a competitive basis, which effectively led to exclusion of Kazakh companies.\textsuperscript{173} In short, support of Kazakh oil companies was “not part of the policy.”\textsuperscript{174}

9.2. Key Decision-Makers

When Kazakhstan gained independence, production associations accounted for three quarters of its oil.\textsuperscript{175} The initial effort to re-organize the sector created Kazakhstanmunaigaz that included all sector’s enterprises. The newly established Ministry of Energy and Fuel Resources and the Ministry of Geology and Protection of Mineral Resources struggled to coordinate their

\textsuperscript{170} LeVine, 255.
\textsuperscript{171} Interview with Oleg Egorov, Institute of Economy of the Ministry of Education and Science of the Republic of Kazakhstan, senior scientific expert, Almaty, 29 June 2010.
\textsuperscript{173} Ostrowski, 71.
\textsuperscript{174} Interview with an expert, Kazakhstan, 2010.
\textsuperscript{175} Peck 2004, 144.
Kazakhstanmunaigaz, which held some of the most promising economic assets, did not receive any special treatment from the government, which in the early 1990s offered some of its shares to foreign investors. It also did not play any official role in PSAs.

In an effort to streamline the opening up of the industry to foreign investors, Nazarbaev initiated laws regulating FDI in the energy sector, such as the laws “On Petroleum” of 26 June 1995 and “On Subsurface and Subsurface Use” of 27 January 1996. The latter law introduced PSAs and excess profit tax regime. The laws restricted the ability of governors and regional executive bodies (akims) to negotiate PSAs with foreigners. Nazarbaev replaced personnel and re-organized institutions in order to undermine potential challengers to his pro-FDI policies. For example, when the Ministry of Energy and Fuel Resources opposed Nazarbaev’s plan to invite foreign investors into the sector, Nazarbaev simply abolished it and created new Ministry for Oil and Gas Industry. When Nazarbaev became concerned that an “oilman” Ravil Cherdabaev began dominating the new ministry by bringing his own people into the ministry, he replaced the latter with the more loyal Nurlan Balgimaev and filled in key government positions with new people without connections to the “oilmen.” When Balgimaev objected to selling large packages of shares to foreigners, Nazarbaev put the State Property Committee in charge of holding residual interests in oil projects and in such a way weakened the Ministry of Oil and Gas. Kazhegeldin and Nazarbaev retained control over privatization at the time and the mass sale of property in the sector continued.

9.3. Strengthening of Control

By the end of the 1990s, Kazakhstan’s policy regarding FDI began changing. Its officials visibly toughened their rhetoric for the first time in 1997, when Nazarbaev declared, “We sold everything which could be sold. I won’t allow the sale of the remaining enterprises.” In March 1997, the president strengthened his formal control over the sector through creation of a national oil company Kazakhoil. Until then, no single institution effectively coordinated activities of foreign companies and planned the sector’s long-term development. As one of my interviewees

---

176 Ostrowski 2010, 34.
177 Challenges of the Caspian resource boom: domestic elites and policy-making 110.
178 Jones Luong, 261-265.
179 Challenges of the Caspian resource boom: domestic elites and policy-making 110.
180 Peck, 149-150.
181 Quoted in: Peck, 3.
182 Challenges of the Caspian resource boom: domestic elites and policy-making 111.
noted, before that, Kazakhstan had “decided to be more American than the Americans themselves” by eschewing the creation of a strong national energy company. After its creation, Kazakhoil received state shares in PSAs, including state share in the Caspian pipeline consortium, various enterprises, and the JVs in the sector. Nurlan Balgimbaev stood behind the initiative to create the national oil company and briefly headed it before succeeding Kazhegel’din as the PM in October 1997. As the PM, Balgimbaev launched a formal review of the past sales in the sector to determine whether investors had been observing the terms of their contracts.

Even though the rhetoric toward foreign investors toughened in 1997, changes in the actual policy did not immediately follow. Policy toward foreign investors at the time was formulated in an ad hoc manner. For example, in 1997-1998, Nazarbaev gave key posts in Kazakhoil to the “newcomers” in order to counterbalance Balgimbaev, who objected to further sales of sector’s assets to foreigners. Balgimbaev was dismissed in 1999 after he had tried to sell an additional part of the state share in Tengizchevroil. However, a year later, Kazakhstan sold a 5 per cent ownership in TengizChevroil to Chevron. The next government was even more assertive: its PM Kasymzhomart Tokaev threatened to cancel all guarantees that had been given to foreign investors. In addition to strengthening control over oil revenues, creation of Kazakhoil also served personal interests of Nazarbaev’s family. President’s son-in-law Timur Kulibaev became the financial director and vice-president of the company. Revenues from Kazakhoil’s sales were technically not government revenues, which eased their misappropriation and misallocation. Some of them financed construction of new capital city in Astana.

Nazarbaev’s toughening attitude towards foreigners may have been an attempt to strengthen Kazakhstan’s (and therefore his own) position in negotiation of the projects as the original bargain was becoming “obsolete” and the Kazakhstanis gained experience in dealing with foreigners. However, the most significant change regarding FDI became first observable as
oil prices began rising in the 2000s.\textsuperscript{188} Greater demand for hydrocarbons on the part of foreign investors eventually empowered Kazakhstan to take much bolder steps towards re-establishing the state’s official control and ownership in the sector than in 1997-1999. Throughout the 1990s, the president and his closest allies had informal control over projects developed by foreigners, in part due to their concealed participation in these projects as private parties. When energy prices began rising rapidly, informal control was no longer sufficient. Kazakhstan’s officials could gain a lot more personally and also strengthen their popularity with the public at large by strengthening the formal control of the state. By 2000, Nazarbaev’s regime was finally ready to sideline James Giffen by declaring that Kazakhstan was now ready to negotiate on its own.\textsuperscript{189} In many ways then, Kazakhstan resembles Russia where rising energy prices allowed Putin to re-define relations with domestic oligarchs. Interest from more players, in particular, the Chinese energy companies, in Kazakhstan’s energy resources further empowered the regime vis-à-vis foreigners.

Another way the regime strengthened control over the sector was through the establishment of national energy companies. Even though Kazakhoil was established only in 1997, six years into independence, it soon became a powerful actor in the sector and strengthened the position of Nurlan Balgimbaev personally. In order to undercut Balgimbaev, in 2002 Nazarbaev created Kazmunaigaz by merging Kazakhoil and the national company Oil and Gas Transportation CJSC. Kazmunaigaz was established as a vertically integrated and a fully state-owned JSC.\textsuperscript{190} President’s second son-in-law Timur Kulibaev, who had been behind the formation of Kazmunaigaz, became the company’s vice president.\textsuperscript{191} For Nazarbaev’s regime, Kazmunaigaz turned into the main vehicle for strengthening control over the sector. Unlike Kazakhoil, Kazmunaigaz was created \textit{after} energy prices had begun rising, which boosted the company’s position in negotiations with foreigners. Kazmunaigaz was to be widely involved in production, refining, transportation, and sale of hydrocarbons. It received the authority to act on behalf of the government as part of the Karachaganak and North Caspian PSAs. The company

\textsuperscript{188} A number of my interviewees pointed this out. The 1997 Law on Support of Foreign Investment was cancelled in January 2003. See \url{http://adilet.zan.kz/rus/docs/Z970000075}.
\textsuperscript{189} LeVine, 370-371.
\textsuperscript{190} Kalyuzhnova, 112.
\textsuperscript{191} Peck, 181-182.
was to have at least 50 per cent of equity participation in all new oil and gas projects. Its control over key export gas pipelines (through its subsidiary KazTransGaz) gave Kazmunaigaz de facto power to set up export quotas for domestic and foreign producers of hydrocarbons. At the same time, very few mechanisms were put in place to ensure that Kazmunaigaz acted in public as opposed to private interests. Similarly to Russia’s Gazprom, Kazmunaigaz combined the roles of being a state-owned company (which should aim to receive profit despite a share of state ownership) and the function of a regulator (the quasi-state functions). Creation of Kazmunaigaz also gave local elites access to the oil sector. The oilmen received top positions in the company, which further secured their support for Nazarbaev’s regime. The company “employs children and relatives of important people and has to give them nice salaries.” It has become a source of patronage that sustains the regime in power.

The toughening of attitude towards FDI was also formalized through a number of legislative changes. For example, in 1999, Kazakhstan amended the 1996 Subsoil law by making it mandatory for all new bidders to work with the national oil company in gaining rights for subsoil usage. The new laws that strengthened government’s control over the sector were prepared in an ad hoc manner. In 2004, legislation awarded the state the right to acquire shares in new and existing contracts, which allowed Kazakhstan to obtain half of BG’s 16.67 per cent ownership in Kashagan that was offered for sale at the time. In July 2005, the President signed a law that gave Kazmunaigaz the right to buy 50 per cent or larger ownership in all offshore projects. In 2007, the state granted itself the right to amend or annul contracts in cases of substantial change in economic interests or a threat to national security. For the first time, the government allowed itself to violate stability of the signed contracts.

---

192 Kalyuzhnova, 115.
194 Interview with an expert, Kazakhstan, 2010.
195 Ostrowski 2010, 58.
196 Interview with an expert, Kazakhstan, 2010.
197 The other half was distributed among the existing members of the consortium after they had objected to the purchase of it by China National Offshore Company and Sinopec. Kaiser et al 2007, 309-310.
199 OECD investment policy reviews, 13. For the first time, the government allowed itself to violate stability of the signed contracts.
200 The previous law that guaranteed stability was cancelled in 2003.
Since the content of PSAs remains unknown to the public, it is not always clear whether either the government or foreign investors have the right to renegotiation.\textsuperscript{201} Foreign investors have also feared losing the right to dispute settlement through international arbitrage.\textsuperscript{202} The government announced that it would cancel tax stability guarantees for all existing agreements, with the exception of TengizChevroil and 15 operating PSAs. It also abandoned PSAs altogether as a form of investment. In June 2008, a government resolution listed 231 subsoil areas of strategic importance in which the state would remain the sole owner.\textsuperscript{203}

The main formal venue for interaction between foreign investors and the government has been the Council of Foreign Investors chaired by President Nazarbaev. At its bi-annual meetings, foreign companies’ CEOs have been mostly learning about new developments in the industry that concern them. They do not raise sensitive topics and avoid criticizing the government since, if they do so, they may encounter problems later.\textsuperscript{204} If the government has reached a decision, foreign investors effectively do not have an opportunity to modify or reverse it.\textsuperscript{205}

\section*{9.4. Relations Turn Sour}

Foreigners had seen bad times in Kazakhstan in the 1990s.\textsuperscript{206} However, in the early 2000s, after energy prices had begun rising steadily, conflicts became much more common and bigger in scale. Disputes broke out about all three major projects developed by foreign investors. In their aftermath, Kazmunaigaz increased its participation or entered projects developed by foreigners through a variety of methods. For example, both the central and local governments often used tax audits as a way to extract concessions from foreign oil companies or to resume bargaining with them on an unrelated issue.\textsuperscript{207} Foreigners were found guilty of administrative and environmental violations and falling behind the extraction schedule. For example, in 2002,

\begin{itemize}
\item \textsuperscript{201} This is different from Azerbaijan, where PSAs were given the status of laws. Kazakhstan joined Tony Blair’s Extractive Industries Transparency Initiative in October 2005. Not only the content of PSAs is unknown to a larger public in Kazakhstan, but also the extent of state presence in energy projects is not clear. Moreover, specific data on company payments to the budget and payments on dividends has been missing entirely. Jenik Radon, \textit{Expanding the Extractive Industries Transparency Initiative (EITI) Agenda to Transportation of Hydrocarbon Resources Revenue Watch Institute, 2009}) 15.
\item \textsuperscript{202} OECD Investment Policy Reviews 73.
\item \textsuperscript{203} OECD Investment Policy Reviews 251.
\item \textsuperscript{204} Interview with an expert, 2010.
\item \textsuperscript{205} Interview with an expert, 2010.
\item \textsuperscript{206} One of the first big conflicts that broke out between the Canadian Hurricane Hydrocarbons Ltd (HHL), the owner of Yuzhneftegaz, and the Kazakh business group Central Asian Industrial Holdings associated with Timur Kulibaev and Kazkommertsbank. Peck, 163.
\item \textsuperscript{207} Jones Luong, 269.
\end{itemize}
the Ministry for Natural Resources fined Tengizchevroil $72 million for storing sulphur. During
the same year, disagreements arose between the government and ChevronTexaco about financing
of gas processing and recycling projects at Tengizchevroil, which put the project on hold
altogether. Although many government inspections and formal complaints were not
completely unwarranted, the speed with which the conflict subsided after the government
established control over a project suggested that the disputes were used as a tool to exercise
pressure rather than to protect the environment or increase budget revenue.

The government tried to renegotiate the forty-year contract on Kashagan that had been
signed in 1997 claiming that the terms of the contract were excessively favourable to foreign
investors. Kashagan’s economically “flexible” PSA allowed the state to capture excess profits
if the project turned out to be more successful than expected while imposing heavy penalties on
the state if the project was less successful. The state’s share of revenues rather than companies’
profits was to finance any increase in project costs. The initial expected delay of oil extraction
by two years and the doubling of project’s cost meant that Kazakhstan’s revenue would be cut
from $28 billion to $8 billion. The government responded by demanding that Kazmunaigaz
become an operator for the project, to double its own share in it, and to raise the share of
Kazakhstan’s “profitable oil” from 10 to 40 per cent. The consortium had to accept these
demands, which increased Kazakhstan’s ownership to 16.81 per cent. The sides agreed that
commercial extraction would begin no later than 2013. Kazakhstani authorities agreed to an
increase in expenses from $57 billion to $136 billion, but the state would now receive royalty of
$74 billion at the oil price of $85 per barrel until 2040. The North Caspian Operating Company
(NCOC) succeeded the former operator Agip KCO. Kazmunaigaz appointed the consortium’s

---

208 Peck, 157-158.
209 See, for example, on Karachaganak: “Podpisanie ‘Mirovoy’ Po Karachaganaku Sovpalo S Okonchaniem
210 In 2001, Kashagan was developed by BG (16.67%), Eni-Agip (16.67), ExxonMobil (16.67) Shell (16.67), Total
211 Muttitt, Greig. 2007. Hellfire Economics. Multinational Companies and the Contract Dispute Over Kashagan,
the World’s Largest Underdeveloped Field. Available at
212 Muttitt 2007, 3.
deputy director and became responsible for management of production jointly with Shell. At the request of Exxonmobil, Kazakhstan increased the duration of PSA by four years.\textsuperscript{214}

In 2012, after persistent pressure and accusations of tax evasion, environmental violations, overstating of costs, and violations of Kazakh immigration laws, Kazmunaigaz also acquired shares in the Karachaganak Petroleum Operating B.V. (KPO), a consortium of British BG, Italian Eni, American Chevron, and Russian Lukoil that developed the Karachaganak gas condensate field.

\textbf{9.5. Regime Legitimization}

The regime explained the change of policy toward FDI by arguing that in the 1990s, foreign investors had taken advantage of Kazakhstan’s lack of negotiating experience and dire economic situation. By strengthening state ownership and control position in the sector, Kazakhstan would now take back what duly belonged to it, the regime claimed. When in spring 2011 the government initiated a “people’s IPO” to sell shares in 22 “national champions” to citizens of Kazakhstan below the market prices, foreigners were explicitly banned from purchasing these assets. This step aimed at boosting regime legitimacy amidst growing social inequalities. The same president who had established the policy of openness was now trying to re-claim the assets.

The regime has also tried to gain the support of domestic business by demanding that foreign investors increase the share of local content (local goods, services, and labor) in their projects.\textsuperscript{215} There was no such concern in the 1990s.\textsuperscript{216} The Subsoil Law of 1995 set up conditions that allowed non-Kazakh companies to enter the Kazakh market.\textsuperscript{217} Now the 2002 amendment to the Oil and Gas Law made it mandatory for companies operating in these sectors to purchase local goods and services. Since 2006, companies have been required to meet annual local content benchmarks. Estimates of how much local content is presently used in the sector vary. One official calculation made in 2008 stated that “local content” constituted only 10-15 per cent in foreign projects.\textsuperscript{218} In practice, local content requirements have often allowed regional authorities to demand that foreign investors hire a specific person or take a specific company on

\begin{footnotesize}
\begin{enumerate}
\item For more discussion, see Ostrowski, 109.
\item Interview with an expert, Kazakhstan, 2010.
\item Ostrowski, 102.
\item OECD investment policy reviews 38.
\end{enumerate}
\end{footnotesize}
as a subcontractor irrespective of their qualifications. These demands are partly responsible for the increasing costs of extraction the government has been complaining about.\textsuperscript{219} Having avoided the establishment of domestic actors in the key sector, the regime now needed to give actors a stake in supporting its policies.

Recent tensions between higher-paid foreign and low-paid Kazakh workers have given the regime additional reasons for concern.\textsuperscript{220} In 2011, the situation escalated when workers of Kazmunaigaz’s affiliate company demanded wages on par with foreign workers. Negotiations with the company management failed and approximately 2000 workers were fired. Workers’ demonstrations turned violent when protesters clashed with police. By December, at least 10 people were killed. The demonstrations became Kazakhstan’s “deepest unrest since independence.”\textsuperscript{221} In order to de-escalate the conflict, Nazarbaev fired Kulibaev from the post of chairman of Kazmunaigaz’s board of directors and dismissed him as the CEO of Samruk Kazyna, the company’s main shareholder.\textsuperscript{222} So far, the president has managed to keep the situation under control. The “soft authoritarian” regime had to make declarative steps and conduct informal negotiations in order to shift the responsibility for its policies.

9.6. Resource Nationalism?

Some authors have referred to the toughening of regime’s attitude toward foreign investors in oil and gas sectors as “resource nationalism.” This term has a variety of meanings, which makes it difficult to apply it empirically. One simple definition of the term is “policies that are intended to increase state control over natural resources vis-à-vis private actors.”\textsuperscript{223} The term fits Kazakhstan’s post-2000 relations with foreigners only when applied very broadly as it does not capture the goals the regime pursued in strengthening control and the inconsistencies of policies that followed.

\begin{flushleft}
\textsuperscript{219} Interview with Zhassulan Kuzhakov, RFE/RL correspondent in Astana, founder of the website Atyraunews.com, Astana, 18 June 2010.
\textsuperscript{220} The Wikileaks Cable “Kazakhstan: the Tengiz ‘Brawl’ Highlights Underlying Problems,” Embassy Astana, 8 November 2006.
\textsuperscript{222} Challenges of the Caspian resource boom: domestic elites and policy-making 113-114.
\textsuperscript{223} Caspian energy politics: Azerbaijan, Kazakhstan and Turkmenistan, ed. Indra Øverland, Andrea Kendall-Taylor and Heidi Kjærnet (New York: Routledge, 2010) 20.
\end{flushleft}
Nazarbaev’s “resource nationalism” has not been directed at the exit of foreigners. Kazmunaigaz lacks the necessary experience, technologies, management skills, and capital to develop hydrocarbons independently. The majority of the company’s fields are old and have already passed the peak of extraction. That is why in Kazakhstan, “resource nationalism” has been more about gaining control than ownership over resources. Kazmunaigaz entered a number of projects as a minority shareholder. This re-entry had a high price. For example, the exit from Kashagan and the subsequent return to the project cost Kazakhstan almost 2 billion dollars. Renegotiation was not easy: in the course of the 1990s, the major fields ended up in the hands of a large number of foreign investors, each with financial resources and power to counteract the pressure of Kazakhstani government. Foreign investors that came from countries with significant geopolitical weight, such as the US, used their home government to protect their interests.

Within projects, Kazmunaigaz exercises control that is higher than its level of formal ownership might suggest. The company has the right to nominate a project operator without having a 50 per cent ownership. For example, in Kashagan, Kazmunaigaz owns only 16.88 per cent yet it reorganized the entire management scheme of the project. Other companies had to follow its “recommendations.” Kazmunaigaz’s main function within projects developed by foreigners is to exercise control over finances. The entry of Kazmunaigaz has often lengthened the duration of projects and created additional bureaucratic hurdles. For example, after Kazmunaigaz became responsible for HR issues in the Kashagan project, the “economy of nephews” started, where people with connections to company management and the regime get the high-paid jobs.

Another reason that “resource nationalism” does not easily apply to Kazakhstan’s policies regarding FDI is that after re-gaining those assets, the government re-sold some of them,

224 Interview with an expert, Kazakhstan, 2010.
228 Interview with an expert, Kazakhstan, 2010. Nazarbaev had to promise Obama that the contracts would not be reconsidered.
229 Tompson, 174.
230 Interview with Dosym Satpaev, Risk Assessment Group, director, Almaty, 31 May 2010.
231 Interview with an expert, Kazakhstan, 2010.
232 Interview with an expert, Kazakhstan, 2010.
in particular, to the Chinese investors. In 2005, China’s CNPC acquired Canadian-registered PetroKazakhstan, Kazakhstan’s second largest oil producer. In 2009, Kazmunaigaz together with China’s CNPC bought Mangistaumunaigaz from the Indonesian Central Asia Petroleum Ltd, which is rumored to be associated with Timur Kulibaev. The Export-Import Bank of China gave a loan for this purchase.\footnote{224} Although Kazakhstan returned some of assets it had sold before, it has been getting into large debts, and therefore dependencies on the lenders.\footnote{225} The Chinese presence became especially prominent during the global financial crisis, when China offered loans in exchange for stakes in a local oil producer and commitment of future energy supplies.\footnote{225} Mukhtar Ablyazov, who is now in opposition to Nazarbaev, claimed that the Chinese investors had made their way into Kazakhstan’s energy sector by giving some of the shares they purchased personally to Nazarbaev free of charge.\footnote{227} Nazarbaev has been returning the “favors.” When in 2003 Western participants of the Kashagan consortium exercised their right of first refusal to prevent the Chinese CNOOC and Sinopec from purchasing BG’s 17 per cent stake, it only took Nazarbaev several hours to withdraw the consortium’s pre-production exemption from paying the value-added tax.\footnote{227} Despite privileged treatment on a number of occasions, Chinese companies have also suffered from inconsistent policies and unreasonable demands by Kazakhstani officials.

Kazakhstan still needs Western firms to develop its oil and gas resources.\footnote{228} The calculation that foreign, particularly Western, investors would stay on despite increased pressures generally proved to be correct.\footnote{229} For the most part, foreign investors agreed to the conditions the government presented while renegotiating the old contracts. Foreign investors will stay as long as energy prices remain high. Inviting Chinese companies in will not necessarily

\footnote{224}“Kazmunaigaz I CNPC kupili vse aktsii Mangistaumunaigaza,” Vesti, 25 November 2009.
\footnote{225} Interview with Oleg Egorov, Institute of Economy of the Ministry of Education and Science of the Republic of Kazakhstan, senior scientific expert, Almaty, 29 June 2010.
\footnote{227} According to Alyazov, Nazarbaev put forward the same demands regarding shares of Ablyazov’s BTA bank. He wanted to obtain half of the ownership for free. Officially, Bulat Utemuratov, the presidential affairs manager, was to own the shares. See http://www.rbcdaily.ru/2011/07/13/finance/562949980627615.
\footnote{227} Alexander Cooley, Great games, local rules: the new great power contest in Central Asia ([S.I.]: Oxford University Press, 2012) 137.
\footnote{228} Caspian energy politics: Azerbaijan, Kazakhstan and Turkmenistan 127.
\footnote{229} ConocoPhillips also discussed the possibility of leaving. Annual FDI in Kazakhstan has remained much higher than in other parts of the former Soviet Union, standing at US$6.1 billion, or about 8 per cent of GDP, in 2006 (World Bank 2008). Caspian energy politics: Azerbaijan, Kazakhstan and Turkmenistan 131.
help Kazakhstan gain control over its resources. Chinese companies are generally less technologically advanced than Western firms and often buy assets that are already producing. The technical challenges Kazakhstan’s oil and gas fields present will thus likely limit Chinese presence in the sector in the long-term. That is why Kazakhstan has showed restraint in re-asserting itself vis-à-vis foreigners. Nazarbaev has been playing a balancing game of formally strengthening the role of Kazakhstani state in its oil and gas sector without jeopardizing the sector’s long-term future (should foreign investors leave) and his own personal interests. Exactly how Nazarbaev’s private unpublicized stake in the projects influences formal relations between foreign investors and the government is a matter of speculation since few details are known to the public.

10. Kazakhstan’s Metallurgy and Mining

Kazakhstan’s metallurgy and mining sector consists of coal, ferrous, and non-ferrous minerals produced by approximately 230 enterprises. The sector is responsible for one third of Kazakhstan’s exports and one third of government tax revenues. The dissolution of the USSR led to collapse of traditional markets for mining and metallurgy, which threatened to stop production and lay off hundreds of thousands of employees. This challenge was common to all former republics. Sector’s enterprises also provided essential infrastructure and social services in the communities where they were located. The regime needed to maintain continuous work of these enterprises in order to avoid social tensions, which made the sector important politically. Nazarbaev knew this sector very well: in the Soviet times, he had worked at the Karaganda Metallurgical Combine before becoming the republic’s Chairman of the Council of Ministers in 1984. As one of my interviewees noted, “as a metallurgist, Nazarbaev understood well that, for example, not a single plane can take off without copper, not a single TV can be turned on.” The sector was certainly important and had a lot of potential, yet at the same time it came second in importance to oil and gas as regime’s source of revenue.

244 Interview with an expert, June 2010.
Table 11. Balance Reserves of Major Commodities, Kazakhstan

<table>
<thead>
<tr>
<th>Commodity</th>
<th>Kazakhstan’s % of total world reserves</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lead</td>
<td>16</td>
</tr>
<tr>
<td>Zinc</td>
<td>18.9</td>
</tr>
<tr>
<td>Copper</td>
<td>7</td>
</tr>
<tr>
<td>Iron ore</td>
<td>3.8</td>
</tr>
<tr>
<td>Manganese</td>
<td>8</td>
</tr>
<tr>
<td>Titanium</td>
<td>2.5</td>
</tr>
<tr>
<td>Chronium</td>
<td>22.4</td>
</tr>
<tr>
<td>Bauxite</td>
<td>1.2</td>
</tr>
<tr>
<td>Gold</td>
<td>20.8</td>
</tr>
</tbody>
</table>

Source: Ministry of Natural Resources and Ecology. Taken from Doing Business with Kazakhstan. 245

One of the problems lingering from the Soviet era was that production in non-ferrous sector concentrated on extraction while more advanced processing had been done in other republics. 246 In contrast, ferrous metallurgy saw an increase of the share of final products yet a decrease of extraction rates. Levels of equipment renewal were low. 247 The sector’s outdated technologies required replacement in the long-run, yet in the short-run they could maintain production: the sector could “be making some money by itself, little by little.” 248 The technical personnel was also highly qualified. 249 The sector also needed smaller capital investments than oil in order to continue production since basic infrastructure was already in place. 250 In the 1990s, availability of inputs and possibilities for selling produced goods were bigger challenges for Kazakhstan’s metallurgy than the level of sector’s development itself.

It may therefore be surprising that Kazakhstan put so much effort into attracting FDI into a sector it could develop on its own (metallurgy and mining became the second largest recipient

246 For discussion, see A. K. Koshanov, Industrialnyy progress Kazakhstana v period razvitogo sotsializma (Alma-Ata: Nauka, 1979) 156.
247 For data, see See Fondoemkost’ produktsii v promyshlennosti Kazakhstana 145-146. Although the situation was somewhat better in non-ferrous than in ferrous metallurgy, the share of aged equipment was also higher in the latter.
248 Interview with Zhassulan Kuzhekoy, RFE/RL correspondent in Astana, founder of the website Atyraunews.com, Astana, 18 June 2010.
249 Interview with Tulegen Mukhanov, Republican Association of Mining and Metallurgical Enterprises of Kazakhstan, deputy executive director, Astana, 24 June 2010.
250 Interview with Zhassulan Kuzhekoy, RFE/RL correspondent in Astana, founder of the website Atyraunews.com, Astana, 18 June 2010.
of FDI after oil and gas sector). In 2011, gross FDI in Kazakhstan was about $21.2 billion, out of which investment in crude petroleum and natural gas accounted for about 2.1 billion whereas the total mining investment was 10 billion. Investment in nonferrous and ferrous metallurgy accounted for $1.5 billion and $1.0 billion, respectively. At the same time, the share of metallurgy in domestic industrial production was much smaller than that of oil (crude oil was usually about 50 per cent while metallurgy was 4-5 per cent). The explanation is that many foreign investors were de-facto not “foreign” but domestic and had close connections to the President. The welcoming policy regarding FDI in the sector suited the regime’s interests and gave the domestic elites opportunities for self-enrichment.

10.1. Management Contracts as a Method of Privatization

The regime’s main strategy of transformation for metallurgy and mining became the signing of management contracts with investors where firms (mostly foreign but also domestic) leased an enterprise for a defined term while taking on assets and liabilities of this enterprise. At the end of a lease, a “manager” was to pay royalties to the government. The managing companies also had the right of first refusal if the state decided to sell its ownership. Even though management contracts were signed elsewhere at the time (for example, in Ukraine), Kazakhstan is unique in the large number of contracts it signed. The majority of them were signed during Kazhegel’din’s premiership.

Nazarbaev post-factum praised the decision to turn to management contracts as a way to revive the sector. Initial privatization efforts by the locals had made matters worse, he claimed. For example, Karmetkombinat was first given to domestic entrepreneurs that worked together with an Austrian company, yet, Nazarbaev complained, domestic investors lacked the necessary expertise and funds and “were simply not ready” to run the enterprise. Kazakhstan invited Mittal Steel to take over instead because “[i]n conditions such as these, only major investments on the part of companies in a firm position on world metal markets could save the enterprise.” Management contracts were supposed to help the state verify investors’ credentials and test their

---

253 Nazarbaev, 171-172.
254 Nazarbaev, 173.
management skills. In their essence, management contracts were a form of privatization since the majority of foreigners quickly transformed them into ownership.

Management contracts allowed the regime to shift formal responsibility for a socially important sector to outsiders: in the majority of cases, the regime tasked managers with taking care of social infrastructure and maintaining existing employment levels and therefore easing social strains. However, from the workers’ perspective, the success was partial: they retained their jobs since the enterprises continued to work, yet faced wage arrears. It is also unclear to what extent management contracts helped revive the sector in general. For example, the first enterprise given to foreign management was the Pavlodar alumina plant, even though its output decline was least substantial. The speed with which managing teams reversed output decline suggests that the sector may have not been in as desperate a shape as the regime suggested. Most importantly, management contracts failed to establish clear patterns of ownership and control over enterprises because real owners often concealed their identity. The majority of “foreign” investors who signed management contracts were de facto offshore investors with close ties to Nazarbaev himself.

During the 1990s, Kazakhstan’s metallurgy and mining sector witnessed a massive reduction of state ownership. Yet, it was not for the sake of letting the “invisible hand of the market” rule. The regime selectively opened up the sector to private investment. Residual shares that the state retained gave it weak decision-making powers regarding enterprises. One staff of the Committee of State Property and Privatization (Ministry of Finance) and one person from the corresponding ministry (Ministry of Energy and Natural Resources) who sat on company boards were usually middle-ranking employees, often over-burdened with responsibilities and without sufficient information to make key decisions. Although the state withdrew from the sector, regime representatives privately controlled the sector while exploiting their privileged connection to the state.

255 Interview with an expert, Kazakhstan, 2010.
256 Peck, 73.
257 Peck, 102-103.
259 World Bank, 76.
10.2. Who Were the Investors?

A diverse group of foreign and domestic companies worked in the sector in the 1990s. The majority of “foreign” investors were not well-established foreign companies specializing in metallurgy and mining but trading companies whose core business was anything but minerals production. By contrast, in oil and gas the foreign investors were well-known international energy companies, even if this did not make the deals they signed with Nazarbaev’s regime any less shady. There is a strong “perception that privatization of Kazakhstan’s metallurgy was structured to serve the personal needs of the regime.” As in oil and gas, the preference for foreigners (including “foreigners”) over local companies that were beginning to establish themselves slowed down the formation of domestic business community in the sector. The majority of investors came in by the mid-1990s and left the country by the late 1990s-early 2000s. Some investors found the investment climate to be too unfavorable. Others left because they had fulfilled their role of formal asset holders for the highest officials or were pushed out by well-connected domestic business.

One prominent “foreign investor” who was pushed out was the shady Trans World Group (TWG) that dominated Russia’s metallurgy in the 1990s. TWG actively used tolling in both Russia and Kazakhstan, which allowed enterprises to maintain production by processing inputs secured by TWG for a small fee. The TWG pocketed the much more substantial profit. TWG first gained control over the Pavlodar aluminium plant in 1994 together with Swiss-registered Kazakhstan Mineral Resources Corporation (KMRC) following “little consultation and virtually no financial review.” The two companies formed a JV named Whiteswan Ltd that was registered in the British Virgin Islands. KMRC was affiliated with the Eurasian Bank Group and was most closely associated with three very famous Kazakhstaniis – Alexander Mashkevich, Fatakh Shodiev, and Almaz Ibragimov. Today, Mashkevich continues to have very close ties

---

260 World Bank, 24.
261 Olcott, 163.
262 Cummings, 149.
263 For example, Kazakhstan had a very rare provision that investors had to reimburse Kazakhstan for “historic costs” occurred in the Soviet time if they wanted to work in Kazakhstan’s metallurgy and mining sector: World Bank, 53.
264 Other foreigners who came into Kazakhstan are Swiss-based Glencore, whose Marc Rich “who is no stranger to the murky ways of the metals business in the post-Soviet world.” Glencore stood behind the formation of Kazzync out of three large zinc-producing complexes in 1997. Olcott, 145.
265 Peck, 119.
266 Peck, 75.
with the president. TWG and KMRC converted the initial management contract into equity in less than two years. The management contract over the Pavlodar plant, which together with other assets became part of a new JSC Aluminium of Kazakhstan, was considered a “success story”: the new owners had paid off enterprise’s debts and workers’ wages and maintained output levels. TWG recreated the old production links by uniting smelters with their bauxite and alumina suppliers. At the same time, the selling price for this enterprise was unjustifiably low: the reported profits of TWG and KMRC at the plant in 1995 were more than double the price they had paid for the enterprise a year earlier. According to persistent rumors, the highest government officials privately benefitted from the sale.\(^{267}\)

After a dispute over management of the enterprise broke out between TWG and the EBG, Kazakhstani government sided with the latter and ousted TWG from Pavlodar. The same happened with the Sokolov-Sarbai Mining and Enrichment Combine and Kazakhstanmarganets, Kazakhstan’s manganese producer, which TWG co-owned with the EBG in Kazakhstan. TWG also had a stake in Kazchrome – Kazakhstan’s main producer of ferroalloys formed by Japan Chrome Corporation registered in the British Virgin Islands (identified in some sources as a JV between TWG and the EBG).\(^{268}\) Conflicts between TWG and the EBG provided a formal justification for policy change in the sector when in 1998 Kazakhstan announced a moratorium on further sale of large enterprises and initiated audits of existing contracts.\(^{269}\) The change of policy regarding FDI in metallurgy and mining reflected the change of attitude in oil and gas sector under PM Balgimbaev.

In ferrous metallurgy, Mittal Steel established itself through Ispat International, which acquired Kazakhstan’s largest ferrous metallurgy enterprise Karmet (later renamed as Ispat-Karmet). The government initially attempted to maintain production by obtaining foreign loans on the enterprise’s behalf. These measures failed to reverse output decline. After a few short-term acquisitions by foreigners, Ispat International acquired the enterprise in October 1995. The EBG then introduced Mittal Steel to Nazarbaev.\(^{270}\) Ispat converted its contract into an outright purchase almost immediately. It paid a $225 million bonus to the government and committed itself to a $500 million investment. Ispat also agreed to pay off immediate debts of $50 million,

\(^{267}\) Peck, 80.
\(^{268}\) Peck, 122.
\(^{269}\) Peck, 81.
\(^{270}\) Peck, 126.
settle wage arrears for $11 million, and reimburse the government $32 million for payment of Karmet’s debts. In 2002, a close representative of Lakshmi Mittal admitted that his company had paid $100 million commission to the Chodiiev group (Chodiiev’s is one of EBG’s three famous representatives) for assistance in purchasing Karmet and that Mittal Steel had used the Chodiiev group as a go-between with President Nazarbaev. Local authorities have few means of influencing the work of ArcelorMittal located in their region. The company enjoys a number of tax preferences. It is not clear to what extent Mittal Steel actually owns and controls its assets in Kazakhstan. Again, there are persistent speculations that Mittal Steel could be operating, at least to some extent, on behalf of Nazarbaev himself.

In copper mining, in 1995 South Korean Samsung signed a management contract over Zhezkazgantsvetmet, a fully integrated copper production enterprise. In less than a year, Samsung converted management into a 40 per cent equity interest. It also received the right to manage the state’s share of 35 per cent. It was later permitted to buy an additional 11 per cent that was part of the state ownership package. Over time, Samsung acquired further assets in the sector and created Kazakhmys. According to Ablyazov, Samsung exercised its ownership in Kazakhmys in Nazarbaev’s personal interest. Eventually Samsung sold its stake in 2002.

10.3. Business-Regime-State Relations in the Sector

After a decade, the metallurgy and mining sector became consolidated. In ferrous sector, the two main owners were EBG and Ispat International of Mittal Steel. EBG owns Aluminium of Kazakhstan in non-ferrous sector. Other large JSCs in non-ferrous metallurgy include Kazakhmys, Kazzync, and Yuzhpolimetal. Private owners obtained a majority stake in the majority of these companies. According to numerous accounts, President Nazarbaev stood behind many of these companies. His personal informal role in the sector defined the relations

---

271 Peck, 113.
272 “The Steel Maharajah,” BBC News, 24 July 2002. The story changed later. Lakshmi said that payments were only for the iron ore for the steel plant. Peck, 114.
274 Interview with an expert, Kazakhstan, 2010.
275 Exports of copper and copper products are the largest component of Kazakhstan's nonferrous exports, generating $700.0 million in 1997 and $619.2 million in 1996—representing 11.0 percent and 9.9 percent of total Kazakh export earnings, respectively.
277 Peck, 100-101.
between domestic and foreign business, the regime, and the state that formed around mining and metallurgy. The regime aimed to create a small number of strong players in the sector who would be monopolists in their production sphere. The regime would control them through undisclosed personal ownership and by balancing players against each other. The state also strengthened its formal role in the sector during the second decade of independence eventually creating the national mining company “Tau-Ken Samruk” in January 2009. Tauken Samruk is to be the formal analogue of Kazmunaigaz in the sector: it cannot regulate the sector yet helps consolidate state assets and also fulfill some controlling functions. People who are close to Timur Kulibaev are running the company.

Another company under strict control of the government is the Eurasian National Resources Corporation (ENRC), which was formed by three founders of the EBG in 2006. The ENRC serves as a holding company for all assets Alexander Mashkevich, Patokh Shodiev, and Alizhan Ibragimov acquired throughout the 1990s. The trio helps Nazarbaev maintain his power by providing PR and lobbying services. Through their affiliations with different institutions, Mashkevich and Shogdiev have organized public events to improve Nazarbaev’s image. Most likely, these managers simply “hold” assets for Nazarbaev, who is the real owner. Since 2001, the trio has been closely working with president’s nephew Kairat Satybaldy who has been viewed as a potential counterweight to Timur Kulibaev.

The murky ownership structure of metallurgy and mining companies presents a significant challenge to their long-term development, especially to their aspirations of becoming global companies and raising capital abroad. In October 2005, Kazakhmys was the first company from the post-Soviet region to be listed on the London Stock Exchange. The listing allowed it to raise over US$491 million. As an international watchdog Global Witness argues, this presents serious reasons for concern because of the strong ties between Kazakhmys’s Vladimir Ni, Vladimir Kim and President Nazarbaev. The president is reported to exercise undue influence

278 Interview with an expert, Kazakhstan, 2010.
279 ENRC Company website (http://www.enrc.com/about-us/our-history). ENRC controls Alferon Management, the group’s London-based company that holds mines throughout the Sub-Saharan Africa, Indonesia, Kosovo and Russia, as well as Kazchrome, Aluminium of Kazakhstan, the industrial and mining complexes of Zhairem and SSGPO, Eurasian Energy Corporation and ENRC Marketing. Marlène Laruelle, Globalizing Central Asia: geopolitics and the challenges of economic development, ed. Sébastien Peyrouse (Armonk, NY: M.E. Sharpe, 2013) 192.
281 Interview with an expert, Kazakhstan, 2010.
over the decision-making process within the company.\footnote{Risky Business: Kazakhstan, Kazakhmys Plc and the London Stock Exchange Global Witness, 2010) 3.} There are few safeguards in place to prevent Kazakhmys from disregarding the interests of minority shareholders. Kazakhmys enjoys the favor of Kazakhstani authorities.\footnote{In 2009, the company received $2.7 billion out of the $3 billion that the state-owned Samruk-Kazyna borrowed from China’s Development Bank. Adilov, Mukhamedzhan. 2011. “Pochemu Nazarbaev lubit Kazakhmys?” Respublika, 13 July.} However, this does not mean that foreign minority investors would be able to benefit from these privileges.

Some established Western mining companies entered Kazakhstan in the 2000s. For example, London-based Rio Tinto signed agreements on formation of two joint ventures in the copper sector with Kazakhstan’s National Company Kazgeologiia in 2013. In 2009, Canadian Cameco formed a 60/40 JV Inkai with KazaAtomprom. The government has clearly favored formation of JVs over other forms of investment: because the JVs are registered in Kazakhstan, this form of investment gives the government more formal control over the projects.\footnote{Interview with an expert, Kazakhstan, 2010.}

11. Conclusion

In the 1990s, Kazakhstan opened up key sectors of its economy to foreign investors. FDI was to strengthen economic independence and help the newly established country face the particularly acute challenges of state- and nation-building. For Nazarbaev’s regime, Western FDI has served as a legitimization tool inside and outside Kazakhstan. Throughout the 1990s, foreign capital, in particular FDI that went into the oil sector, also helped Nazarbaev’s regime maintain its power directly by bringing revenues into the budget and by providing the regime with slush funds to reward loyal societal actors.\footnote{I am grateful to Ed Schatz for helping me formulate this point.} FDI-driven economic performance became an integral part of Nazarbaev’s legitimization strategy even if FDI-fostered economic growth did not translate into adequate welfare expenditure and investment in human development.\footnote{Dave, 159.} The early entry of FDI, in particular into oil and gas, strengthened Nazarbaev’s “soft authoritarian” regime by boosting its legitimacy, which in its turn reduced dependence on domestic social actors. Unlike Yeltsin, who helped create his own political ally – domestic business – Nazarbaev tried to prevent the rise of a domestic big business sector that could challenge his power. Instead, the
regime’s focus on cooptation through appointment to positions of power rather than dispersal of economic assets helped solidify its power.

One of the biggest puzzles Kazakhstan’s FDI presents is the fact that Kazakhstan’s oil and gas sector attracted well-established Western companies while metallurgy and mining attracted mostly offshore companies. Whereas Kazakhstan could not develop its oil and gas on its own, it could do so with metallurgy and mining. A large part of investment that came into the latter originated in Kazakhstan and was tied to President Nazarbaev personally whereas in oil and gas the main actors developing the fields were “real” foreigners.287

In the 1990s, Nazarbaev sat in his autocrat’s chair much more comfortably than Yeltsin did in Russia or Kuchma did in Ukraine. Part of the explanation for this is the particular circumstances in which he obtained his power and the resources he inherited from the Soviet era. Another reason is simply that Nazarbaev chose “smarter” (from today’s point of view) strategies for maintaining his power. Similarly to Ukraine and Russia, Nazarbaev’s regime preyed on the state, capturing its institutions and resources, yet was more effective in doing so. Even though in the 1990s the state lost ownership and control in the key economic sectors, individual representatives of the regime exercised informal control and ownership to their own benefit. While eroding state structures through corruption and rentierism, the regime also occasionally and selectively strengthened state institutions, for example, through meritocratic appointments.

Soviet legacies manifest themselves differently across the two sectors in Kazakhstan. The rhetoric of “resource nationalism” has been directed at Kazakhstan’s population but has also allowed increasing pressure on foreigners. Yet, Kazakhstan is unlikely to make drastic moves against foreign energy companies since it continues to be dependent on foreigners for development of its oil and gas. The weakness of domestic business undermines Kazakhstan’s position in negotiations with foreigners. Because Kazakhstan can develop its metallurgy and mining resources on its own, Nazarbaev’s policy towards the sector in the last decade has been to create monopolists who have preferential access to state resources. Nazarbaev is considered to have acquired significant personal ownership in these companies. Kazakhstani officials have been selling assets in Kazakhstan to foreign investors in exchange for cash or shares in the

287 He is said to have an informal stake in oil and gas too, but smaller compared to the size of the project.
investing company itself, which allows Nazarbaev and his closest associates to lower political risks should property re-distribution follow his departure from office.\footnote{\textquoteleft\textquoteleft Khoroshiy cash lishnim ne byvaet,	extquoteright\textquoteright Respublika, 13 May 2011.}

After a decade of pro-FDI rhetoric, the regime then began toughening its attitude towards foreigners. Similarly to Russia, in Kazakhstan informal control by individual representatives of the regime became insufficient when profits in the sector increased significantly due to rising energy prices. The state with its formal powers remains the most direct and effective tool of boosting the regime’s legitimacy and obtaining revenue from key sectors. The regime increased formal control in order to preserve its power. Whether a domestic big business representative or a president, one can still gain more by working through the state than working outside the state as a private entrepreneur. Kazakhstan’s story of relations between the regime, business, and foreign investors is a clear case of this phenomenon.
Chapter 7. Ukraine’s Policy Choices Regarding FDI: Domestic Business Comes First

Extensive development of Ukraine’s metallurgy sector during Soviet times allowed decision makers to keep the sector in domestic hands after independence. Even though the state retained formal control over it. This was subcontracted to cronies of the regime in exchange for political loyalty. Shortly before leaving office in 2004, Kuchma launched privatization of these assets, during which he exchanged metallurgical assets for guarantees of his safe political retirement. By contrast, poor development of oil and gas during the Soviet times left this sector underdeveloped (or even undeveloped) during independence as neither foreigners nor domestic actors were interested in extracting the limited resources that were believed to be in the ground. This sector subsequently became a venue for rent-seeking.

Ukraine is important for my research for two main reasons. First, it is the only country studied in this dissertation that has had a period of democratic rule: during Victor Yushchenko’s presidency (2005-2010), Ukraine was a democracy, albeit unconsolidated. It thus presents a good test case for examining how the state and the regime shape each other. Second, it is the only case where metallurgy has been a more important economic sector than oil and gas.1 This allows me to examine in which ways the structure and the nature of a sector influence policy choices that political regimes make.

Table 12. Ukraine and Its Presidents

<table>
<thead>
<tr>
<th>President</th>
<th>Years of presidency</th>
<th>Regime type</th>
<th>Exit from power</th>
</tr>
</thead>
<tbody>
<tr>
<td>Leonid Kravchuk</td>
<td>1991-1994</td>
<td>Transitional, with some democratizing tendencies</td>
<td>Agreed to early elections</td>
</tr>
<tr>
<td>Leonid Kuchma</td>
<td>1994-2004</td>
<td>Competitive authoritarianism</td>
<td>Left office after two terms, unsuccessfully tried to secure a political successor</td>
</tr>
</tbody>
</table>

1 This was due to Soviet legacies but even more so due to less generous natural endowments of oil and gas.
1. The Nature of Kuchma’s Political Regime and Its Relations with Business

When the second president Leonid Kuchma came to power in 1994, many experts within and outside Ukraine expected him to move the country along the path of democracy and market reforms. The first president, Leonid Kravchuk had chosen economic gradualism as his reform strategy yet did very little to reform the country’s economy. At the time, Kravchuk had other, arguably more important tasks on his agenda, such as preserving the country’s unity and consolidating independence. He feared that “radical economic measures would upset the social balance and endanger the nation-building process, which was a priority.” Kravchuk did hardly anything about building of state institutions or reforming the existing ones. He also was unable to stop rent seeking that quickly deprived the state of its resources. The task of launching meaningful economic reforms thus fell on Kuchma.

Ukraine’s economy had to undergo significant restructuring in order to be competitive in the global economy. Even though Ukraine had seen impressive industrialization during the Soviet era, independence led to the break-up of many industrial ties. Only 20 per cent of enterprises carried out their production exclusively within Ukraine’s territory. Even then, many of these enterprises depended on supplies of inputs from other former Soviet republics.

---

In October 1994, Kuchma gave his first presidential address to the parliament entitled “On the Road of Radical Economic Reform.” He proposed a comprehensive program that aimed at reduction of the budget deficit, currency stabilization, introduction of a national currency, and acceleration of privatization, reduction of the tax burden and business regulation, and easing restrictions on foreign currency. Kuchma also wanted to re-establish ties with Russia. The reforms were moderately successful. By 1996-1997, the currency had stabilized and inflation rates decreased. GDP growth finally recovered from -22.9% in 1994 to -0.2% in 1999. However, Kuchma postponed more challenging second-tier reforms that were needed to ensure long-term economic growth. Instead of completely restructuring the economy, the governments “tried for a long time to save the un-saveable structures of value-subtracting factories.”

Regime vulnerabilities played an important role in the efforts to preserve the status quo. The main vulnerability of Kuchma’s regime (as with Yeltsin) was that during his presidency, Kuchma did not become either a “democrat” to win elections on his own or a strong autocrat like Nazarbaev who would be able to prevent opposition from arising or effectively suppress it. Regional divisions between West-oriented Western Ukraine and Russia-oriented Eastern and Southern Ukraine, weak ruling-party organization, and a generally weak authoritarian state undermined efforts at authoritarian consolidation.

Kuchma was elected on a platform that promised to strengthen ties with Russia, which appealed to Ukraine’s industrial east. However, in the mid-1990s, he began focusing on building support in Ukraine’s nationalist west, which provoked a strong negative response from his original electorate. This move also strengthened the leftist forces that blocked Kuchma’s initiatives in the parliament. Like Yeltsin, Kuchma relied on situational party alliances and personalized relations with regional political and economic elites instead of building political parties and working through formal institutions. This strategy did not allow Kuchma to have effective and permanent control over his allies. Kuchma’s Ukraine represented a case of what Way calls “pluralism by default,” which is characteristic of competitive authoritarian regimes:

---

7 Way, 255-256.
8 Way, 256.
political competition existed not because of a robust civil society and strong democratic institutions. Indeed, Kuchma’s regime consistently worked to weaken civil society and limited freedoms. Rather, competition was the result of “incumbent incapacity.” Another power maintenance strategy Kuchma employed was a constant change of prime ministers. Ukraine had seven PMs during his presidency. As a rule, Kuchma dismissed prime ministers when they became too popular and threatened their boss politically or when he needed to put blame on someone else. Some of these PMs (Lazarenko, Yushchenko) were then able to challenge Kuchma’s power while they were out of the PM office.

Throughout his presidency, Kuchma oscillated between supporting reforms (usually in times of deep financial crises) and ultimately ending them (usually as a result of the lobbying efforts of economic actors whose interests the reforms undermined). Prime Minister Victor Yushchenko made another attempt at liberal reforms in 2000-2001. The oligarchs eventually ousted Yushchenko’s government. However, the reforms Yushchenko launched had a positive impact on Ukraine’s economy since they closed off opportunities for rampant corruption in some spheres.

2. The Origin of Big Business

Early into independence, the “red directors” were a very influential group in Ukraine. Their interests were represented by the Union of Industrialists and Entrepreneurs (UIIE). And Kuchma served as head of the UIIE in 1993-1994. Initially, the Soviet-era managers continued to receive cheap energy supplies from Russia and actively supported the status quo of delayed market reforms. They repeatedly blocked privatization of large industrial assets. In 1994-1995, under the influence of the “red lobby,” the parliament excluded 6102 enterprises from privatization deeming all of them to be of “strategic” importance to the state. Effectively, this move brought official large-scale privatization to a standstill. Although by the end of 1998,

---

9 Way, 232.
55,000 enterprises underwent a nearly full privatization (mostly by managers and employee groups), privatization of the largest enterprises was delayed.¹⁴

By opposing official privatization, the “red directors” de facto privatized profits of the state-owned enterprises under their control and channelled these profits to smaller companies affiliated with or owned by them.¹⁵ In the parliament, the “red directors” consistently voted in favour of granting budget subsidies to unprofitable enterprises.¹⁶ Even though the UUIE had brought him to power, Kuchma did not become a hostage to the interests of the Soviet industrialists. The status quo was not sustainable in the long term as it threatened to strip the state of its resources and ultimately undermine his regime.¹⁷ In fact, the industry generals were becoming more of a problem for Kuchma than an ally even before he became president. For example, the coalminers’ strikes of 1993 that demanded resignations of the political leadership (Kuchma was a PM at the time) ended only when Kuchma appointed one of their alleged organizers, a Donetsk red director Yukhym Zvyagil’s’kyy as his vice premier. Full dependence on industry generals promised to make his political power unstable.¹⁸

Kuchma also needed to look for new allies because the positions of the industry generals began weakening when Russia stopped supplies of cheap energy in 1994. Industry was already suffering from serious liquidity problems: enterprises struggled to pay for input deliveries or pay wages to their workers. The “red directors” sought help from gas traders, who became important players after decentralization of the gas distribution system in 1996. Gas traders could help enterprise managers solve the problem of poor liquidity through barter.¹⁹ In metallurgy, the key economic sector, traders supplied overpriced gas to enterprises and purchased metallurgical products below their market price. They avoided paying their own gas bills to the state because

¹⁴ Kravchuk, 49.
¹⁶ Puglisi, 109.
¹⁷ Ukraine’s government and the National Bank were able to resist the demands of the UUIE even though the government was composed largely of Kuchma appointees due to IMF’s demands for austerity. The government needed IMF stabilization loans to support the economy. See Paul Kubicek, Unbroken ties: the state, interest associations, and corporatism in post-Soviet Ukraine (Ann Arbor: University of Michigan Press, 2000) 124.
¹⁹ Balmaceda, 48.
the PM Pavlo Lazarenko patronized them. Eventually, many “red directors” lost control over enterprises to traders.20

Gas traders used profits from gas deliveries to create the Financial-Industrial Groups (FIGs). In the majority of Ukraine’s FIGs, managing companies were in charge of industrial enterprises.21 The other type of FIGs, where the banks were central to the structure, were much rarer.22 FIGs began forming even before Kuchma’s accession to power. Many of them were formed in Kuchma’s hometown Dnipropetrovs’k. It was under Kuchma that FIGs became powerful economic actors.

3. Business-Regime Relations under Kuchma

Initially, domestic business was fully dependent on regional authorities for access to state resources. For example, the Industrial Union of Donbas (IUD) became a monopoly supplier of gas in the Donetsk region due to its close relations with regional authorities. Regional officials and representatives of business groups shared rents.23 After becoming prominent actors in the regions, these groups began entering the national level. Their political allies took important offices in Kyiv and continued to patronize businesses through informal networks.24 The central government facilitated creation of FIGs through soft budget constraints, low prices for key industrial outputs, favorable privatization policies, and toleration of corruption and rent-seeking at the regional level.25 When the deputy Prime Minister in Pavlo Lazarenko’s government, Victor Pynzenyk launched reforms in 1996-1997 that aimed to eliminate taxation exemptions

---

21 Some of the most influential groups of the first type are the Industrial Union of Donbas, Interpipe, System Capital Management, Ukrprominvest, UkrAvto. Some authors, for example, Margarita Balmaceda, have preferred the term “Business-Administrative Groups” to denote the fact that “these groups combine both economic resources and administrative decision-making power.” See Balmaceda, 17.
22 The most influential group of the second type is “Pryvat.” Verkhovodova, Voronkova, and Ageeva, 16.
23 Verkhovodova, Voronkova, and Ageeva, 30.
24 Presidents, oligarchs and bureaucrats: forms of rule in the post-Soviet space 127.
and privileges that benefited the oligarchs, the latter were able to undermine these reform efforts.26

The oligarchs helped Kuchma maintain his power. Kuchma himself initially patronized one regional business group – the so-called Dnipropetrovsk clan – but later began catering to the interests of other business groups too by giving them access to state resources.27 Political loyalty was the main determinant of who got what and how much. Under Kuchma, the state did not serve public interests and was not a powerful actor on its own. Instead, it became a potent instrument in the hands of political elites who used the state’s resources and formal powers, in particular the powers to command and penalize, to sustain their power, and to enrich themselves.

Some of Kuchma’s relations with the oligarchs were built on “carrots.” Initially, the regime outsourced state control over enterprises to the benefit of politically loyal business groups. The legislation did not provide for a “golden share” mechanism.28 The groups were supposed to manage state packages of shares yet used state property as a start-up for establishing their own businesses.29 Some groups gained control over enterprises by issuing large loans to the state or establishing “strategic partnership” with state-owned enterprises, which eventually allowed them to gain control over or even purchase these enterprises.30 In yet another example, private actors diluted the state stake in an enterprise through additional emission of shares.31 State weakness can partially explain the state’s loss of control and eventually ownership over its assets. The State Property Fund (SPF) focused its efforts on selling state property and did not have sufficient resources and staff to ensure that private owners fulfilled their pre-purchase obligations. The SPF also neglected its official responsibility to exercise control over the property that remained in state hands and represent of the state at shareholder meetings.32 For a

26 Kravchuk, 55.
27 Puglisi, 114.
30 Verkhovodova, Voronkova, and Ageeva, 28.
31 Pashhaver, Verkhovodova, and Ageeva, 38.
long time, the Fund did not even have a registry of the property it owned. However, lack of capacity to exercise control is only part of the story. Release of control was to a large extent intended in order to give business groups stakes in maintaining Kuchma’s regime.

Industrial policy at the time consisted of subsidies, price controls, and import and export restrictions for enterprises connected to the regime. Subsidies to what were called “strategic sectors” amounted to about 3-5 per cent of GDP. Connection to the state, not entrepreneurial initiative, was the recipe for success in the economic sphere. State-owned banks and ministries participated in establishment of FIGs without any long-term goal in mind. They provided access to state resources for business entities that aimed to produce profit for private actors. In this context, businesses did not have any structural power to affect the regime since they usually had little capital of their own. They could only get empowered if they received access to capital flows and physical assets of the state. For this, they needed to be on good terms with the regime.

Kuchma also promoted “business-friendly” regional officials, facilitated sales of state property at discounted prices and granted political protection to businesses. The main goal behind privatization was to distribute property in a way that would strengthen the oligarchs’ stakes in keeping Kuchma in power. Privatization largely ignored the interests of the population since the public was excluded from the process of policy-making. Many assets were sold just above the asking, heavily discounted prices. Besides, privatization failed to create an “effective owner” since privatized enterprises continued to draw resources from the budget to run their operations. Every successful business owed something to the President. Kuchma also played an important role of an arbiter vis-à-vis business. He ensured that no group became too strong to threaten others or him personally. He helped the system of intra-business relations achieve stability as he forced FIGs to play by certain, usually informal, rules. Kuchma made an effort to

33 Tolokin, Victor. 2004. “Privatizatsia po-ukrainski: narodnaia sobstvennost’ taet na glazakh.” Pravda, 23 September. The article states that during the preceding four years, the Fund did not conduct the indexing of the value of enterprises even though the index of inflation during this period was 369 per cent. As a result, only about 25 per cent of the real value of assets that were sold were getting into the budget, the newspaper estimates.
34 VonHirschhausen, 455-458.
36 Interview with Vladimir Dubrovskiy, senior economist, CASE Ukraine, 30 September 2009.
prevent “winner-take-all” practices among business. The losers had the right of veto or the possibility of winning next time.\footnote{Interview with Vladimir Dubrovskiy, senior economist, CASE Ukraine, May 2014.}

In other cases, Kuchma’s relations with the oligarchs were built on “sticks.” The low level of public legitimacy of business also weakened it vis-à-vis the regime. The population at large did not view domestic business as “job creators” – the image big business has actively and to some degree successfully promoted in the West – but as “thieves” who left everyone else poor. Low levels of legitimacy made the oligarchs further dependent on the executive. The regime was aware of the extent of illegal privatization and mismanagement of state funds that was taking place. In fact, during Kuchma’s presidency “individuals were allowed, if not encouraged, to steal from the state organs and enterprises under their control, and the state even intervened to assist the perpetrators in covering their tracks.”\footnote{Keith Darden, “Blackmail as a Tool of State Domination: Ukraine Under Kuchma,” \textit{East European Constitutional Review} 10.Spring/Summer (2001).} The president systematically collected compromising materials on a large number of actors, which created a possibility of blackmail in the future. Managers of state-owned holdings had enormous power and could take advantage of state property that ended up in their hands.\footnote{Verkhovodova, Voronkova, and Ageeva, 7.} Corruption and systematic tracking of it served to maintain Kuchma’s regime while depriving the state of its valuable assets. As Keith Darden argues, graft resulted in “a state organization with a robust, impersonal hierarchy that can be quite effective at collecting taxes or other centralized tasks but that also affords its leaders considerably more discretion than a Weberian bureaucracy.”\footnote{Keith Darden, “The Integrity of Corrupt States: Graft as an Informal State Institution,” \textit{Politics & Society} 36.1 (2008): 54.} Graft created possibilities for strengthening state force while weakening state power.

While it is difficult to call Kuchma a “state-builder,” in certain cases he made a clear effort to preserve the power of the state and its control over its assets.\footnote{See, for example, work by Lucan Way, who argues that the Ukrainian state did not completely lose the “public dimension of the state” and engaged in distribution from richer to poorer regions to fulfill at least some social functions. See Way,} Interestingly, when Kuchma served as a PM under Kravchuk, he was among those very few who tried to limit rent-seeking opportunities and therefore to protect the state from complete disintegration.\footnote{Serhiy Kudelia, “The sources of continuity and change of Ukraine’s incomplete state,” \textit{Communist and Post-Communist Studies} 45.3-4 (2012): 420.}
President, Kuchma became a “corruption manager” who weakened the state by using it for maintaining his own regime, yet also ensured the state did not disintegrate completely. Kuchma understood clearly that his regime was ultimately dependent on the fate of the state. Kuchma did not allow “too much” stealing from the state. For example, he had been receiving reports about PM Pavlo Lazarenko’s steadily growing fortunes for some time, yet interfered only when Lazarenko came close to establishing a monopoly over the gas sector and grain and spirits sectors. As Kuchma later recalled, “if he [Kuchma] had given him more time Lazarenko would have privatized the entire country.”

Kuchma’s primary concern was not about the state losing its resources but about Lazarenko getting too powerful and threatening the president politically by challenging the hierarchy Kuchma had established. Nevertheless, Lazarenko was removed from the position that enabled him to loot enormous state resources.

Despite the dominance of the regime and its role in creating domestic business, Kuchma depended on business as well. His “moment” of dependence on the oligarchs came later than it had for Yeltsin since Kuchma faced reelection in 1999, three years later than Yeltsin. Lack of permanent organizational support left Kuchma (like Yeltsin) vulnerable before elections. The prospects of getting the increasingly authoritarian and increasingly unpopular president reelected in 1999 were far from being certain. With the help of the oligarchs, Kuchma was able to ensure victory in the second round over the Communist Party contender Petro Symonenko. The support of the Donetsk regional administration, in particular of its head Victor Yanukovych, was particularly important in ensuring Kuchma’s victory in the heavily populated Donetsk region. Rewards for this support came quickly. In December 1998, the Verkhovna Rada passed a law that created special zones and territories of priority development in the Donetsk region and exempted them from import duties and taxes for five years. In July 1999, the same year Kuchma faced reelection, his regime initiated an “experiment” in metallurgy, which provided very beneficial terms for the sector (I discuss this in more detail below). Support from domestic

45 See, for example, discussion in Bondarenko, 259 about the challenge of re-election for Kuchma.
46 Re-constructing the post-Soviet industrial region: the Donbas in transition, ed. Adam Swain (London: Routledge, 2007) 73-74. In 1998, the pro-presidential parties faired very poorly in Donetsk, a politically very important region, because the Donetsk business groups did not support them. The centre learned from its mistakes when the time to re-elect Kuchma came in 1999. Verkhovodova, Voronkova, and Ageeva, 70.
47 Re-constructing the post-Soviet industrial region: the Donbas in transition 72.
business became a crucial factor that allowed Kuchma to retain his power in 2000-2001, when the allegations that Kuchma had ordered the murder of an opposition journalist Heorhiy Gongadze led to mass demonstrations against the President. Kuchma barely retained his power during what became known as the “Kuchmagate” scandal.

4.2004 Presidential Elections and “On-Demand” Privatization

Unlike Yeltsin, who resolved his “succession problem” by going into early political retirement and designating the popular PM Vladimir Putin as his successor, Kuchma was determined to hold on to his office until the end of his second term. The outgoing president struggled to find a reliable successor who could guarantee his safe exit from politics, secure his personal assets, and take the possibility of imprisonment out of the picture. That is why for Kuchma, the 2004 presidential election was in many ways even more important than his initial election or first reelection. For big business too, the victory of any candidate other than Kuchma’s appointed successor threatened new rounds of property re-distribution. Besides, the compromising material Kuchma had collected over the years was dangerous should power end up in the hands of opposition. Stakes were high for both the regime and its cronies.

The delayed privatization that had kept a bulk of valuable enterprises in the state hands provided Kuchma with resources for building political alliances before his eventual departure from office. After 2002, state property distribution intensified. Business groups aimed to draw clear lines of control over assets by establishing formal ownership. During 2003-2004, the last two years of Kuchma’s presidency, the regime carried out the so-called “on-demand privatization” when it sold the most lucrative industrial assets to a small number of favoured

---

48 The allegations were based on the tapes that became public in November 2001 with a voice similar to Kuchma’s ordering the security apparatus to kill an opposition journalist Georgiy Gongadze, who disappeared in September 2001 and was found dead soon afterwards.
49 Verkhovodova, Voronkova, and Ageeva, 36.
50 Even after the moratorium of privatization was lifted and privatization proceeded very quickly, the most lucrative assets (such as energy companies and big “strategic” enterprises) were not offered for privatization. In 1998, the Cabinet on Ministers excluded them from the list of assets to be privatized and transferred to the newly created National Agency on Management of State Corporate Rights, which did not have an institutional interest in initiating their privatization. Paskhaver, et al, 15.
51 Verkhovodova, Voronkova, and Ageeva, 37.
business groups and high-placed government officials. The terms of privatization allowed only specific, informally and in advance determined contestants to gain ownership. The main beneficiaries of on-demand privatization were the “friends” of the regime – in particular, System Capital Management (SCM), the IUD, Pryvat, and Interpipe business groups. In return, business groups temporarily put their conflicts aside and agreed to support Victor Yanukovych, the “political roof” of the Donetsk group, in his bid for the highest office. At the same time as on-demand privatization was going on, the oligarchs launched a legitimization campaign to portray themselves as respected “national capitalists” rather than murky “oligarchs” in order to gain legitimacy and secure their property.

5. Victor Yushchenko’s Presidency

Yanukovych’s attempt to win the presidency at any cost, including election fraud, led to the Orange revolution, when hundreds of thousands of people came out into the streets in November-December 2004 to protest election results. Yanukovych’s main opponent, the once ousted Kuchma’s PM Victor Yushchenko, claimed that victory had been stolen from him. Under intensive domestic and international pressure, the regime and the opposition agreed to repeat the second round of elections, which brought Yushchenko the victory. The Orange revolution was the first time when the political capital (Yushchenko’s popularity) gained victory over administrative capital (economic resources combined with ties to the regime) in Ukraine.

The Orange revolution awarded Yushchenko’s presidency a tremendous boost of popularity within and outside Ukraine. Yushchenko could have been Ukraine’s Putin at the time. His former opponents were preparing for the worst since one of the slogans of the Orange revolution was “prison to the bandits!” Yet, Yushchenko ultimately turned out to be a weak president. First, the agreement on changes to the Constitution that redistributed powers from the president to the prime minister and ended the Orange revolution significantly undermined

53 Paskhaver, Verkhovodova, and Ageeva, 36.
56 Interview with Vladimir Dubrovskiy, senior economist, CASE Ukraine, 30 September 2009.
presidential powers. Second, Yushchenko was weak in exercising even the official powers he did have. He maintained his power by appointing political allies to different positions and attempted to balance them against each other. This was not so different from Kuchma’s way of maintaining power except for Yushchenko did not manage to retain control over the system of power relations.

One of the reasons the Orange revolution did not bear fruit is because Yushchenko was unable to successfully re-define relations between regime and big business. In the post-Orange Ukraine, and more democratic Ukraine, personal connections continued to matter more than institutionalized forms of interaction. Yushchenko’s 2004 election campaign drew support from a number of business representatives – mostly those who for one reason or the other had not managed to become part of Kuchma’s close circle of favorites. After the victory, these businessmen were not interested in changing relations between business and the regime and establishing new fair rules of the game for everyone. For them, “fairness” was past-oriented: it meant privileging those who had been left out by the previous regime. Some authors called the Orange revolution a “revolution of millionaires against billionaires.” Yushchenko did not break ties with business that had supported him (in particular, Petro Poroshenko) and rewarded those who had helped him come to power. That is why deryban – Ukraine’s informal term for distribution and redistribution of state assets and budget resources marked by pervasive corruption – continued. After initial fear and withdrawal from politics, the oligarchs who had previously supported Kuchma found new political patrons. The chance to redefine the relations between business and the regime in favor of de-personalized and institutionalized interaction was not used. Under Kuchma, the system was centered on the president. The hierarchy in business-regime relations was rather strict and stable. Under Yushchenko, alliances between politicians and business became very fluid. Constitutional changes that empowered the parliament and the PM at the expense of the president created more potential political patrons to appeal to, yet implementation of reached agreements was not guaranteed since power became very dispersed and someone else’s political patron could veto a deal.

57 Interview with Vasyl’ Yurchysyn, Director of Economic Programs, Razumkov Centre, Kyiv, 14 October 2009; interview with Mykhaylo Salnykov, expert, “Sokrat,” 1 October 2009.
58 Interview with Vasyl’ Yurchysyn, Director of Economic Programs, Razumkov Centre, Kyiv, 14 October 2009.
60 Interview with Dmytro Boyarchuk, executive director of CASE Ukraine, 14 October 2009.
Political freedom increased in the aftermath of Orange revolution, yet the changes that took place were insufficient to put Ukraine decisively on a path to consolidated democracy. Paradoxically, the democratization that made elections meaningful also increased the dependence of politicians on FIGs for resources to win elections. During Yushchenko’s presidency, elections were always “just around the corner” due to inherent instability of the new system of power. The ever-approaching elections defined any decision- and policy-making at the time and were not conducive to launching economic reforms. Capital “mattered” in a very particular way: not as an investment resource that could keep the economy running and make voters happy (to over-simplify Lindblom’s argument), but in a much more limited way – as money spent on leaflets, campaign posters, media resources and outright purchases of votes in favor of a politician or a party. Ironically, business resisted its own influence to a degree: it tried to avoid financing numerous political campaigns, yet generally had to play by the rules and supported political patrons financially once elections were called.

Paradoxically, democratization that made political elites dependent on oligarchs under Yushchenko had a damaging effect on the state. In Central Europe, robust competition had induced “anxious governments to moderate their behavior, create formal state institutions, and share power – in short, to construct safeguards against the extraction of state resources.” In Ukraine, the existence of several institutional power centers headed by politicians with short-term political considerations led to the weakening of the state. Political and economic elites were interested in quickly taking control over these institutions before losing power in the next election. State officials thus continued to “privatize” the state and its functions under Yushchenko. Yet, in contrast to Kuchma’s era, Yushchenko was too weak politically to ensure corruption stayed within limits. As one of my interviewees put it, under Yushchenko “the state

---

62 Interview with Serhiy Taran, Chairman, National Agency of Ukraine for Foreign Investment and Development, Kyiv, 9 October 2009.
63 Interview with Vladimir Dubrovskiy, senior economist, CASE Ukraine, 30 September 2009; with Vasyl’ Yurchyshyn, Director of Economic Programs, Razumkov Centre, Kyiv, 14 October 2009.
64 Anna Maria Grzymala-Busse, Rebuilding Leviathan: party competition and state exploitation in post-communist democracies (New York: Cambridge University Press, 2007) 1.
65 Interview with Vladimir Dubrovskiy, senior economist, CASE Ukraine, 30 September 2009.
has become unruly.\textsuperscript{66} The state consisted of a number of autonomous centres of administration that were unable to “conduct a unitary policy of state property management.”\textsuperscript{67}

Shortened periods in office also gave politicians an incentive to pursue “populist” policies immediately before elections. Kuchma could afford to direct financial resources to the oligarchs at the expense of social programs for the population because what voters thought of his policies did not really matter in a competitive authoritarian regime.\textsuperscript{68} However, in a more democratic setting, governments under Yushchenko needed to find funds for these programs to win elections. Filling in the budget became a major challenge for the government.\textsuperscript{69} Businesses had to make “voluntary” contributions to the budget.\textsuperscript{70} Instead of implementing the much-needed reforms of the taxation system, the governments – in particular Yulia Tymoshenko’s government that was prone to populism more than any other prime minister – focused on extracting revenues through privatization and re-privatization of previously sold assets at higher prices.

Tymoshenko’s government launched “re-privatization” (as it became known in Ukraine) shortly after coming to power in January 2005. The government declared that in order to restore justice, it would take away assets that had been “stolen” by the oligarchs during the Kuchma era. It would then re-sell them, now at a “market” (i.e. considerably higher), price. Yushchenko initially supported this campaign since it allowed him to fulfill his campaign commitments. More importantly, re-privatization promised to make some of the previously privatized assets available for new rounds of redistribution and satisfy businesses with ties to the new regime.

Privatization and re-privatization resulted in fierce political battles. Tymoshenko was prepared to go as far as possible with re-privatization. Two years earlier, Putin had bankrupted the oil company Yukos and imprisoned its owner Mikhail Khodorkovskiy in Russia. By launching re-privatization, Tymoshenko in some ways followed suit: she tried to fill the budget coffers but also re-define relations with business groups in favor of the government. Tymoshenko’s government used Kuchma’s techniques of maintaining power by threatening to

\textsuperscript{66} Interview, Kyiv, fall 2009.
\textsuperscript{68} Paskhaver, Verkhovodova, and Ageeva, 41.
\textsuperscript{69} Interview with Yaroslav Zhalilo, National Institute of Strategic Studies, deputy director, Kyiv, 19 October 2009; \textit{Ukrayins’ka pryvatyzatsiia: grupy interesiv, prychyny kryzy, shlyakh yiyi podolannia} [Ukrainian Privatization: Interest Groups, Factors That Have Caused the Crisis, Ways of Overcoming It] (Kyiv: Centre for Economic Development, 2008) 46.
\textsuperscript{70} Interview with Dmytro Boyarchuk, executive director of CASE Ukraine, 14 October 2009.
implement the law.\textsuperscript{71} Due to harsh criticism of her policies within and outside the country, Tymoshenko only managed to re-privatize Kryvorizhstal’, at a price ten times higher than the initial price Kuchma-friendly oligarchs had paid for it. Re-privatization stalled with Tymoshenko’s dismissal from the office in fall 2005. The campaign neither restored justice nor created a good climate for domestic and foreign investment in Ukraine. Even though the State Property Fund gained a higher political clout during Yushchenko’s presidency due to its role in re-privatization, the state as such did not strengthen its control over property. Neither did it gain power, or even force.

6. Victor Yanukovych

In 2009, Victor Yushchenko lost a reelection bid to his former political opponent Victor Yanukovych. In fact, Yanukovych had returned to power even earlier. The 2004 constitutional changes enabled him to become prime minister during Yushchenko’s presidency in August 2006-December 2007. During his very first premiership in 2003-2004, Yanukovych clearly favored the Donetsk business group that had supported him in his power bid. During the second premiership in 2006-2007, Yanukovych (like Kuchma in the second half of the 1990s) attempted to strengthen his political power by granting other groups access to the state. Although Yanukovych continued to depend on Akhmetov’s financial resources for maintaining his power, he “acquired political capital and started to behave as if he were equals with Akhmetov.”\textsuperscript{72} Akhmetov in his turn on a number of occasions declared that he did not want Yanukovych to monopolize power.\textsuperscript{73} Neither the prime minister nor Ukraine’s richest businessman wanted to put all their eggs into one basket in a more democratic system characterized by increased decentralization of political and economic power.

However, upon becoming president, Yanukovych restored the power of the presidential office by reversing constitutional changes that had taken place and re-launching privatization of state-owned assets.\textsuperscript{74} Under Yanukovych, business-government relations preserved some features of the previous system but also underwent significant changes. Both continuities and changes are important to analyze since they had significant impact on the regime itself.

\textsuperscript{71} Interview with Vladimir Dubrovskiy, senior economist, CASE Ukraine, 30 September 2009.
\textsuperscript{72} Interview with Vladimir Dubrovskiy, senior economist, CASE Ukraine, 30 September 2009.
\textsuperscript{73} Interview with Vladimir Dubrovskiy, senior economist, CASE Ukraine, 30 September 2009.
\textsuperscript{74} “Yanukovych Dozvoliv Pryvatyzatsiu Strategichnykh Pidpryemstv,” BBC (in Ukrainian), 13 December 2010.
The most important continuity was the preservation, or rather, further strengthening of *deryban* of state property.\(^{75}\) None of Ukraine’s presidents were able or willing to stop it. After his return to power as a PM under Yushchenko, Yanukovych began reinstating Kuchma’s system of maintaining power by channeling budgetary funds to loyal business as opposed to directing it to social initiatives.\(^ {76}\) Big business continued to depend on access to the state for its success and the regime was in the best position to offer this access. What changed was the number of people who could gain this access. Until 2012, Yanukovych maintained some form of balance among business groups. After 2012, this balance was destroyed as Yanukovych sought to become an economic actor himself and to help his son do so too. He returned to the old strategy of seeking narrow support among big business (he continued to favor Rynat Akhmetov and Dmytro Firtash), yet the opportunities for profit- and rent-seeking decreased for other business groups.\(^ {77}\) Regime-affiliated businesses could obtain low-interest credit while for others loans came at extremely high interest rates. The “unruliness” during Yushchenko’s presidency made Ukraine’s investment climate unpredictable. Working under Yanukovych was arguably even worse as the blunt enforcement of formal and informal rules favoring Yanukovych and his allies allowed the president and his very few businesses to monopolize control over key economic sectors (electricity, coke, steel) and heavily centralize political power.\(^ {78}\)

Yanukovych reverted to authoritarianism – an even cruder version than Kuchma’s. He purposefully destroyed and undermined state institutions. The looting of state property by the few, including Yanukovych and his son, was unprecedented. The reforms Yanukovych officially launched correctly identified some of the most pertinent economic problems and proclaimed modernization as the main goal. However, the government and the president themselves de facto ignored these reforms. Yanukovych expected to sustain his power by avoiding price increases for gas and heating for the population. However, the economic situation was deteriorating. Also, the state presence in the economy was “creeping in”: in 2000, the share of state revenues in the GDP was 33 per cent. It increased to 43 per cent in 2005 during Tymoshenko’s populist policies, and

---


\(^ {76}\) *Ukrayins’ka privatyzatsiia: grupy interesiv, prychyny kryzy, shlyakhy vivi podolannia* [Ukrainian Privatization: Interest Groups, Factors That Have Caused the Crisis, Ways of Overcoming It] 47.

\(^ {77}\) Interview with Borys Dodonov, senior energy economist at New Social and Economic Policy, Kyiv, May 2014.

\(^ {78}\) Interview with Vladimir Dubrovskiy, senior economist, CASE Ukraine, May 2014.
to 45 per cent in 2011-2013, when Yanukovych became president. The regime was taking a larger share of the pie for itself, yet the pie was getting smaller and smaller.

Facing the possibility of a looming economic crisis, Kuchma was able to convince the oligarchs to join forces and restrain rent-seeking in order to prevent default in 1998. This is how the oligarchs agreed to the appointment of Victor Yushchenko in 1999. The reforms that were launched under Yushchenko closed many loopholes for the oligarchs yet in the end resulted in economic growth. Yanukovych could not force the oligarchs to give in the same way since rent-seeking and corruption benefited a much narrower group of people, Yanukovych first among these. The extent of looting was much higher – in retrospect, the regime overgrazed state resources and took away incentives from business elites to support it in power. Yanukovych was then forced to seek finance abroad, which resulted in the protests at Maidan in December 2013 – February 2014 and his escape to Russia. His brand of authoritarianism was harsher than Kuchma’s, yet at the end it was also weaker as he relied on crude force and did not wish to leave any competitors in the key economic spheres. Yanukovych may have wanted to become Ukraine’s Putin or Nazarbaev and centralize political and economic control, yet the absence of oil to boost the regime in power and an earlier decade when business groups did have a chance to establish themselves did not allow him to realize his goals.

7. Policy Regarding FDI in General

After independence, Ukraine attracted little FDI compared to its Central European neighbours and even some of the post-Soviet states. In 2011, net inflows of FDI into equity in Ukraine accounted for 4.4 per cent of GDP. The majority of Ukraine’s FDI went into financial services (approximately 1/3 of the total stock by 2010), manufacturing (28 per cent), real estate and trade and repair (slightly more than 10 per cent each).

---


80 I am heavily indebted to Vladimir Dubrovskiy for helping me understand the nature of business-government relations in Ukraine and the regime-state-business interaction.

81 Interview with Vladimir Dubrovskiy, senior economist, CASE Ukraine, May 2014.


83 OECD investment policy reviews, 22.
Ukraine would certainly have benefited from FDI. Its economy required extensive modernization as outdated equipment was responsible for approximately half of production capacity. The state was supposed to withdraw from the investment process. It did however provide capital through various subsidies based on political rather than economic rationale. In the 1990s, FIGs could not finance investment since they themselves had originated in the post-Soviet industry rather than the banking sector and did not have capital. The full-fledged banks were not yet established either. Whichever capital enterprises did have usually went into solving urgent tasks, such as paying off credit and acquiring operating capital, not into modernization.84

A poor investment climate certainly helps explain why Ukraine did not attract FDI. Pervasive corruption and “red tape” were hardly welcoming to FDI.85 Foreigners were outsiders to informal networks of politicians and business. Those who were willing to give a bribe did not

84 Verkhovodova, Voronkova, and Ageeva, 52.
85 OECD investment policy reviews, 11.
always know how to give it and whom to approach for a desired decision to be reached.\textsuperscript{86} Even though the 1996 Law “On the Regime of Foreign Investment” established national regime for foreign investors, the realities of investment into Ukraine for foreign and domestic businesses were very different – the former were let in only if none of the domestic actors with strong ties to regime in power had an interest in taking the asset, which was hardly ever the case in key sectors such as metallurgy.\textsuperscript{87} In short, none of Ukraine’s presidents had a systematic approach to attracting FDI.\textsuperscript{88}

With the partial exception of Yushchenko’s presidency, neither politicians nor domestic big business wanted FDI to come in on a large scale. In the 1990s, the oligarchs had short-term outlooks and did not invest in the assets they controlled. They feared that FDI would create competition and raise asset prices. In the 2000s and later, the oligarchs placed more importance on retaining control over assets than on the long-term development of these assets. They preferred to finance investments with their own funds. At the turn of the 21\textsuperscript{st} century, some Ukrainian FIGs tried to attract capital by issuing corporate bonds and explored possibilities of listing at European stock exchanges.\textsuperscript{89} Bank loans were responsible for approximately a quarter in 2013 while foreign capital financed only 1.2 per cent of capital investment in Ukraine.\textsuperscript{90} Loans meant indebtedness and therefore vulnerability, but they allowed FIGs to retain control over the enterprises.

\textsuperscript{87} The first framework law “On Foreign Investment” adopted in March 1992 promised favourable conditions for foreign investors, including certain benefits that were granted to foreigners exclusively. In 1993, a decree of the Cabinet of Ministers made these benefits dependent on the size of foreign investment. The 1996 Law cancelled these legislative acts. “Nezakhyshcheni inozemni investytsii” [Unprotected Foreign Investment]. \textit{Pravovy Tyzhden’} No.35, 1 September 2009, available at \url{http://www.legalweekly.com.ua/article?uid=1355}. OECD investment policy reviews, 34.
\textsuperscript{88} Interview with Olena Hantsiak-Kas’kiv, acting director, Ukrainian Centre for Fostering Foreign Investment, 12 October 2009.
\textsuperscript{89} Verkhovodova, Voronkova, and Ageeva, 55.
\textsuperscript{90} “Investytsiinyy klimat v Ukrayini.” Ukraine’s Ministry of Economy Official Website.
7.1. Kuchma

Despite some moderate pro-FDI rhetoric, Kuchma de facto supported domestic producers.\textsuperscript{91} In his book, Kuchma argued that only Ukraine’s officials and big capital working together could create “a Ukrainian social-economic miracle.”\textsuperscript{92} As Kuchma explained, both Russia and Ukraine at the time politically “could not afford and did not want to pursue” a formally restrictive policy regarding FDI coming from the West and had to use informal methods of regulating FDI.\textsuperscript{93} Ukraine’s FDI policy at the time consisted of formal and informal mechanisms of FDI regulation, which usually meant exclusion. Throughout his presidency, Kuchma remained committed to keeping industry in domestic hands. For him, keeping foreign investors out was not part of any developmental strategy as Kuchma asserts in his book but a way to maintain his regime. Exclusion of outsiders protected the rising domestic business from competition with foreigners, who had more resources and could potentially raise the price of economic assets. Ukrainian business supported the regime in return. For the regime too, maintaining control over domestic business was easier because of the large quantity of kompromat (compromising materials) he collected on the Ukrainian oligarchs. Political considerations were thus one of the main factors responsible for Ukraine’s poor record of attracting FDI in the course of economic transition.\textsuperscript{94}

Together, business and the executive in 1994-1998 developed what Puglisi calls an “ideology of national bourgeoisie.” They promoted the idea that Ukraine needed to create an indigenous class of property owners in order to develop.\textsuperscript{95} According to this “ideology,” foreign capital did not have the same attachment to Ukraine as national capital and therefore lacked commitment to Ukraine’s long-term development and democratization.\textsuperscript{96} The officials also

\textsuperscript{91} I start with analysis of Kuchma’s policies since Ukraine’s first president Leonid Kravchuk did not do any substantial steps in regulating or attracting FDI during his presidency. Ukraine did not even collect statistics on FDI until 1994, the year he became president.


\textsuperscript{93} Kuchma, 71.

\textsuperscript{94} Interview with Igor Burakovsky, director, Institute of Economic Research and Political Consultations, 15 October 2009.


\textsuperscript{96} In privileging domestic capital over foreign for these reasons, the authorities faced a dilemma: offshore capital was not formally allowed into the country, yet a large share of Ukrainian capital was in the offshores. That is why the government first needed to “attract” domestic capital back in, only to give a privileged status. Mikhail Chechetov, “Cherez Investitsii k Ekonomicheskomu Rostu,” \textit{Zerkalo Nedeli}, 23 February 2001. Available at
claimed that the public was not ready for the entry of foreigners. In the meantime, oligarchs used loopholes in legislation that was supposed to foster FDI for their own benefit.

For Kuchma, privatization turned into a process of giving stakes to different constituents in supporting the new economic system and ultimately his political regime. During privatization, individual citizens and “collectives of workers” formally had priority in purchasing state property. The voucher method of privatization was supposed to limit participation of foreigners since only citizens could obtain vouchers. The law prohibited the re-sale of vouchers. In reality, “they were sold and bought [by the locals]; however, if foreigners had come, they would not be allowed to do this.”

At the policy level, the 1996 State Concept for Industrial Policy was intended to support domestic industrial producers in key sectors of the economy. However, Ukraine’s legislation focused on “strategic enterprises” rather than “strategic sectors.” This opened room for negotiating each enterprise, usually to the benefit of domestic actors with strong political connections. Foreign investors interested in purchasing a “strategic” enterprise had to obtain a special permit from the parliament and the Cabinet of Ministers. This was a lost cause from the beginning given the domination of the left in the Verkhovna Rada. Foreigners were completely blocked from obtaining property in sectors such as banking, metallurgy, chemicals, and gas trading. At the same time, the legislation did not restrict residents from re-selling their privatized shares in “strategic” enterprises to non-residents or established foreign-controlled enterprises at the secondary market. The Ukrainian FIGs had a chance to make a profit selling an asset it had acquired very cheaply to foreigners at a higher price in the future. This also suggests that keeping assets in domestic hands was not the first priority for the government, but

97 Interview with Lidia Verkhovodova, vice president of the Centre for Economic Development, Kyiv, 28 September 2009; also Kuchma, 71.
99 Interview with Lidia Verkhovodova, vice president of the Centre for Economic Development, Kyiv, 28 September 2009.
100 Interview with Vladimir Dubrovskiy, senior economist, CASE Ukraine, 30 September 2009.
101 OECD investment policy reviews, 37.
102 Interview with Lidia Verkhovodova, vice president of the Centre for Economic Development, Kyiv, 28 September 2009.
103 OECD investment policy reviews, 37.
catering to politically loyal big business was. Foreigners also had no chances of winning competition for assets during “on-demand” privatization before Kuchma’s departure from power.

7.2. Yushchenko and Yanukovych

For “pro-Western” Yushchenko, attracting FDI became a defining feature of his declared economic course. It was to become an important source of legitimization for the formally pro-Western president who sought to be different from his predecessor. During Yushchenko’s presidency, it became easier for foreigners to work in Ukraine. FDI stock increased across the entire economy, but in particular in food, beverages, and tobacco production, metal and metal products, trade, and finance. When Kuchma was leaving office in 2004, Ukraine’s total FDI stock was 9047 million USD. When Yushchenko was leaving office in 2009, the total FDI stock was 40,053 million USD – an increase of almost 4.5 times.

Yet, the new regime lacked a coherent approach to attracting FDI just as its predecessor had. Because Yushchenko was unable and unwilling to redefine regime’s relations with domestic business, the latter kept a number of sectors closed to foreign investment. Parliament continued to block privatization by compiling the not-to-be-privatized lists of enterprises. A socialist head of the State Property Fund Valentyna Semenuyk who was openly hostile to foreign investors was not a good “host” to foreigners who came at the president’s invitation.

Yushchenko’s “open” policy regarding FDI was not purely declarative. Whereas Kuchma privileged his cronies’ interests over filling in the state coffers, collection of budget revenues became much more important under Yushchenko. The regime needed to finance extensive social commitments in order to win the frequent elections. Higher financial offers could sometimes make an investor a winner independently of its domestic or foreign origin.

---

104 Interview with Lidia Verkhovodova, vice president of the Centre for Economic Development, Kyiv, 28 September 2009.
105 Interview with Dmytro Boyarchuk, executive director of CASE Ukraine, 14 October 2009.
107 Taken from: Investment Country Profiles: Ukraine UNCTAD, 2012). The three years with the highest FDI inflows were 2008 (10,913 million USD, out of which 9,440 equity investment); 2007 (9,891 million USD, out of which 8,364 million USD was equity investment), and 2005 (7,808 million USD, out of which 7,489 was equity investment). See OECD investment policy reviews, 18.
108 Paskhaver, Verkhovodova, and Ageeva, 25.
109 Kuchma, 72.
110 Interview, Kyiv, fall 2009.
111 Interview with Dmytro Boyarchuk, executive director of CASE Ukraine, 14 October 2009.
Tymoshenko focused on filling in the budget even more so than other PMs had in order to maintain her image as a pro-people, pro-social justice politician. Her government favored auctions as a form of property sale since auctions allowed the government to obtain the highest possible price for an asset.\footnote{Interview with Lidia Verkhovodova, vice president of the Centre for Economic Development, Kyiv, 28 September 2009.} Tymoshenko’s government resold Kryvorizhstal’ to a transnational metallurgical giant Mittal Steel in 2005 at a price 6 times higher than Kuchma’s cronies had paid for it (discussed in more detail below). However, no other large sales followed. The focus on filling in the budget did not allow generate a coherent approach to attracting FDI. Getting the highest price for an asset today is not necessarily the optimal strategy for long-term development. Kuchma often ignored the issue of what price he could get for an asset, but for the wrong reason: his criteria were political rather than economic.\footnote{Some experts pointed out that resale of Kryvorizhstal’ to ArcelorMittal only strengthened Ukraine’s dependence on exports of technologically low-grade metals since the global company aims to export metals out of Ukraine rather than strengthen its positions in the Ukrainian domestic market. Interview with Yaroslav Zhalilo, National Institute of Strategic Studies, deputy director, Kyiv, 19 October 2009.} Tymoshenko was inconsistent for other reasons too: FDI promotion and filling in the budget came second when interests of business groups that supported her in office were at stake.\footnote{For example, Tymoshenko during her premiership promoted the interests of Pryvat group, which wanted to gain control over the Nikopol Plant of Ferroalloys that had been privatized by Kuchma’s son in law in 2003. The premier warned the interested Russian companies against competition for this lucrative piece of property because Pryvat was already interested in it. As the newspaper argues, this was because the property was already meant to go to Pryvat. See Denis Fedorenko, “Novaya Ukrainskaia Vlast’ Spotknulas’ o Reprivatizatsiu Nikopol’skogo Zavoda Ferroslavov;”, \textit{Zerkalo Nedeli}, 12 August 2005.} Her government initiated changes to the Law on Privatization of State Property that gave the government an opportunity to cancel privatization agreements without compensating investors for the funds they had invested into an enterprise.

Yushchenko’s policy regarding FDI effectively translated into creation of multiple institutions tasked with attracting foreign capital into the country that from the beginning had no resources, overlapping functions, no clear understanding about the long-term goals, and no political clout to achieve these goals.\footnote{The goal was characterized by my interviewee: Vasyl Feduk, head of a department, National Agency of Foreign Investment and Development, 10 September 2009.} The institutions had short-term goals – for example, the National Agency on Foreign Investment and Development was formed as an “anti-crisis measure” at the time when Ukraine badly needed capital.\footnote{Interview, Kyiv, fall 2009.} Results had to be visible in the short-term, and creation of formal institutions was to create an impression of Ukraine as a...
country open to FDI. Overhauling the system and improving Ukraine’s investment climate was too difficult. The officials thought that they could simply “lead a foreign investor in through the right door by hand” without changing the system of economic relations. “Strategic enterprises” remained beyond the competence of these institutions. FDI-promoting and other institutions in Ukraine have been highly sensitive to political changes since they were created to fit the needs of a specific politician. Change of political power usually led to their reorganization or even liquidation. For example, in 2010 the newly elected President Yanukovych reorganized the Consultative Council on Foreign Investment in Ukraine into the Council of Foreign and Domestic Investors and tasked it with attraction and effective utilization of domestic investment. The ongoing institutional reorganizations made this particular institutional change an unremarkable event. However, the formal change suggested that, in contrast to Yushchenko’s formal focus on FDI, Yanukovych would concentrate on domestic business.

Under Yanukovych, privatization gained significant pace. The new president returned to the Kuchma-era privatizations when “friends of the regime” bought lucrative assets at heavily discounted prices. Filling in the budget was, once again, no longer a priority. In 2012, the budget was to receive 10,575 billion UAH from privatization yet only received 6,763 billion. In a number of cases, owners of newly privatized assets paid just a bit more than the starting price for an asset.

The 2010 privatization program also tried to institute formal limitations for privatization by foreigners. It prohibited investments where the consolidated part of foreign capital in a specific strategic sector exceeded the limit set by sectoral programs to eliminate the “risks for economic independence and security of the state.” Parliament rejected the government’s bill on strategic sectors of the economy, which would have allowed the government to determine

---

117 Interview with Igor Burakovsky, director, Institute of Economic Research and Political Consultations, 15 October 2009.
118 Interview with Olena Hantsiak-Kas'kiv, acting director of the Ukrainian Centre for Facilitating Foreign Investment, 12 October 2009.
which sectors were “strategic” at that moment and open or close them to foreign investors on an ad hoc basis – something that governments had been doing in the past through informal methods. However, the formulation of a “strategic enterprise” in legislation was preserved.

7.3. Russian FDI

Since independence, neighboring Russia had presented the biggest security threat to Ukraine. The attitude of Ukraine’s political regimes toward Russian FDI was formed through the prism of a choice between economically costly political independence from Russia, and (short-term) economic prosperity, necessitating closer economic ties with Russia. Vulnerability to external pressure that could compromise Ukrainian autonomy and ultimately sovereignty was the main deterrent to active pursuit of integration. When in 1995 Russian Gazprom produced a list of 15 Ukrainian companies (among them ferrous alloy plants and gas storage and transport facilities) and offered 30-50 per cent ownership packages in these companies as the settlement of Ukraine’s $1.5 billion debt for gas deliveries, the Ukrainian government objected. When Putin came to power in Russia in 2000, Kuchma’s regime became concerned that Russia’s private capital was connected to the Kremlin and resisted their entry too. Preservation of Ukraine’s autonomy, sovereignty, and their own political power was at stake.

Ukrainian domestic business was prepared to cooperate with Russian oligarchs when this created rent-seeking opportunities and resisted Russian FIGs when the latter threatened to undermine their control over economy. While some foreign investors did not come into Ukraine because of poor investment climate and thus spared Ukrainian big businesses of competition, Russian investors were used to operating in a corruption-prone environment. They had “similar mentality” and were willing and able to broker deals with political elites. The ideology of “national bourgeoisie” was directed primarily against Russian investors. Official data on Russian investment into Ukraine suggested very low numbers – for some years, below

124 Puglisi, 832.
125 Interview with Mykhaylo Salnykov, expert, “Sokrat,” 1 October 2009.
126 Balmaceda, 61.
127 Interview, Kyiv, fall 2009.
128 Puglisi, 836-837.
Kuchma’s regime changed its attitude toward Russian FDI in 2000 during the course of the so-called “Kuchmagate” scandal discussed above. Kuchma urgently needed political support as relations with the West soured and situation within Ukraine was not favorable. He turned to President Vladimir Putin for support. As a result, Kuchma made a political decision in favor of Russian FDI and what one journalist called “Kuchma’s garage sale” began. The entry of Russian FDI in exchange for political support of Kuchma’s regime confirms that whenever regimes face the threat of losing power, they broker deals with those actors – domestic or foreign - who help them preserve their power.

In order to persuade the public that he was not “anti-Russian” during his 2004 presidential campaign, Yushchenko claimed credit for the fact that during his premier-ship foreign bidders tended to win privatization auctions and Russian investors won half of these auctions. During his presidency, Russian official stocks of FDI into Ukraine increased almost 5 times. Most Russian capital went into oil refining, metallurgy and, in particular, aluminium, and telecommunications. Under President Yanukovych, Russian FDI came in whenever its entry was not resisted by business groups that were affiliated with the president and whenever Russian investors could establish informal connections with Ukrainian decision-makers. There is also evidence that as the economic crisis was worsening for Ukraine, the regime was increasingly prepared to sell some of its strategic assets to Russian investors and in this way go against the interests of its domestic allies.

---

129 Puglisi, 833. Some of the Cypriot FDI could have been originally from Russia.
133 It increased from 720.8 million USD in 2004 to 3403 million USD in 2010. See Investment Country Profiles: Ukraine.
135 See, for example, discussion in Vladimir Lartsev, “Itogi tenevoi privatizatsii,” Ukrayins’ka Pravda, 30 January 2013.
8. Ukraine’s Metallurgy and Mining

When Ukraine became independent, its metallurgy had been in poor technological shape as the sector had experienced a decade of underinvestment during the Soviet era. It also had been receiving a considerably smaller share of imported equipment than Russia’s metallurgy sector had. As a result, by the early 1990s, 60-70 per cent of sector’s industrial capacity had been worn out. Ukraine continued to manufacture steel in open-hearth furnaces whereas other countries had moved on to more effective and environmentally-friendly technologies, such as basic oxygen steelmaking. Production was very energy intensive. The share of high value-added product in overall production was less than 20 per cent. Inputs and semi-finished products accounted for the remaining share. Over time, the availability of inputs became an issue. For example, geological conditions in the Kryvyi Rih iron ore field rapidly deteriorated after production had shifted from underground to surface mining. From 1981-1985, Ukraine’s ferrous metallurgy devoted one-fifth of investment to counteract diminishing returns in iron ore mining.

The collapse of the USSR only made a bad situation worse. Declining defense spending and decay of the largest consumers such as machine building left Ukraine’s metallurgy sector with significant extra capacities. As a result, in 1995 production of steel – the key component of metallurgical sector – fell to 42.4 per cent of the 1990 level.

However, already by 2000, the decline was reversed. From 1996-2000, steel production grew annually at 8.5 per cent annually. Recovery of ferrous metallurgy led to revival of sectors associated with it, such as electricity production, machine-building, and transport. Ferrous metallurgy was the main driving force behind the improvement of Ukraine’s economy until 2001, when other sectors began contributing to economic growth.

---

139 Paskhaver, Verkhovodova, and Suplin, 47.
140 Kuchma, 174.
141 The Ukrainian economy: achievements, problems, challenges 126.
142 Paskhaver, Verkhovodova, and Ageeva, 27. The exception was 1998, when Ukraine was hit by the crisis.
143 Paskhaver, Verkhovodova, and Ageeva, 28.
The sector found a “way out” of its crisis through utilization of extra production capacities and exports abroad. For example, its exports increased from 3 million tons of rolled ferrous metal products in 1990 to 24.8 million tons in 2003.\(^{144}\) In 2003, the sector was responsible for a third of Ukraine’s export.\(^{145}\) Today, Ukraine’s metallurgy is the third largest in the world (based on export) after Japan and Russia. It is the chief exporter, responsible for 2.5 per cent of GDP and 17.4 per cent in industrial production.\(^{146}\) Ukraine’s legislation does not define “strategic sectors” yet metallurgy is certainly the country’s key economic sector. Its individual enterprises are on a list of “strategic enterprises,” privatization of which is subject to special regulations.

9. Key Actors and Developments

Metallurgy became one of the few spheres where one could earn high profits (mostly in the form of rents at the time) through exports.\(^{147}\) As discussed above, in 1996, trading companies established themselves as suppliers of gas to metallurgical enterprises, which gradually awarded them control over these enterprises’ supplies and sales. Eventually, gas traders gained control over enterprises themselves while the former “red directors” lost out. Banks also sought to establish control over metallurgical enterprises – their important clients – by exploiting the enterprises’ dependence on credit.\(^{148}\) However, banks did not gain the same presence in the sector as gas traders.\(^{149}\) Today, Ukraine’s big business is heavily rooted in metallurgical sector.\(^{150}\) Under Kuchma, the sector was divided between the country’s largest FIGs: Donetsk-based IUD and SCM and Dnipropetrovs’k-based Interpipe and Pryvat.

However, the ability to export was not a panacea for all problems of the sector. An underdeveloped domestic market for metallurgy consumption, which purchases up to 20 per cent

\(^{144}\) Paskhaver, Verkhovodova, and Suplin, 49.
\(^{145}\) Paskhaver, Verkhovodova, and Suplin, 47.
\(^{146}\) Rozvytok Sektora Chornoii Metalurgii v Ukraini [The Development of Ferrous Metallurgy in Ukraine] 6. This number tended to be higher during the 1990s, when other sectors took time to recover. Metallurgy was responsible for approximately a quarter of industrial production for most years in the mid 1990s rising to almost 30 per cent in 2000. See Hayduts'kyi, 247.
\(^{147}\) Paskhaver, Verkhovodova, and Suplin, 49.
\(^{149}\) Rozvytok Sektora Chornoii Metalurgii v Ukraini [The Development of Ferrous Metallurgy in Ukraine] 16-17.
\(^{150}\) See Paskhaver, Verkhovodova, and Ageeva, 14: in the list of biggest businesses in Ukraine, almost everyone in the first 10 are either in oil or metallurgy.
of sector’s production, made metallurgy highly dependent on those external markets.\footnote{Rozvytok Sektora Chornoii Metalurgii v Ukraini [The Development of Ferrous Metallurgy in Ukraine] 7.} Competing with other producers was difficult due to the sector’s low labor productivity and high input and energy intensity. External vulnerability increased the dependence of metallurgical companies on the state and the political regime in charge of it.

The state supported metallurgy in a number of ways. For example, the budget compensated coalmines for discounts awarded to those metallurgical enterprises that kept coke prices low.\footnote{Paskhaver, Verkhovodova, and Suplin, 59. Also see OECD investment policy reviews, 100: “Most of domestic coal production, which is hard to extract and generally of poor quality, is sold at a loss to the steel industry enabling it to be profitable.” State-owned enterprises pay higher price for coal: “Perspektyvy Rozvytku Sektoru Energetychnogo Vuglya V Ukrayini – Nastav Chas Dlya Reformy,” Institute of Economic Research and Political Consultations, 10 December 2009, available at http://www.ier.com.ua/ua/publications/policy_briefing_series/?pid=1841} Metallurgical enterprises also misused a portion of budgetary funds they received. Despite active exporting, formally state-owned enterprises accumulated substantial debts in the early 1990s.\footnote{Paskhaver, Verkhovodova, and Suplin, 60.} In July 1999, Kuchma initiated an “experiment” in the sector that ran until January 2002. As part of this experiment, the state cancelled late tax payment fees incurred before July 1999 and reduced these payments afterwards by half for the sector. In certain cases, metallurgical enterprises could qualify for a deferral in tax payment for up to 36 months.\footnote{See Law of Ukraine “Pro provedennia ekonomichnogo eksperymentu na pidpryemtsvakh girnycho-metallurgiynogo kompleksu Ukrayiny.” 14 July 1999. Available at http://zakon.rada.gov.ua/cgi-bin/laws/main.cgi?nreg=934-14. For the list of participating enterprises, see the Cabinet of Minister’s Decree: http://zakon.rada.gov.ua/cgi-bin/laws/main.cgi?nreg=1820-99-%EF.} Sixty-three enterprises participated in the experiment. Experts estimated that the experiment cost the budget approximately 2.7 billion UAH (approximately half a billion USD). Then, in July 2000, President Kuchma signed a decree stipulating re-investment of 25 per cent of funds received from privatization of “strategic enterprises” into these very enterprises – the regime-friendly oligarchs could have their cake and eat it too.\footnote{Mikhail Chechetov 2000. “Dokhody Budzheta ili Effektivnyy Menedzhment: Tekst I Podtekst Privatizatsii.” Zerkalo Nedeli, 3 November.}

The regime presented its experiment as a definite success. Participating metallurgical enterprises finally began reporting profits and receiving investment.\footnote{Their net profit increased 2.2 times. Paskhaver, Verkhovodova, and Suplin, 61.} At the same time, the experiment was hardly a policy characteristic of a developmental state. Its initiation was highly political – the experiment served as a “carrot” for business groups to help Kuchma get reelected.
in 1999. The law set the general rules for the “experiment” yet the FIGs that controlled them had to negotiate with the regime individually in order to be included in the list of participating enterprises. Besides, it is not clear to what extent these enterprises had been loss-making before the experiment: they remained state-owned, yet the state exercised poor control over them. In 1998, the government awarded control over a number of enterprises to cronies of the regime that were supposed to manage these enterprises. After leaving office, Kuchma himself noted that the tendency to “conceal, expropriate, including from oneself” has been dominant in the Ukrainian metallurgy since Soviet times. He had certainly been one of the main facilitators of this tendency.

Over time, informal control became unreliable. The investments FIGs made aimed at selective increases in productivity. In the long term, this strategy was not feasible. That is why by 2002, the emerging business groups decided to translate their informal control into formal ownership. Having increased the value of sector’s assets at the expense of the budget, the regime soon sold off these assets to its cronies. Privatization in the sector took place in 2003-2004, a period when both export and internal prices for metallurgical products grew quickly. Yet, the state received little in return since “on-demand” sales were not competitive. Kuchma later claimed that privatization “saved” Ukrainian metallurgy even though the sector clearly owed its survival to the state itself as its long-term donor.

Although Kuchma complained that Yushchenko’s regime “treated metallurgy as an ‘oligarchic’ sphere where wars should be fought,” involuntary re-distribution of assets after Kuchma’s departure from power was very limited (with the exception of Kryvorizhstal’). In October 2005, the Constitutional Court dismissed the attempt of several MPs to challenge privatization of sector’s enterprises. Property rights did not become fully secure, yet the oligarchs’ worst fears that they would lose these assets did not come true either.

157 Kuchma, 190.
158 Verkhovodova, Voronkova, and Ageeva, 16-17.
160 Pashkaver, Verkhovodova, and Ageeva, 8-9.
161 Kuchma, 180.
162 Kuchma, 182.
163 Dubrovskyy, et al, 34.
During Yushchenko’s presidency, the 2008 financial crisis resulted in a rapid decrease of world metal prices. The government responded with selective short-term measures, such as haphazard efforts to re-orient the sector to serving the needs of the domestic market and abolishing a 12 per cent surcharge on natural gas consumed by metallurgical enterprises. The budget, however, lacked the resources to truly mitigate sector’s losses. Ukraine’s metallurgical companies failed to modernize their industry between 2005 and mid-2008, when external conditions were favorable. Kuchma, who had praised privatization in the sector, put the blame on the government for “failing to notice” this fact – so much for responsibility of private owners! Business and politicians continued to use informal methods of communication and rendering personal favors to each other.

During Yanukovych’s presidency, re-distribution of assets in the sector continued. Yanukovych was pre-occupied with strengthening the positions of Rynat Akhmetov and his own family in the sector. In 2011, SCM acquired Zaporizhstal. Also, Metinvest (SCM’s metallurgical branch) gained ownership over the Illich plant. The plant became vulnerable because it lacked its own resource base. In December 2009, Russian steel producers Evraz Group and Alisher Usmanov’s Metalloinvest obtained a controlling stake in the IUD, one of the world’s 30 largest producers of steel, which also lacked its own resource base and therefore ran into difficulty maintaining production.

The sector has since been facing an acute crisis due to reduced demand for its products and the rising cost of gas. The majority of enterprises are officially unprofitable, especially when it comes to production of high value added mill products. The only exception is the iron-ore enrichment combines, which continued to bring very high profits. Akhmetov had acquired them during Kuchma’s presidency and used his control over this crucial input to acquire additional property in the sector. Problems such as dependence on exports of raw materials and underdeveloped internal metals markets have remained. Investment into modernization has been declining steadily since 2007. For example, Akhmetov’s Metinvest decided to cut its investment program by 40 per cent (from 477 to 733 million USD) in order to pay off 800 million USD...
worth of dividends to its owners. Short-term thinking and focus on control made possible through political connections predominates.

Under Yanukovych, the state remained a tool in the hands of the regime. For example, during Yanukovych’s presidency, the state support for the coal sector more than doubled while the production of coal decreased. This is because Akhmetov controlled extraction of close to half of Ukraine’s coal production. Yanukovych’s son was gaining influence in the coal sector too through supplies of equipment at increased prices and purchases of coal at lowered prices. All enterprises except for Akmetov’s faced significant delays in return of the Value Added Tax (VAT), which took significant capital out of production and stalled any investments into modernization. Kostyntyn Zhevago, who had supported Yanukovych’s main opponent Yulia Tymoshenko, saw almost no VAT returns to his ore-processing combine. The regime was using the powers of the state to maintain its own power.

10. Policy Regarding FDI in Metallurgy and Mining

Ukraine’s metallurgy sector needed investment for its long-term development. In 1999, the sector received only one fifth of the investment it had received in 1990. On average, the level of assets depreciation reached 60 per cent by the end of 1990s (70 per cent for steelmaking). Despite its need for capital, Ukraine attracted very little FDI into metallurgy.

Despite outdated technological state and poor financial state of the sector, foreigners were not welcomed. Since Ukraine lacked both state and private capital at the time, availability of extra capacities played an important role in maintaining production for export. The sector could function without investment, including foreign investment, for some time capitalizing on capacities that had been built during the Soviet era. The steel sector, which is a key part of Ukraine’s metallurgy complex, could operate as a closed technological system since it covered raw materials extraction and processing, coke manufacturing, cast iron, and steel smelting. It had

---

169 Interview with an expert, Kyiv, May 2014.
171 Paskhaver, Verkhovodova, and Suplin, 51.
very limited dependence on imports. The developed transportation and power systems also helped maintain production in metallurgy.\textsuperscript{172}

In the 1990s, FIGs had poor incentives and a lack of funds to invest in the sector. Instead, they focused on acquiring short-term rents. It was only the transformation of control into ownership during the “on-demand” privatization and rising world metals prices finally brought some investment into the sector.\textsuperscript{173} In 2003, ferrous metallurgy received 331.1 million USD of investment – a significant increase compared to 1999, when the sector received only 155.4 million USD.\textsuperscript{174} In 2004, business groups such as the IUD, SCM, and Interpipe, began attracting long-term investment credits from foreign banks.\textsuperscript{175} Ironically, high metal prices on the world market allowed them to postpone the beginning of large investment projects. Although investment funds went into the sector, these were insufficient for in-depth restructuring and upgrading. Investment funds focused on small investment projects. They led to partial and narrowly selected upgrading of those assets in the worst technological and physical shape. Export growth was still driven by increased capacity utilization and recovery of non-operating units. This strategy resulted in the low capital intensity of current production, which was 2-2.5 times less than in Russia and 3-4 times less than in OECD countries.\textsuperscript{176} Throughout the post-Soviet era, Ukraine’s emerging business groups gave preference to retaining control and ownership to obtaining investment capital through sharing control and ownership with foreigners.

Foreigners were excluded from privatization in the sector through formal and even more often informal mechanisms. Since the process of acquiring control over a sector’s assets was


\textsuperscript{173} In 2003, investment increased by 35% compared to 1995 and constituted more than 330 million dollars. Rozvytok Sektoru Chornoii Metalurgii v Ukraini [The Development of Ferrous Metallurgy in Ukraine] 8. Still, in 2003 it only approached 2/3 of the 1990 level (“Ukrainian Steel Export …,” p.102).

\textsuperscript{174} 1999 was the worst year for Ukraine’s ferrous metallurgy in terms of investment. It received 210.4 million USD in 2000, for example. The numbers for other years since independence are closer to the 2000 levels than 1999, yet still significantly lower than 2003. See Paskhaver, Verkhovodova, and Suplin, 2004.

\textsuperscript{175} Paskhaver, Verkhovodova, and Ageeva, 30.

chaotic (but never random), some intermediary financial institutions acquired assets in the sector but were not interested in launching any kind of production. Upon the suggestion of a respected Kyiv-based Centre for Economic Development, the 2000-2002 privatization program introduced the term “industrial investor” for buyers of strategic enterprises and monopolies. The Centre offered to put forward a number of specific requirements to ensure that an investor had long-term interest in the asset undergoing privatization. Legislative provisions were supposed to exclude intermediary financial institutions from ownership in the sector. The head of the Property Fund Mykola Chechetov announced that the Fund would now begin focusing on finding a long-term owner for enterprises and no longer needed to pursue the goal of attracting funds into the budget. He promised that no capital in Ukraine would be discriminated against “based on its nationality or geographic origin.”

The legislation solved the problem of “ownership without control” by financial institutions but purposefully created loopholes: the requirements it put forward for an “industrial investor” were so specific that only “friends of the regime” could meet them. For example, legislation stipulated that an industrial investor had to have produced similar products to the ones produced by an enterprise offered for privatization for at least three years. Alternatively, it had to have used the products of this particular enterprise as its main inputs or have directly controlled the privatized enterprise for at least one year. Because the FIGs already controlled the sector’s enterprises, they received an unfair advantage in gaining ownership at discounted prices. In 2004, eighteen out of twenty “strategic” enterprises gained ownership through non-commercial sales with established qualification criteria. The 2004 Law regulating the privatization of enterprises that belonged to Ukrrudprom – the state holding in the sector that formally owned enterprises in the sector – had similar provisions and goals. A variety of forms for the

177 Verkhovodova, Voronkova, and Ageeva, 37.
179 Interview with Lidia Verkhovodova, vice president of the Centre for Economic Development, Kyiv, 28 September 2009.
182 It stipulated that investors who already owned 25 per cent of shares and more of Ukrrudprom’s enterprise undergoing privatization had a priority right to purchase Ukrrudprom’s shares in this enterprise giving the Kuchma-friendly FIGs a substantial advantage in purchasing these enterprises. http://zakon4.rada.gov.ua/laws/show/1677-15 Verkhovodova 2003, p. 17.
purchase of Ukrrudprom’s shares were allowed, such as buyout, competition with a limited number of participants, and open auction. Open auctions were to be held only when none of the current owners wished to purchase Ukrrudprom’s shares – that is, hardly ever. 183

Access by outsiders, both domestic and foreign, was limited. Legislative provisions regulating “on-demand privatization” excluded interested foreign investors from purchasing Kryvorizhstal in 2004. Cronies of the regime bought the enterprise despite higher financial offers from foreigners. The State Property Fund put forward a condition that the future buyer of Kryvorizhstal had to have experience in the relevant market, in particular sales of at least one million tonnes of coke coal in Ukraine in the three preceding years. Because Ukraine’s coal market was state-controlled and coking plants belonged to industrial holdings from Donetsk and Dnipropetrovsk, this condition effectively excluded foreign bidders. 184 While blocking foreigners’ entry at home, the FIGs welcomed cooperation with foreigners outside Ukraine. 185

Ukraine’s metallurgy sector did not welcome FDI under Yushchenko either. The re-sale of Kryvorizhstal to ArcelorMittal in October 2005 was more a political “declaration” and a way to generate quick revenue for the government than a sign of fundamental policy change. 186 This re-sale of a large equity to foreign investors was also only politically possible in 2005. 187 Soon afterwards, Yushchenko began losing popularity and business-regime relations came to resemble those that existed during the Kuchma era. The powerful world steel producer ArcelorMittal had its own share of problems with Kryvorizhstal after the purchase of enterprise, including the threat of losing ownership. During the presidency of Yanukovych, the main problem was the delays with returns of VAT. The state owed the company 2.3 billion UAH as VAT returns, which was the biggest debt of all Ukrainian enterprises. ArcelorMittal also had to pay more than 1 billion UAH in advance towards its profit tax in order to help the government finance the budget deficit. 188

183 See Pleines, 1190.
184 Pleines 2008, 1191.
185 For example, foreign trading companies continue to be important partners for Ukrainian metallurgical companies in order to be able to access foreign markets. Rozvytok Sektora Chornoii Metalurgii v Ukraini [The Development of Ferrous Metallurgy in Ukraine] 8.
186 The second big FDI deal in metallurgy during Yushchenko’s presidency was the purchase of Sukhaya Bulka Ore-Enrichment Combine by Evraz Group SA in 2008 for 2189 million USD. OECD investment policy reviews, 22.
187 Interview, Kyiv, fall 2009.
long-term modernization. In 2006-2013, ArcelorMittal invested less than $2 billion into Kryvorizhstal, which is half of what Metinvest invested and considerably less than what the company planned to invest initially.

11. Key Actors in Oil and Gas and their Relationship with the Regime and the State

Up to the mid-1970s, Ukraine produced about one third of the Soviet Union’s gas supply. Several rich oil fields were discovered in the 1960s and 1970s, among them Dolyns’ke (38.3 million tons of oil), Hnidyns’tsivs’ke (38 million tons), and Lelyakivs’ke (52.4 million). After discoveries of more abundant oil and gas reserves in Western Siberia, Soviet planners largely ignored Ukraine’s energy complex. Unlike Kazakhstan, the reserves of which were explored but left underground, Ukraine’s reserves were largely left unexplored. That is why it may not be surprising that little FDI came into the sector after independence. Because considerably more energy abundant republics gained independence at the same time as Ukraine, foreign investors focused on exploring opportunities in these states. Indeed, Ukraine itself focused on other sectors, such as metallurgy, which was more developed.

Although Ukraine’s oil and gas reserves are much smaller compared to other post-Soviet states, they are not insignificant. As of the late 1990s, Ukraine had 395 million barrels of proven oil reserves and 39.6 trillion cubic feet of gas. Its reserves-to-production ratios are approximately 61 years for gas and 75 years for oil. According to International Energy Agency, Ukraine “has potential to meet its gas consumption with domestic production by 2030.” The Agency advised that in order to increase its domestic production and strengthen energy security, Ukraine needed to conduct comprehensive reforms and attract foreign investment. Even though dependence on imports of Russian oil and gas threatened Ukraine’s sovereignty, the political elites failed to develop a coherent policy to boost energy independence. They also did

---

189 Interview with Borys Dodonov, senior energy economist at New Social and Economic Policy, Kyiv, May 2014.
191 See Mykhaylo Honchar, ed., Naftogazovyy sektor Ukrayiny: prozorist' funktsionuvannya ta dokhodiv [The Oil and GAs Sector of Ukraine: Transparency of Functioning and Revenues] (Kyiv-Sevastopol': Anna-T, 2008) 64.
192 A Study of the Soviet economy 257.
193 Zarko Stefanovski, Ukraine Oil and Gas Sector Overview FD Capital, 2005).
not make use of opportunities to increase production of oil and gas at home. Instead, since 1990, production for both resources decreased by about one third.

The sector became a major venue for rent-seeking, when the most important areas of energy policy were given to actors who had a clear interest in maintaining the status quo.\textsuperscript{195} The majority of rent-seeking activities took place in gas trading. Leveraging off Ukraine’s developed oil and gas pipeline system and energy storage, Kuchma’s regime was able to negotiate heavily discounted prices for supplied gas from Russia. This move took away incentives to develop domestic production and only solidified Ukraine’s dependence on its neighbour.\textsuperscript{196} Ukraine’s heavy indebtedness to Russia for delivered gas led the latter to pressure Ukraine to hand over the latter’s energy infrastructure as debt repayment.\textsuperscript{197} Yet Ukrainian political leadership consistently resisted this pressure.\textsuperscript{198}

Kuchma tried to eliminate Ukraine’s sovereign debt to Russia by changing the gas supplies system: in April 1996, he introduced a gas trading concession system that eliminated sovereign guarantees for gas imports. Instead, the government awarded selected gas traders exclusive rights to import gas (mostly of Russian and Turkmen origin) and re-sell it to consumers.\textsuperscript{199} Instead of de-monopolizing the market, this measure only created a “cartel” of wholesale gas traders.\textsuperscript{200} A variety of actors from different backgrounds, among them the so-called “hard-to-track actors,” made fortunes.\textsuperscript{201} As discussed above, these gas traders eventually gave rise to Ukraine’s FIGs. While the well-connected gas traders serviced the most profitable industrial contracts, the state continued to supply gas to residential customers, who often could not pay their bills.\textsuperscript{202} Since gas traders’ profits depended on the volume of gas they sold, the traders ultimately depended on political patronage from the government, which assigned quotas on how much gas the traders could supply. Pavlo Lazarenko, first a vice-premier and then a prime minister during Kuchma’s presidency in 1995-1996, built his political capital and financial

\textsuperscript{195} Balmaceda, 76.
\textsuperscript{196} For an excellent and detailed analysis of how this dependence was maintained, see Balmaceda, 4-4.5 billion USD for 1990-1994. See Pirani, 19.
\textsuperscript{197} See Pirani, 18-20.
\textsuperscript{198} It's a Gas. Funny Business in the Turkmen-Ukraine Gas Deal Global Witness, 2006) 22.
\textsuperscript{199} Pirani, 20.
\textsuperscript{200} Balmaceda, 141.
\textsuperscript{201} Balmaceda, 49.
fortunes by patronizing gas traders. Lazarenko lost his post in the summer of 1997 when Kuchma began fearing that Lazarenko would challenge him in 1999 presidential elections.

In order to regain control over the sector, in 1998 Kuchma sanctioned creation of a fully state-owned oil and gas company Naftogaz, which became the “Gazprom” for Ukrainian politicians: it has been a source of rents, a means of controlling other players in an important market, and a substantial resource for sustaining political power. Publication of unconfirmed evidence that Ihor Bakai, Naftogaz’s chairman and Kuchma’s close friend, had created a multi-million dollar slush fund for Kuchma had caused public outrage that eventually led to the Orange revolution.

Naftogaz became a near-monopoly in Ukraine’s gas and oil sector soon after its creation. It supplied almost 85 per cent of Ukraine’s gas. Its formal task is extraction, transportation, and processing of hydrocarbons. Naftogaz operates Ukraine’s gas and oil pipeline system and supplies hydrocarbons to industrial and domestic consumers. Through a system of extensive and often misused budget subsidies, expropriated loans, and intermediaries in gas trade, the management teams of the company managed to enrich themselves. The state did not control the company it officially owned: when Bakai headed the company, no audits of Naftogaz were allowed. In 1997, Kuchma vetoed the bill that would have allowed the Accounting Chamber to look into Naftogaz’s accounts twice. Despite its lucrative position, Naftogaz managed to accumulate large debts. Bakai himself estimated this debt to be US$760 million in 2000. The state was again “robbed of valuable resources … and … further weakened, which in a vicious circle, made it less able to get a grip on the energy system and its problems.”

Unfortunately, the looting of Naftogaz and therefore the state by private actors continued during Yushchenko’s and Yanukovych presidencies. Perhaps the most well-known case that

---

203 It’s a Gas. Funny Business in the Turkmen-Ukraine Gas Deal 22.
204 Pirani, 23.
205 See Honchar, 63.
206 It’s a Gas. Funny Business in the Turkmen-Ukraine Gas Deal 25.
207 Balmaceda, 77.
revealed the extent of corruption at Naftogaz were the infamous “Boyko’s towers.” Yuri Boyko, who was the minister of coal and energy under Yanukovych’s presidency, approved the purchase of two drilling units at 400 million USD each from abroad in 2011 through intermediary companies. It soon turned out that the actual price of the units was 220 million USD.209 In 2012, Yanukovych’s regime initiated a reform of Naftogaz that would delegate the profitable function of gas supplies to industrial consumers to gas traders once again and leave the state-owned company the loss-making functions and all other liabilities.210 After Yanukovych’s flight from power in 2014, the future of Naftogaz was still being decided.

Naftogaz has strong positions in the oil sector too. At the time of its creation in 1998, the company received 50%+1 share of Ukrnafta, Ukraine’s main oil company that was responsible for 68 per cent of oil extraction and 11 per cent of gas extraction in 2011. During 1995-1997, almost half of Ukrnafta’s shares ended up in private hands.211 Even though the state has preserved some ownership in the sector, it does not effectively control Ukrnafta and the oil-processing plants it still owns.212 Since 2003, the Pryvat Group has controlled about 40 per cent of Ukrnafta’s shares.213 In 2004, Pryvat attempted to increase its ownership in the oil company, yet Kuchma preserved the existing package of shares in state property.214 Afterwards, the Pryvat Group tried to take as many resources out of Ukrnafta as possible through a variety of “traditional” means, such as purchases of overpriced equipment from affiliated firms or selling oil at discounted prices to Pryvat-controlled enterprises. Ukrnafta with its majority state ownership has little information about its profits. The available data suggests that even though its profits have increased since 2007, the volumes of exploratory drilling dwindled. Extraction and capital investment fell too.215 Instead, Ukrnafta has been focusing on construction of gas stations

209 “Vyshky Boyka Kupyly Naspravdi u Norvezhtsiv - ZMI,” Ukrayins'ka Pravda, 2 September 2013. Because the drilling units were bought for Chornomornaftogaz, a subsidiary of Naftogaz in the Black Sea, after Russia’s annexation of the Crimea in 2014 the units are now located on Russia’s territory and likely lost for the Ukrainian state.
212 Honchar, 79-80, Honchar, 87.
and small gas-processing plants, which will not help Ukraine gain energy independence in the long-run.\textsuperscript{216}

\section*{12. Policy regarding FDI in Oil and Gas}

When Kuchma was leaving office in 2004, the FDI stock into mining and quarrying was only 174 million USD – less than 2 per cent of the total FDI stock. The numbers for FDI increased under Yushchenko. During the last year of his presidency in 2009, FDI stock into the sector stood at 1050 million USD – but still about 2.5 per cent of all FDI stock into Ukraine since independence.\textsuperscript{217} This is very little FDI for a country that wants to boost its oil and gas production and strengthen its energy independence from Russia and cannot develop the sector on its own.

Nafrogaz and Nadra Ukrayiny\textsuperscript{218} have a number of licenses for extraction in the Black Sea, yet they are incapable of organizing exploration either technologically or financially.\textsuperscript{219} The primary reserves of the main gas fields are close to depletion. In order to increase production, Naftogaz needs to open new wells and drill investigation holes for commercial production. It also needs to increase the level of preliminary drilling in order to expand the volume of explored resources. Therefore, the company will need both capital and equipment since the most promising gas reserves are located at depths of 5500-6300 meters in central Dnipro-Donecky basin. Lack of financial resources has been an obstacle in developing the Subotynske oil field estimated to contain 100 million tons of oil.\textsuperscript{220} Extraction is extremely difficult. Significant oil resources are located offshore. Therefore, Ukraine would need to rely on foreign (likely Western), investors in order to raise extraction levels. The Ministry of Fuel and Energy calculated that the gas sector alone needed the annual investment of 2.1-2.3 billion UAH during 2005-2010 to extract desired volume of gas.\textsuperscript{221} Ukraine also lacks capital and technologies to discover and extract unconventional hydrocarbons, such as shale gas, located on its territory.

\begin{thebibliography}{99}
\bibitem{216} Honchar, 80.
\bibitem{217} Investment Country Profiles: Ukraine
\bibitem{218} It is a state company managing 13 exploration and other specialized enterprises.
\bibitem{220} Honchar, 65.
\bibitem{221} Honchar, 256.
\end{thebibliography}
The political will to invite foreign investors and raise extraction levels has been missing. Rent-seeking during Kuchma’s presidency left no room for any long-term ambitions regarding the sector. Kuchma’s main achievement was that he did not surrender control over Ukraine’s pipeline system to Russia. There were reports that Shell made an offer to gain ownership in the system in 1997, but Kuchma’s regime refused to sell equity. Yet, when Kuchma needed to gain Russia’s political support during legitimacy crisis at home, Ukraine agreed to the creation of the Ukrainian-Russian gas transit consortium that gave Russia de facto power in Ukraine’s transit policy. During Kuchma’s legitimacy crisis, Ukraine also allowed Russian investors to acquire control over its four most important oil refineries. State interests have been compromised whenever it came to supporting the regime in power. Besides, boosting production would also serve the political elites, which have been supported in power by economic interests and would benefit from more reliable domestic sources of energy. Unfortunately, the focus on rents predominated over other incentives. For example, instead of boosting domestic production, Tymoshenko and Yanukovych focused on eliminating the sources of rent for each other. Even though metallurgy is Ukraine’s key production sector, oil and gas still play an important political role too, more as a source of rents than distribution of assets or production of revenue.

Concern about boosting Ukraine’s self-sufficiency came in 2006 during Yushchenko’s presidency after a number of bitter stand-offs with Russia’s Gazprom about increasing energy prices. Yushchenko’s efforts to open up the sector to foreign investors were semi-successful: the amount of FDI increased, yet corruption and rent-seeking continued. However, overall, legislation regulating oil and gas sectors and mining in general became better developed. The state retained exclusive ownership over subsoil and set up standard mandatory licensing for most activities. Legislation stipulated competitive granting of subsurface use rights through auctions. The only exception was cases when a bidder explored the surface at his own cost and wished to undertake exploration. Even though the law generally set reasonable conditions for exploration and extraction, the State Budget law established the Cabinet of Ministers as the main

---

223 Balmaceda, 29.
224 Balmaceda, 31 Verkhovodova, Voronkova, and Ageeva, 41-42.
225 Interview with Vladimir Dubrovskiy, senior economist, CASE Ukraine, 30 September 2009.
226 See the list of laws regulating the sector in: Conducting Business in Ukraine Baker and MacKenzie, 2011) 204.
227 OECD investment policy reviews, 41.
228 Conducting Business in Ukraine 206.
licensing agency, which made the distribution of licenses highly dependent on short-term political considerations.\textsuperscript{229} Licensing of oil exporting operations remained non-transparent. The Ministry of Energy issued these licenses based on closed information and procedures that changed annually. Foreign investors could not be sure they would be able to export the oil they produced in Ukraine.\textsuperscript{230} At the same time, domestic prices for hydrocarbons were lower than external prices. The regulation of the Cabinet of Ministers adopted in January 2007 forced independent companies to sell gas extracted in partnership with state enterprises at regulated, lower prices.\textsuperscript{231}

One of the most promising areas for gas extraction was offshore in the Black Sea. Ukraine had attempted to begin extraction there, however, unsuccessfully, in large part due to lack of PSA legislation. The only tender that was held resulted in a major scandal. In 2007, despite interest from the powerful Royal Dutch Shell and Exxon Mobile, the small Vanco International Limited (Bermudas), an affiliated company of Vanco Energy Company (the USA) was awarded the license for geological prospecting, research, and commercial production of oil, gas and gas condensate in the Prykerenchenskyy field covering almost 13,000 square kilometres.\textsuperscript{232} The commission that determined the winner made its decision based on assessment of experience and financial guarantees of Vanco Energy Company. However, it was Vanco International Ltd – a different company – that submitted the application.\textsuperscript{233} The PSA was signed in 2007 with a third company – Vanco Prykerchenska Ltd registered in the Virgin Islands. When the details of the first PSA became public, a scandal broke out. The Ministry of Ecology and Natural Resources annulled the license and cancelled the PSA in spring 2008. Vanco Prykerchenska took Ukraine to the Arbitrage Court in Stockholm.\textsuperscript{234} It turned out that Rynat Akhmetov was behind Vanco Prykerchenska.\textsuperscript{235} None of the companies that owned Vanco Prykerchenska had offshore exploration experience or technologies. Yet, Yushchenko insisted that Ukraine uphold the agreement because he had established close relations with Rynat Akhmetov by the time the story

\textsuperscript{229} Honchar, 73.
\textsuperscript{230} Honchar, 90.
\textsuperscript{231} Honchar, 256.
\textsuperscript{232} Read about how the company was selected in: Alla Eremenko, “Ukraina uchitsya privlekat’ investorov na morskoy shelf: pervyy opyt,” \textit{Zerkalo Nedeli}, 29 April 2006.
broke out. During the presidency of Victor Yanukovych, Akmetov’s political “roof”, Ukraine
and the company signed a settlement agreement that essentially restored the old PSA in
November 2012.

Although President Yanukovych favored his “friends” from the big business, he also
showed significant interest in attracting real (not originating in Ukraine) FDI into gas and oil
sector. The results came very soon. First, legislation on FDI was improved significantly. The
licensing regime as an alternative to PSAs did not provide meaningful opportunities for
obtaining a license for outsiders and did not offer stability guarantees for those who did manage
to obtain the license. After a long political battle, in 2012 the parliament amended the
legislation on PSAs. Foreign investors generally welcomed the introduced changes. In January
2013, with the participation of Victor Yanukovych in Davos, Ukraine’s Nadra Uzivs’ka and
Shell signed a PSA on extraction of shale gas in the Yuzivs’ka field in Kharkiv and Donetsk
region. In September 2013, Ukraine signed a PSA with ExxonMobil, Royal Dutch Shell, and
OMV Petrom regarding development of hydrocarbons in the Skifs’ke field in the Black Sea.
In October, the government approved the PSA on Oles’ke gas field with Chevron. New
legislation provided an opportunity to convert an existing subsoil license (the majority of them
were in the hands of domestic private and state companies) into a PSA. An investor could now
directly negotiate a PSA with the government without holding a PSA tender if it had reached an
agreement on PSA conversion with the local license holder. This provision put those who
already had licenses into a powerful position to benefit from cooperation with foreigners.

Why did Yanukovych specifically make an effort to attract FDI into Ukraine’s energy
sector given that he did not like to share assets and rents? The new political will to increase

236 For more detailed discussion, see Ukraine Legal Group’s website:
237 90 per cent of the company is owned by national company Nadra Ukrayiny. 10 per cent belong to SPK
Geoservise, whose owners are unknown. See “Shell I Nadra Uzivs’ka Domovyllysya Pro Rozrobku Uzivs’kogo
Rodovyschha v Ramikakh SRP,” Ukrainskie Novosti, 12 September 2013.
238 See, for example: “Shell Provedet Experiment Po Dobycze Gaza Na Odnom Iz Istoshchennykh Mestorozhdieny
v Ukraine,” Zerkalo Nedeli, 12 September 2013.
239 “Ukrayina I Konsortsium Exxon Pidpysaly Dogovor Shchodo Vydobutku Vuglevodniv,” Ekonomichna Pravda,
25 September 2013. Also: “Dobycha Gaza na Chernomorskom Shlefie Nachnetsya Do 2017 Goda,” Ukrrudprom,
25 September 2013.
241 Irina Paliashvili,
Overview of Ukraine’s Legal Regime for Upstream Oil & Gas Sector in 2012-2013 RULG-Ukraine Legal Group,
2013).
extraction levels through FDI was explained by continuously rising prices for energy imports. After Russia no longer sold cheap energy to Ukraine, possibilities for rent-seeking became limited. Yanukovych was also interested in entering the sector himself. In tenders in 2012, the government imposed a local partner requirement (based on 50-50 participation) for onshore projects. Ukrainian experts named these local partners the “stuffing companies” (kompanii-prokladky): development of projects did not need these companies with obscure identity that were focused on earning rents. Yanukovych and his family were behind these companies. At the same time, the government imposed no local partner or a partner with a smaller interest (less than 50 per cent) for offshore projects that were more difficult to develop. This practice suggests that historic legacies - the inherited inability of Ukraine to develop its offshore resources on its own - interact with the desire of the regime to secure control over its key resource to the domestic cronies. “Real” foreign companies gained access to Ukraine’s resources only when there was political will to open up, yet the state as such had little control over its sector.

Conclusion

Despite shortage of capital and poor technological state of Ukraine’s metallurgy and mining and oil and gas, little FDI came into these sectors since independence. Soviet legacies and political considerations by the regime about sustaining its power played a key role in determining the policy choices Ukraine made regarding these sectors.

In metallurgy, the infrastructure was in place to re-launch production under the new economic system after the effects of the first shock of transition subsided. “Red directors” were much more active in lobbying the state for subsidies than in restructuring enterprises they controlled and eventually lost control of these enterprises to gas traders. At the same time, production levels recovered rather quickly. The state retained formal ownership in the sector until the “on-demand” privatization of 2003-2004, when the regime’s cronies received the main assets in the sector at heavily discounted prices. The re-sale of Kryvorizhstal’ to Mittal Steel in 2005 at a price six times higher than the domestic oligarchs had paid for it was a “success story” of Yushchenko’s presidency, yet it did not mark a change in the general trend: assets of

metallurgy as the key sector of Ukraine’s economy remained in domestic hands. Yanukovych continued to favor enterprises of businessmen who supported him in power. Therefore, throughout independence, metallurgy has been the venue and the resource for forging alliances in support of different political regimes that held power at the time.

The oil and gas resources in Ukraine were neither prospected nor developed during the Soviet era. That is why domestic actors initially lacked interest in FDI. Foreign investors in their turn lacked interest in entering Ukraine because business opportunities there were considerably smaller than in Russia, Kazakhstan, or Azerbaijan. The sector played an important political role, but more as a source for rent-seeking intended to give actors stakes in maintaining the regime and enriching the highest officials than as a source of property for distribution. The national company Naftogaz became a vehicle for looting state resources. Unable to raise extraction levels with the use of domestic resources, Ukraine finally opened up the sector to foreign investment under President Yanukovych. The regime kept tight control over the opening, making sure those who sustained it in power got a (large) slice of the pie. It was only when there was political will to open the key sector to FDI that foreigners were finally welcomed in the sector.

In Ukraine, property has been used as a way to quickly gain profit – when property was valued for the assets that could be stripped off rather than for what it can be grown into, - as the basis for building up domestic business groups, as a way to gain political power and neutralize political and business opponents. The relationship based on mutual interests that was established between domestic business and the regime under Kuchma evolved under Yushchenko and Yanukovych yet preserved itself in its general form up to this day: the regimes have been offering business access to state resources in exchange for sustaining their political power. In fact, formal ownership was not always desirable if it meant breaking off the ties to the state and its resources. Establishment of formal ownership by private actors did not mean these actors were prepared to take responsibility for their assets. While profits have tended to be private, losses incurred by politically loyal business groups have tended to be public. Deryban of state resources has remained a significant source of revenue stream for domestic big business. Ukraine’s poor investment has been a by-product of the interaction between political regimes and domestic big business.
Chapter 8. Conclusion

1. Summary of the Inquiry, Argument, and Main Findings

This dissertation explains the policy choices Kazakhstan, Russia, and Ukraine made concerning FDI in the key sectors of their economies. In the early 1990s, all three states needed capital in order to transition from communism to capitalism and modernize their ailing economies. Yet we see a variation in FDI outcomes: significant FDI entered Kazakhstan’s oil and gas and metallurgy and mining sectors but not Russia’s or Ukraine’s. I challenge the claim that the entry of FDI makes countries that attracted FDI a “success story” whereas those that did not are “failures” on the basis of whether or not they manage to provide optimal conditions for the entry of foreign capital. All of the post-Soviet states had significant problems with their investment climate that could have deterred foreign investors from coming in. Yet, I argue that post-Soviet states made their own choices about whether or not FDI was desirable. Domestic politics played a key role in whether or not the post-Soviet states welcomed or eschewed FDI.

Kazakhstan, Russia, and Ukraine made these choices under the influence of two main factors. The first factor was the given level of sector’s development, which influenced whether or not the country’s political elites believed they could develop a sector through the use of domestic resources alone, private or public. This belief was heavily shaped by the level of development that oil and gas, and metallurgy and mining respectively had achieved during the Soviet era. This varied across the republics. A sector that had been more developed during the Soviet era was more likely to stay in domestic (private or state) hands. Post-Soviet political regimes were more likely to invite FDI into sectors that had seen less development during the Soviet era and that could not be developed solely through the use of domestic resources. The late Gorbachev-era reforms thus informed who had power in the sectors across republics when the command economy was initially being dismantled.

The second factor shaping FDI choices was the way post-Soviet regimes maintained their power. The regimes clearly faced different incentives regarding different sectors of their economies. Regimes assigned particular roles to a sector and these were determined by the sectoral composition of the economy and by whether or not a regime had its own sources of
legitimacy or needed allies to sustain itself in power. A key sector could play three main types of political role: i) as a source of revenue generation for the regime (through official channels), ii) as a site for rent-seeking for the regime and its political allies (revenues not registered officially that end up in private pockets), and iii) as a repository of resources (assets) to be distributed among political allies. These roles are not mutually exclusive and were usually *de facto* combined, even though one can identify emphasis by regimes on a particular role in different empirical cases. Generally, states that had oil and gas (or good prospects of developing them) focused their efforts on these sectors, either turning this sector into a generator of revenue for the regime (as in Kazakhstan) and/or treating them as a “carrot” to be given over to political allies (as in Yeltsin’s Russia). Ukraine with its undeveloped oil and gas sector focused instead on metallurgy: the country’s domestic oligarchs received most of that sector’s assets in exchange for support of Kuchma’s regime.

Whenever a regime aligned itself with domestic business, foreigners and their investment capital were not welcomed as they were likely to compete with domestic big business for assets. In Kazakhstan, Nazarbaev turned the country’s impressive oil and gas sector into a revenue generator and a source of rents for the regime’s highest officials. Given that Kazakhstan could not develop the sector purely through the use of domestic resources, Nazarbaev opened the sector up to foreigners. My analysis of Russia and Kazakhstan highlights that the simple availability of abundant hydrocarbons does not automatically sustain a regime in power. The ability or inability of domestic actors to develop these resources had important implications for the regime. Even if domestic actors can develop oil, the regime may not be able to benefit from it if it does not have a sufficient array of mechanisms to collect rents and keep domestic business at bay.

While both the regime’s assessment whether or not a country could develop a sector on its own and the sector’s political role influenced regimes’ policy choices regarding FDI, they did not necessarily have a simultaneous effect. Initially, the level of development defined the (in)-ability of the post-Soviet states to develop their key sectors. Later, the way the regime maintained its power and the political role it ascribed to a sector came to matter as much or even more. Certainly, the level of development also shaped the regime’s power maintenance strategies. For example, the Gorbachev-era institutional reforms in Russia put the “oil generals”
in the best position to gain control and ownership of the sector during the independence era. The sector was also well-developed and thus did not need to rely on FDI on a large scale, at least in the short term. Initially, Yeltsin promoted the interests of the oil generals who could keep the sector intact. Later, when Yeltsin faced reelection, he handed over ownership and control of the sector to the bankers who became his political allies. Ability or inability to develop a sector thus influenced FDI policy choices but did not determine them unilaterally. That is why I treat the sector’s level of development and the regime’s power maintenance strategies as two separate variables. The tables below summarize the effect of both independent variables on policy choices toward FDI across the three studied post-Soviet states.

### Table 13. Oil and Gas: Summary

<table>
<thead>
<tr>
<th>Country</th>
<th>Can we develop it on our own?</th>
<th>How can we use it? (political role of the sector)</th>
<th>Outcome re FDI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russia’s Oil (Yeltsin)</td>
<td>Yes</td>
<td>Repository of resources for Yeltsin’s allies</td>
<td>The sector stays in domestic private hands</td>
</tr>
<tr>
<td>Russia’s Gas (Yeltsin)</td>
<td>Yes</td>
<td>Used to maintain social peace; rent-seeking</td>
<td>The sector stays in domestic hands with state ownership</td>
</tr>
<tr>
<td>Russia (Putin)</td>
<td>Yes (long-term development in question)</td>
<td>Generation of revenues for the regime; rent-seeking</td>
<td>Highly controlled entry of FDI</td>
</tr>
<tr>
<td>Kazakhstan (1990s)</td>
<td>No (explored but not developed)</td>
<td>Generation of revenues for the regime and rent-seeking</td>
<td>Handed over to foreigners</td>
</tr>
<tr>
<td>Kazakhstan (2000s)</td>
<td>No</td>
<td>Generation of revenues for the regime and rent-seeking</td>
<td>Highly controlled FDI</td>
</tr>
</tbody>
</table>
Ukraine (Kuchma and Yushchenko) | No (unexplored and undeveloped) | Rent-seeking | No interest in attracting FDI
---|---|---|---
Ukraine (Yanukovych) | No (unexplored and undeveloped) | Rent seeking, but also exploration in the private interests of the president | FDI was invited in before the regime collapsed

| Russia | Yes | Asset distribution (less important than oil and gas) | Privatization by domestic private actors during Yeltsin; remains privatized during Putin (but more extensive state intervention)
---|---|---|---
Ukraine | Yes, especially ferrous metallurgy | Asset distribution (politically, the most important sector; served to foster support) | Privatization by domestic private actors before and after Kuchma leaves power
Kazakhstan | Yes, especially non-ferrous metallurgy | Rent seeking and assets repository for the president | Privatization, mostly by “nominal” foreign investors; consolidation in domestic and foreign hands during the 2000s

2. Significance of This Study
This dissertation makes three key contributions. First, it brings the study of the post-Soviet region out of the field of transitology into the broader literature on the political economy
of development. It avoids taking a snapshot of various reform attempts that the post-Soviet states have made at different points at time. Instead, it asks how some of the important concepts in political science, such as “regime” and “state,” may be used to explain post-Soviet political and economic development and what the broader literature may learn from the post-Soviet empirics. It also asks the broader questions (for example, how the state may be brought in the literature, what the nature of its relations with the regime is, who is the main actor shaping policy choices and the nature of this influence) and looks in which ways the answers the post-Soviet region gives may be unique and similar to other regional contexts.

Second, it provides clear evidence of the critical role that domestic power politics – especially emanating from the presidency – plays in driving key economic policy choices. Instead of focusing on why the newly independent states were unable to attract FDI, I argue that in some cases a decision was made not to attract FDI. I seek therefore to explain these very policy choices by looking at the domestic factors that influenced them. After reading this dissertation, anyone who wishes to predict whether a particular country will open its key sector(s) to FDI or keep them closed will be equipped with an array of tools for making this assessment. As my work reveals, the first step in understanding specific choices or predicting them is to look at the underlying state of resources of various kinds at the disposal of the political regime, both political (legitimacy of the regime and its key leadership, support among key societal actors, external standing of the regime) and economic (the structure of the economy, the quantity and quality of the physical assets in the hands of the elites, the capacity for economic steering).

Third, my dissertation sheds light on the nature of the capitalism that was established in the post-Soviet states and raises important questions that still need to be addressed in the literature on the region. My dissertation directly challenges the view that those who control capital (specifically, investment capital) enjoy uncontested structural power over states. Many factors may mitigate or even negate the power of capital, especially in sectors such as oil and gas and to a lesser extent in metallurgy and mining too, where rent-seeking and profit-seeking possibilities are extremely high compared to other sectors. Who has this capital and the extent to which the potential recipient needs this capital also play a significant role. My work clearly demonstrates that domestic capital has little structural power (in Lindblom’s sense) in the post-
Soviet region: power lies elsewhere. Whereas in established market economies, governments “must induce [business to invest] rather than command,”\(^1\) in the post-Soviet region governments have generally continued to command. In key sectors of the economy, particularly those that offer lavish rent-seeking opportunities, politically connected post-Soviet business continues to thrive because of its connections to the state, not in spite of them. By contrast, those economic players who lack ties to political regimes often survive or flourish only by chance. Access to the state (through the political regime in charge of it) remains the most important factor that determines whether a certain business thrives or fails, which has important implications for economic and political development in the region.

My dissertation suggests further that foreign capital too is not in an empowered position vis-à-vis the government, contrary to what the “do-all-you-can” literature has argued or implied. Both external and domestic factors limit the power of foreign capital. First, with the rise of energy prices, the entry of foreign investors into energy-rich economies was a prize to be won rather than a “carrot” that could be used to induce the host governments to give in to foreign investors’ demands. In sectors such as oil, capital mobility across borders is restricted simply because the number of countries that have oil is limited,\(^2\) which significantly reduces the power of foreign investors vis-à-vis governments. Secondly, domestic factors may also make political elites unresponsive to “structural pressures” emanating from the possibility of investment. The development that post-Soviet states underwent as part of the USSR put them in a unique position to choose among different sources of capital. Each of these sources could come with their own forms of control and power. Governments could also try to mobilize finance within their countries to diminish dependence on external actors. Also, some political regimes may be facing political opposition that is “un-organized, co-opted, fractured, destroyed, or otherwise rendered ineffectual.”\(^3\) Their stay in power may then depend less on economic performance than on the narrow coalitions they build. This is because for many of them, long-term development is not a goal at all. Many have no will and no power to launch development: they may keep an eye on how the economy performs since the extent of their power is affected by it but their political survival does not depend on it directly. In Kazakhstan, Russia, and Ukraine, what the political

\(^{1}\) Lindblom, 173.
\(^{2}\) The rise of fracking may change this.
\(^{3}\) Winters, 39.
elites in charge of the state wanted (the political role they assigned to a sector) and what they could do (conditioned by the level of sector’s development) with the key sectors of the economy mattered more than the power foreign investors with their capital had or did not have.

While capital did not always award power to domestic and foreign investors, the state’s monopoly position as capital provider could significantly increase its own power relative to other domestic actors. This was particularly evident when the Russian state under Putin was deciding to bail out domestic metallurgical firms during the 2008 crisis. In the relations between the regimes and domestic private business, the regimes in charge of the post-Soviet states were usually the more powerful actors than the latter.

3. Bringing the Post-Soviet State Back In

3.1. The Post-Soviet State

This dissertation asks a very specific question: why did some post-Soviet regimes choose to invite FDI into their oil and gas and metallurgy and mining sectors and others did not. This question matters because FDI can bring in technologies, new management techniques, and capital. The entry or non-entry of FDI can thus make a difference between a sector that stagnates and one that flourishes. In some rare cases, it could conceivably help a country launch a longer term process of development.

My work also raises a broader and even more important question about the role of the state in transition to capitalism and to broad-based and sustainable economic development. The post-Soviet states faced the task of re-building their state apparatus and re-defining the state’s goals in line with the goal of transitioning to a market economy and a democracy. This transformation proved to be a challenging process. The post-Soviet states resembled tired giants: they had plenty of resources and possessed a lot of formal and informal powers, yet were also clumsy at exercising this power. On the one hand, they inherited extensive resources from the Soviet state, their predecessor. On the other hand, they lacked the capacity to formulate effective public policies as they were overwhelmed by challenges of transition.4 The power of post-Soviet states was “largely latent, present mainly as an invitation to evasion.”5 The population viewed

---

4 I am grateful to Antoinette Handley for helping me formulate this point.
5 Gustafson, 97.
the state as ineffective, prone to corruption, and lacking authority to formulate and achieve goals. Nonetheless, the amount of resources the states across the post-Soviet space inherited from the Soviet era rendered them an object of intensive lobbying efforts by a number of actors. After the USSR’s collapse, “the best opportunity [at the time] was ripping off the decaying state.” Many sought to do just that and succeeded. Even if the state retained formal ownership in the economy, it largely released its control over assets.

3.2. Neglect of the State: Why It Happened and How to Bring It Back In?

Throughout the 1990s, due to low public visibility and neo-liberal rejoicing about the “disappearing” state, scholars of the post-Soviet region paid little attention to the state. They returned to it only after a decade, when some regional experts, among them Anna Grzymala-Busse, Pauline Jones Luong, Timothy Colton, and Gerald Easter, pointed out that the state had been ignored (on purpose or unintentionally) and that this was a problem. It turned out that in practice the state had remained very important even if it had fallen out of scholarly view. The state needed to be “brought back in” into the literature on the post-Soviet region. But what was the best way of doing this?

I argue that one of the reasons that the literature on the region overlooked the state was because too many authors failed to make a clear analytical distinction between regime and state. Although the state seemed to have withdrawn from the economy as an actor, individual representatives of the regime often continued to exercise considerable informal control over the economy and the property that remained in the hands of the state. They used state assets as a resource for maintaining the power of the regime and enriching themselves. Scholars who assumed that the state had disappeared largely missed the considerable influence that political regimes exercised by selectively using and abusing the state power in their narrow interests. The state continued to be “there” because it was difficult to take away its powers overnight but also because the regime wanted to keep the state alive. In my dissertation, the state is conceived as an owner of resources and a source of unique powers that only the state can legitimately exercise. These include not only coercive power, but also power to regulate, to tax, for example. The state itself can thus be regarded as an invaluable piece of equipment that is supposed to have the

6 Freeland, 180.
power to deliver the public good. However, it is the political regime that operates this equipment. The regime can make this equipment work in the wider, public interest and therefore strengthen state power or it can hijack the state and use it to serve narrower interests, i.e., rely on force. Unfortunately, even when the state was brought back into post-Soviet politics (as, for example, in Putin’s Russia), it served as an instrument for the political regime rather than being deployed in the broader interest. The state was able to “come back” later in the official role when there was political will on the part of regime representatives to restore the powers of the state. My dissertation provides an entryway into discussing the conditions under which public and the private interests may be aligned or misaligned when pursued by the regimes and the key economic actors.

4. Policy Choices Regarding FDI

When discussing the policy choices of the post-Soviet states regarding assets in the key sectors of their economies, I go beyond the simple dichotomy of the presence or absence of FDI. In reality, the “mechanics” of these choices varied significantly. In order to present a full picture, it is most useful to think in terms of “ownership” and “control.” I borrow these terms from Pauline Jones Luong and Erica Weinthal. However, unlike these two authors who focused on formal share of ownership or formal mechanisms of control, I treat these as categories that need to be established through detailed empirical work. My research shows that the degree of ownership of any actor may not be commensurate with the degree of control it has over an asset. As a rule, the ability to exercise ownership and control is instead dependent on the power of an actor (the state, big business, or foreign investor) and that actor’s ties to key decision-makers, i.e. ties to the regime. We can determine the meaning of policy choices only when we know about the actual degree of ownership and control.

Policy choices regarding FDI are thus determined by the push and pull of relations between the political regime, domestic business, and foreign investors. While all three actors are important in this relationship, I give analytical primacy to the regime, which has the best access to the state, its powers, and to the resources inherited from the Soviet era. In what follows, I briefly reiterate the findings of my dissertation regarding the dynamics of interaction between the
regime and foreign investors. I only make a sketch of some general rules here since “the search for universal relationships is futile”\textsuperscript{7} in this case. A number of factors affect this relationship.

As with business-regime relations, the relations between the regime and foreign investors clearly changed over time under the influence of external (changes of oil prices, the effect of financial crisis) and internal (policy learning, domestic business becoming more mature) factors. The states examined here did not overwhelmingly depend on external capital as dependency literature would predict. Yes, in Kazakhstan, the underdeveloped, yet abundant oil and gas resources put the country into what seemed to be an inevitable dependence on FDI. However, this was in no way a locked-in, one-sided dependency: as energy prices rose a decade later and Kazakhstan’s statehood matured, the regime was able to renegotiate those initial deals with foreigners. Today, Kazakhstan continues to depend on foreigners because it is not capable of developing the sector on its own. However, the fortunes of foreign investors are also dependent on the presence of foreign companies in Kazakhstan. The relationship has been evolving, yet neither side has the power or willingness to rock the boat. In many ways, Nazarbaev’s regime has benefited from FDI that came in and helped sustain his regime and enriched him personally. Nazarbaev played a key role in directing this investment. This is an example of what Bayart calls the strategy of extraversion, “at the heart of which is the creation and the capture of a rent generated by dependency … which functions as a historic matrix of inequality, political centralization and social struggle.”\textsuperscript{8} The distinction between the regime and the state is useful here again: whereas the state as an expression of public good is often a loser in dependent relationship, the regime is an active promoter of this dependency as one of its main beneficiaries.

When FDI does enter key economic sectors, it clearly plays an important political role. Foreign investors themselves usually do not take direct part in any kind of explicit political alliances, yet their presence changes the domestic balance of power between social actors and the regime. On some occasions, FDI may empower domestic business if there are any long-term partnerships between domestic business and foreign investors that are successful. However, in the state-dominated model of capitalism characteristic of the post-Soviet space, FDI often entered only with permission from the regime. In this case, where the regime had a clear

\textsuperscript{7} Schneider, 73.
\textsuperscript{8} Bayart, 222.
dominating role in the economy, such as in Putin’s Russia or Kazakhstan, FDI has been unable to empower domestic business vis-à-vis the regime. In Kazakhstan, revenues from FDI empowered the regime, but left domestic business underdeveloped: the most important economic decisions were made during discussions between the regime and foreigners. Schneider has argued that MNCs are generally “less engaged in politics than are domestic business groups, and fragment and weaken the voice of big business overall.” Their presence often splinters the organization of the business elite.” They are true when there is a business elite to begin with. In the post-Soviet states, the entry of FDI actually slowed down the development of this class of domestic actors. Kazakhstan’s business was being born at a time when FDI was already coming in and strengthening the regime, which put domestic business into a disadvantaged position vis-à-vis the regime. This confirms Evans’ prediction that states (i.e., the regimes in charge of them) may become stronger vis-à-vis other actors as they negotiate with foreigners. In Kazakhstan, close relations between the regime and foreigners left domestic business underdeveloped.  

5. The Questions That Remain

Although this dissertation examined the interaction between regime and state, the nature of this relationship requires yet further exploration. In this work, I focused much more on what the regime does to the state and the regime’s mechanics of power maintenance than on how the state in turn affects regime durability. We also cannot predict how much damage a regime needs to do to the state in order to fall. For example, the fall of Yanukovych’s regime is easier to explain post-factum than it was to predict before the regime fell. We still do not have a full picture of the consequences of the disempowering of the state by “strong” authoritarian regimes. In addition, we need to study in more detail under what conditions the incentives of the regime, of the state as an embodiment of public good, and of domestic or foreign investors can coincide to launch broad-based economic development. The post-Soviet region has not provided any empirical case of such coincidence yet economic development is impossible to achieve without participation of these actors.

This dissertation also offers some insights into what type of capitalism the post-Soviet states have been building. The comparative capitalism literature that studies the varieties of

---

9 Schneider, 86.
10 However, other factors contributed to this strengthening, where the state acquired force, but still lacks power.
capitalism (VofC) is well-developed. Hall and Soskice’s work started an important conversation about the differences in internal structures of capitalist economic systems across the globe. In contrast, the literature on the post-Soviet states has been much more focused on the process of transition to capitalism than on the type of capitalism that is being built there. It is time to analyze in more detail what the product of transition looks like at this point.

The attempts to incorporate the post-Soviet region into the VofC literature that have been made thus far are unsatisfactory. For example, Nolke and Vliegenthart argue that the post-communist region does not fit the VofC literature well because the original VofC framework cannot account for the region’s external dependency. That is why they introduce what they call a dependent market economy category, characterized by institutional complementarities between skilled, but cheap labor, the transfer of technological innovations within transnational enterprises, and provision of capital through FDI. The dependent market economy model of capitalism reveals the problem with the entire literature on the VofC: due to its focus on institutional complementarities, the literature assumes that a model is “somehow working.”

The post-Soviet states are much more prone to rent seeking than the post-communist Central and Eastern European states, in part due to underdeveloped political and economic institutions. More than a decade ago Eyal argued that in the post-Soviet region, while capitalists had established themselves capitalism (understood as a set of institutions) had not. As Hanson and Teague argue, the VoC approach is not useful in understanding the nature of Russia’s capitalism. Instead, Russia is an example of Weberian “political capitalism” where profits remain “a prerogative of political administration.”

It is my contention that this is the case not only for Russia but for other post-Soviet states I examine too. While all capitalism is ultimately political, in these cases the regime in charge of the state is clearly the dominant actor in the economy. It makes little sense then to talk about

---

11 Andreas Nölke and Arjan Vliegenthart, "Enlarging the Varieties of Capitalism: The Emergence of Dependent Market Economies in East Central Europe," World Politics 61.4 (2009): 672. See Chapter 2 in Schneider’s book on how many types of capitalisms exist. Whether or not MNCs are let in and the relations that emerge influence the type of capitalism (but are also influenced by it). The authors themselves acknowledge that the use of this model is limited because it does not account for domestic politics and the domestic origin of institutions.

12 Nölke and Vliegenthart, 695-696.

13 Eyal,

14 Varieties of capitalism in post-communist countries 152. Shevtsova calls Russian capitalism bureaucratic. In the volume by Joel Ostrow Politics in Russia, a Reader. 2013. “Political” is better because bureaucracy does not have independent power in Russia and other post-Soviet states, it is politicized too.

15 Antoinette Handley dissertation.
(formal) institutional complementarities since it is the regime, its interests, and relations with business that shape the type of capitalism most profoundly. Different political regimes build relations with their domestic business community differently and are able and willing to interfere with economic activities to a different extent. Schneider argues that in all subtypes of political capitalism the regime and its individual representatives (not markets) are able to play a crucial role in determining the success or failure of an economic endeavour. In such states, “markets are not the primary factors in distributing gains.” Alas, there are no developmental states (one of Schneider’s subtypes) in the post-Soviet region. State and patrimonial capitalisms are often merged together, making their distinction of little use as state ownership and client-based distribution of resources accompany and enable each other. Soviet legacies of the over-powerful state continue to loom large. Even though these states have travelled far from the planned economy with its formal institutions of command, informally, similar mechanisms of resource allocation and hierarchies often remain in place. To paraphrase Lindblom, governments continue to command rather than induce.

Unfortunately, after more than two decades of independence, the long-term development of the post-Soviet countries continues to be held hostage to the interests of political regimes. The biggest challenge of this type of capitalism is the difficulty of producing economic growth in a setting where regimes are often unresponsive to the interests of the wider business community and the population or are overly responsive to the narrow interests of a few business elites. Private property is a defining feature of modern capitalism, yet in the post-Soviet region the categories of “private” versus “public” or “state” are blurred. Formal owners may be unwilling to publicly identify themselves as such, often because they are part of the political establishment and have a direct conflict of interest as a regulator and owner. On the other hand, outsiders to a project can exercise significant control over it. The interests of the elites in charge of the state trump the power of capital (whether domestic or foreign) much more often than elsewhere.

The fact that in today’s Russia and Kazakhstan, the highest level of political leadership is also the private owner of significant resources in the economy has important but uncertain implications. Across cases, it is difficult to predict which incentives will pre-dominate: the incentive to develop assets in the long-term, which may lead political owners like Nazarbaev or Putin to let foreign investment in, or the incentive to continue to stay in the grey zone and feed

16 Schneider, 31.
off the state. This role that the political elites will play as owners of assets, their needs to maintain power, and their ability or inability to develop assets in the key economic sectors will shape the way and conditions under which post-Soviet states continue to integrate into the global economy and develop henceforth.
Bibliography

Works Cited


---. Genesis of Economic Nationalism in Russia., 2008b.


"Narodnoe Khoziastvo Kazakhstana v ... g."


---. Oil and Gas in the Former Soviet Union: The Changing Foreign Investment Agenda. Ed. Energy and Environmental Programme (Royal Institute of International Affairs) and
Russian and CIS Programme (Royal Institute of International Affairs). London: Royal Institute of International Affairs, 1993b.


List of Consulted Periodical Sources

Non-regional
BBC News
Bloomberg
Foreign Policy
The Asia Times
The Financial Times
The Guardian
The Independent
The Los Angeles Times
The New York Times
The Telegraph

Russia
Dp.ru
Expert.ru
Forbes.ru
Izvestia
Kommersant
Lenta.ru
Metalosnabzhenie I Sbyt

Neft’ Rossii

Novaya Gazeta

Oil and Gas Eurasia

Oilru.com

Promyshlennik Rossii (Promros.ru)

RBC.ru

RIA Novosti

Rossiiskaia Gazeta

Rusenergy

Russia Today

Russkaya Planeta

Segodnya

Slon.ru

Sputnik News

Vedomosti

Vestnik Kavkaza

**Kazakhstan**

Expert Kazakhstan

Kazakhstan International Business Magazine
Novoe Pokolenie (np.kz)
Radio Azattyk
Respublika
Tsentrazia
Vesti

**Ukraine**

Ekonomicheskie Izvestia
Ekonomichna Pravda
Espreso TV
Forbes Ukraine
Pravovyy Tyzhden’
RBK Ukrayina
Ukrainskie Novosti
Ukrayins’ka Pravda
Ukr rudpom
Zerkalo Nedeli
List of Conducted Interviews

In the course of my fieldwork that lasted a total of six months (approximately two months in each country that is covered in this dissertation), I collected more than seventy interviews with policy-makers, business representatives (both foreign and domestic), and experts on business-state relations and foreign investment. In order to protect their identity, I removed the names of those interviewees who did not wish to be associated with a particular quotation or cited at all in the text of the dissertation. Some interviewees did not wish to be listed at all and are therefore not named here.

Russia

1. A foreign investor, Moscow, 19 November 2009.

2. A foreign investor (2), Moscow, 19 November 2009.

3. A foreign investor, Moscow, 4 December 2009.


8. Khalikov Rinat, vice president, board member, the “Renova” group of companies, 25 November 2009.

10. Klevchenkova Maria, senior professor, department of law, Higher School of Economics, 1 December 2009.


12. Levshov Aleksandr, director of government relations, Statoil, 30 November 2009.


14. Mozgunov Oleg, deputy director general of “Basic Element” (Basel) on cooperation with state and societal organizations (correspondence via email), 23 November 2009.


16. Oleinik Oksana, head of the department of business law, faculty of law, Higher School of Economics, 10 November 2009.

17. Pappe Iakov, professor, Faculty of Economics, Higher School of Economics, 2 December 2009.

18. Rodionov Ivan, professor, the department of economics and firm’s finances, Higher School of Economics, 9 November 2009.


20. Shkoller, Roman A., advisor, Department of Economic Policy and Competitiveness, Russian Union of Industrialists and Entrepreneurs, 28
November 2009.

21. Shmal Gennadiy, president of the Union of Oil and Gas Producers of Russia, 14 December 2009.

22. Sorokin Pavel, Vice President, analytical department, oil and gas sector, Unicredit Securities, 11 November 2009.

23. Stankevich Yuri, deputy head of the committee on energy policy, Russian Union of Industrialists and Entrepreneurs, 8 December 2009.

24. Yudaeva Ksenya, director, Centre for Macroeconomic Research, Sberbank of Russia, 11 December 2009.

25. Zubov Valeriy, deputy of the State Duma, member of the faction “Just Russia,” member of the committee on economic policy and entrepreneurship, 11 December 2009.

Kazakhstan


8. Ereshev Diyar E., Olympex Advisers, Managing Partner, Astana, 23 June.


Ukraine


4. Danylyuk Oleksandr, All-Ukrainian Centre for Promotion of Entrepreneurial Activity, 5 October 2009.


10. Hantsyak-Kas’kiv Olena, acting director of the Ukrainian Centre for Promotion of Foreign Investment, 12 October 2009.


13. Lobach Andriy, senior project manager, Fund for Effective Governance, 2 October 2009.

15. Pavlenko Olena, a founder of UA Energy site, Dixi Group, May 2014.


17. Stepura Taras, Chief of Department, Interstate Property Relations and Joint Ventures Department, State Property Fund of Ukraine, 1 October 2009.


22. Yuryk Ivan, advisor to Vice-President, International Affairs and Government Relations, Alfa-Bank, 6 October 2009.