

**Centre for
Economic
and Financial
Research
at
New Economic
School**



January 2006

State Capture: From Yeltsin to Putin

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Working Paper No 94

CEFIR / NES Working Paper series

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0. Introduction

In this short paper we attempt to assess the results of Putin's centralization and anti-corruption measures on the overall level of state capture in the Russian regions as well as on the balance of power between different interest groups. We proceed by, first, describing the results of previous research on state capture in the Russia's regions during Yeltsin in section 1 and, then, analyzing the changes in the nature and the level of state capture during Putin's administration in section 2. Section 3 concludes.

1. State capture during Yeltsin's governance

After the collapse of the Soviet Union a new force emerged in Russia, which was to affect the country's economy and politics. The name of the force was oligarchy. A large-scale privatization of state assets in the beginning of the 1990s, which led to a growth in income inequality, was combined with weak legal and political institutions, a legacy from the communist times. The fragility of democratic institutions and the state's poor accountability to the public made the governments in Russia easily susceptible to "capture" by the new wealth. Politically powerful firms influenced the very rules of the game in the economy: they created obstacles to emergence and development of competitive businesses and changed the direction and speed of economic reforms.¹ The 1999

[±] Authors are from CEFIR; and CEFIR and CEPR, respectively.

¹ The phenomenon of shaping institutes by powerful businesses is called *State Capture*. See Olson (1965, 1982), Stigler (1971) for pioneer works. For empirical work on state capture in transition countries see Hellman, Jones, Kaufmann, and Schankerman, 2000; Hellman and Schankerman, 2000; Hellman, Jones, and Kaufmann, 2003; Hellman and Kaufmann, 2003; Hellman, 1998; Slinko et al., 2005; Yakovlev and Zhuravskaya, 2003.

BEEPS² survey confirmed that state capture was deeply rooted in economic and political processes of the country: in the composite index of state capture among 20 transition countries Russia ranked fourth³.

At the same time, decentralization brought Russian regions a greater autonomy and the opportunity to pursue their own economic policies. Regional economic policies and, in particular, their susceptibility to capture varied significantly depending on industrial concentration, level of education, voter awareness etc. The study by Slinko et al. (2005) creates a measure of state capture in the Russian regions based on Russian legislation in 1992-2000, and evaluates the effects of capture on politically influenced firms. The authors show that politically powerful firms benefit greatly from their political influence. Compared to firms without political influence, powerful firms' sales and employment grew faster; they invested more and received more profits, and besides, their performance picked up with the growth of capture.

Although there is no evidence that capture had a significant impact on the aggregate economic growth, the study shows that the rest of the economy was suffering from state capture by powerful elites:

- Firms without political influence stagnated, their productivity, sales and investments declined with the increase in capture;
- Regional small business deteriorated, their share of employment and retail turnover went down with the growth in capture.
- Regional budgets were negatively affected as tax collection decreased and arrears to the budgets increased with an increase in the level of state capture.

Many different interest groups competed for influence over the state institutions at the regional level. Who has been the most effective captor of the Russia's regional states? Studies which have looked at this question are scarce mainly due to the lack of enterprise-level data related to

² BEEPS are Business Environment and Enterprise Performance Surveys, conducted jointly by the World Bank and the European Bank for Reconstruction and Development in transition countries in 1999 and 2002. See <http://info.worldbank.org/governance/beeps/> for survey description, data and research.

³ See Hellman, Jones, Kaufmann, and Schankerman, 2000; Hellman and Schankerman, 2000; Hellman, Jones, and Kaufmann, 2003; Hellman and Kaufmann, 2003

politics. According to the studies, a firm's political power is determined by a firm's size, both in terms of cash (and ability to bribe) and employment (social significance)⁴, as well as ownership structure. Frye (2002) shows that Russian state-owned firms are engaged in state capture at least as much as private firms. Since the state does not have a tight control over state-owned firms, these firms' managers appropriate both control and cash flows for their private benefit. Yakovlev and Zhuravskaya (2004) show that enterprises, which belong to foreign or regional private owners, are more likely to be captors whereas enterprises owned by federal private oligarchs are less likely to be captors. They also show that enterprises, which are members of larger financial-industrial groups or members of groups that had engaged in loans-for-share schemes, are more effective captors. As for industrial structure, the World Bank study (2000) shows that enterprises, which operate in natural resource sectors, extract more rents and so are more likely to be captors.

2. State Capture under Putin

All empirical studies of state capture so far examined the phenomenon during the first eight years of Russian capitalism, i.e. during President Yeltsin's term in power. It is widely accepted, however, that there has been a big shift in the relationship between the state and businesses during President Putin's first and second terms. A number of the richest and most famous Russian businessmen found themselves behind bars or in exile abroad. Also, the centralization process, which can eventually reduce local capture, has been initiated. Do these factors lead to a decrease of capture and redistribution of power to new winners?

2.1. Data, methodology, and measures

Our analysis uses an extended version of the data on preferential treatments of large firms by regional legislation from Slinko et al. (2005). For the analysis, we supplement these data with the data on firm ownership structure from Guriev and Rachinsky 2005. These two data sets are described in detail below. Basic financial and other statistical data on enterprises come from the GNOZIS dataset which covers of more than 30000 large and medium-size firms between 1992 and 2003.

⁴ For theoretical prediction see Shleifer, Vishni, 1994, for evidence from Russian regions see Slinko et al., 2005, Yakovlev and Zhuravskaya, 2003

Intersection of data from all of these sources results in a data set with 301 firms in 72 Russian Regions. Region-level statistics come from Goskomstat, Russia's official statistical agency (<http://www.gks.ru/catalog/default.asp>). For the most part, Goskomstat's regional series are available for 1996-2000, but some (e.g., retail turnover) start in 1992.

The preferential treatments data

The database from Slinko et al. (2005) contains all preferential treatments between 1992 and 2000 given by regional legislators and regulators to 978 firms in Russia. Firms were chosen on the basis of being among the five largest firms at least once during 1992 – 2000 in any Russian region. An enterprise was said to be treated preferentially if it received any of the following benefits: tax breaks, investment credits, subsidies, subsidized loans and loans with a regional budget guarantee, official delays in tax payments, subsidized licensing, free grants of state property, or a special “open economic zone” status for their territory. The number of regional laws and regulations that grant distinct preferential treatments to each firm in the sample each year is collected. The source of the information about preferential treatments is the comprehensive database of Russia's regional legislation “Consultant Plus” (www.consultant.ru/Software/Systems/RegLaw).

We extend these data by adding observations for up to 2003 and a sub-sample of firms that were among the five largest in terms of sales in 72 regions for the period from 2001 to 2003. In total, the resulting dataset contains preferential treatments for 1065 firms for the years from 1992 to 2003.

Ownership data set from Guriev and Rachinsky 2005

Ownership data that we start with are described by Guriev and Rachivsky (2005) as follows: “The [] project identified the structure of control for about 1,700 large firms in 45 sectors of Russian economy...[] The sectors were selected based on their size in order for the survey to cover as large a portion of the economy as possible...[] The next stage was to target the largest establishments and firms within the sectors. In industry, for example, our firms represented 35 percent of employment and 85 percent of sales of the selected sectors. Finally, economists and business journalists interviewed investment banks, consultancies, business advisors, information agencies and other

institutions. They identified the main controlling owners of each firm and the portion of the firm they owned and also any subsidiaries owned by the firms. This in turn generated new sets of firms to be investigated – subsidiaries and corporate owners. A chain would stop downward when a firm owned no subsidiaries and would stop upward when an “ultimate owner” or “controlling party” was identified. The data were checked and supplemented with publicly accessible information.” (p. 132).

We follow the methodology described in Slinko et al. (2005). Thus, state capture is measured as the concentration of preferential treatments in the region; and firm’s political influence is measured as a share of preferential treatments given to the firm in the total number of preferential treatments in the region. Figures 1a and 1b present the level of state capture (average across time concentration of preferential treatments) in Russian regions during President Yeltsin’s 2nd term and 1st Putin’s term in power.

[place Figures **1a** and **1b** about here]

2.2. Has overall level of state capture decreased under Putin?

In contrast to Yeltsin’s time, which was notorious for accumulation of power in the hands of oligarchs, Putin’s presidency has been characterized by open fights with the most famous of them: Berezovsky, Gusinsky, Khodorkovsky, and Lebedev. In addition, Putin attempted centralization process, restricting autonomy of regional political elites and moved political and economic power from the regions to the federal center⁵. A new tax law, which restricted the use of individual tax breaks, was adopted, as well as a number of laws, aimed at easing the burden of business regulation.⁶ A new anti-corruption campaign was launched and some governors who were considered most corrupt, e.g. Ruskoy in Kursk region and Nazdratenko in Primorsky region, were not permitted to run for re-election. The governor of Yaroslavl region, Lisitsin, was under a criminal investigation in early fall of 2004 because of pursuing illegal paternalistic policies towards regional business.

Considering the initiatives described above, one can expect a significant decrease in the level of capture in the regions and in its negative effect on the regional economies. However, various polls

⁵ Seven large federal districts were created and took away some regional autonomy.

⁶ See CEFIR study “Monitoring the Administrative Barriers to Small Business Development in Russia”, 2003

and President Putin himself in his annual address to the Federal assembly in 2003 drew attention to the blooming corruption in various government bodies.⁷ Similarly, our data shows no significant change in the level of capture in the regions: the level of state capture grew gradually during Yeltsin's first term and remained almost unchanged during Yeltsin's 2nd term and Putin's 1st term (see Figure 2). State Capture measure in the first four years of Putin's presidency strongly significantly correlates with the measure in Yeltsin's 2nd term and with alternative corruptions measures (see Table 1).⁸

[place Figure 2 about here]

[place Table 1 about here]

Just as in the Yeltsin's time, the regional state capture under Putin's administration negatively affects the small business development as well as growth of large and medium-size firms without political power. Output of small businesses and regional retail turnover significantly go down with an increase in state capture (see Figure 3). Growth in profitability, productivity, sales, employment and investment of firms without political connections also significantly slows down in high captured environments (see Figure 4).

[place Figure 3 about here]

[place Figure 4 about here]

2.3. What was the effect of tax reform aimed at restricting possibilities for preferential treatment of specific enterprises?

Using the available data we present an example of the effect of a partial reform aimed at fighting corruption. At the end of 1999, a tax law restricting tax breaks given to individual firms was enacted. Tax breaks were the most popular type of preferential treatments constituting one-third of the total number of preferential treatments in the Russia's regions. Nevertheless, the law has not resulted in any considerable change of either the number or concentration of preferential treatments provided by

⁷ According to ROMIR polling agency (www.romir.ru), people put unsuccessful anti-corruption measures as the second biggest failure of President Putin.

⁸ State Capture measure in Yeltsin's governance also correlate with alternative corruption indexes (see Slinko et al., 2005).

the regions to firms. The law has only led to a change of the type of preferential treatments given out: as figure 5 shows, the share of tax breaks has significantly decreased, whereas the share of subsidies, subsidized budget loans, budget guaranties of credits and subsidized energy prices has significantly increased after the enactment of this law.

[place Figure 5 about here]

2.4. Who has received preferential treatments?

The question that we address here is whether Putin's measures, in particular his attacks on oligarchs and consolidation of power in the hands of the federal center, have led to real redistribution of political power, rise of new financial-industrial groups and fall of the previous favorites. We address this question by looking at firms' characteristics, such as firms' size and industrial structure.

Theory predicts concentration of political power in hands of the biggest and richest enterprises. The means of their bargaining with politicians are both big employment, which has a great political benefit to politicians and rents that enterprises can use to bribe politicians. During Yeltsin, firms with bigger employment, bigger output and capital, firm in extract industries, and firms that belong to bigger financial-industrial group were more likely to experience the political influence. Things have not changes under Putin. Figure 6 shows that firms with bigger output and employment relative to other firms in the regions received more preferential treatments. Figure7 shows, that firms that belong to bigger financial-industrial group are also likely to be a successful captors. Finally, figure 8 shows that average political influence of firms in extract industries is greater than influence of firms from all other industries, except machine-building and electricity industries.

[place Figure 6 about here]

[place Figure 7 about here]

[place Figure 8 about here]

Concentration of political power in the center during Putin's administration can be traced in the data: enterprises that belong to federal government became the most effective lobbyists during

Putin's governance, whereas private enterprises whose owners previously were engaged in notorious "loans-for-shares" schemes and enterprises that belong to regional government lost their political power. In Putin's governance only one group, enterprises in federal ownership, received significantly more preferential treatments. (see Figure 9).

[place Figure 9 about here]

3. Conclusions

To summarize, our study shows that there have been no significant changes in the overall level of state capture at the regional level in Russia between Yeltsin's and Putin's time in power despite all the attempts of the Putin's administration to centralize governance. We provide illustrations of how firms and regional officials manage to go around the partial reforms that aimed at reducing corruption at the regional level. There was an important change in the nature of most influential groups between Yeltsin's and Putin's time, however. We document that there was a shift in the allocation of bargaining power within regions to firms in federal government from private firms in general and particularly from private firms that belong to the largest national industrial groups as well as from the firms that are owned by the regional government. Firms that belong to the federal government have become the most politically powerful lobbyists at the regional level.

Figure 1a. Mean Concentrations of Preferential Treatments by regions in President Yeltsin's terms (1994-1998) and President Putin's 1st term (1999-2003)

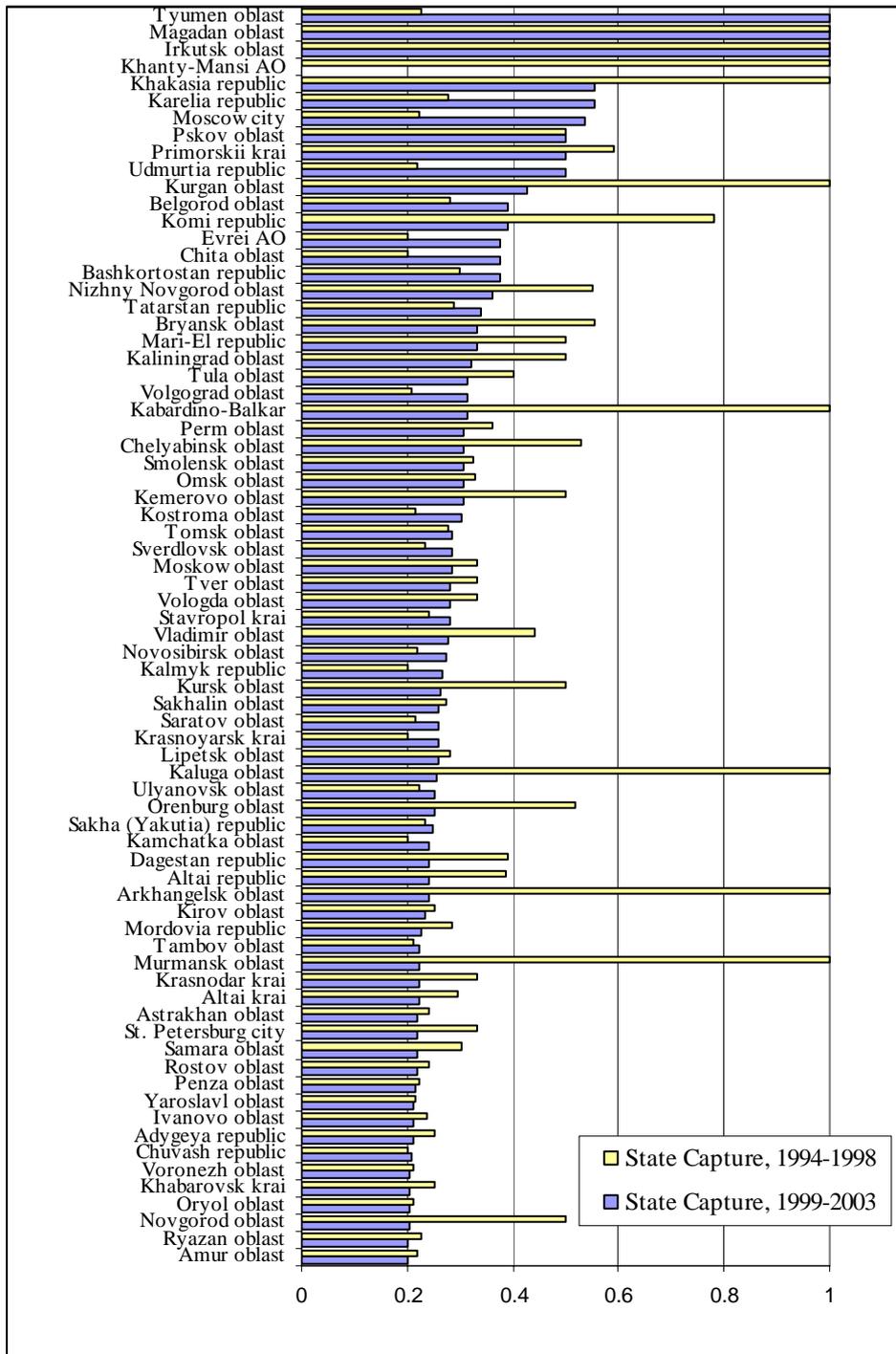


Figure 1b. Regional Distribution of Average Concentrations of Preferential Treatments in President Yeltsin's and President Putin's terms, 1994-2003

State Capture , 1994-1998

State Capture , 1999-2003

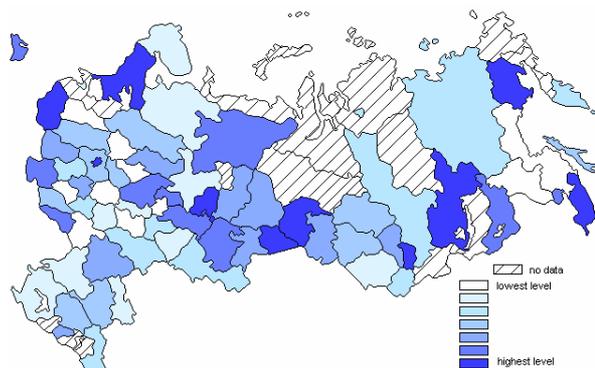
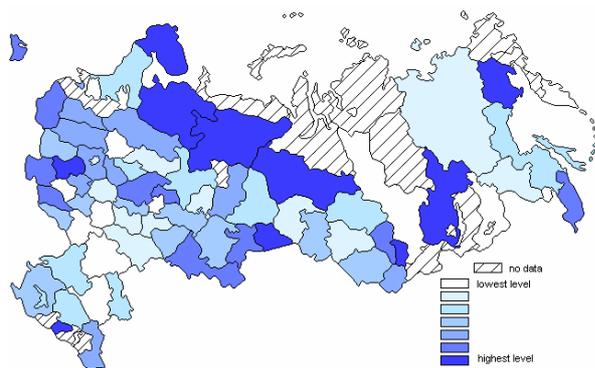


Figure 2. Regional State Capture (Average PTC) and average number of preferential treatments during Yeltsin's and Putin's governance.

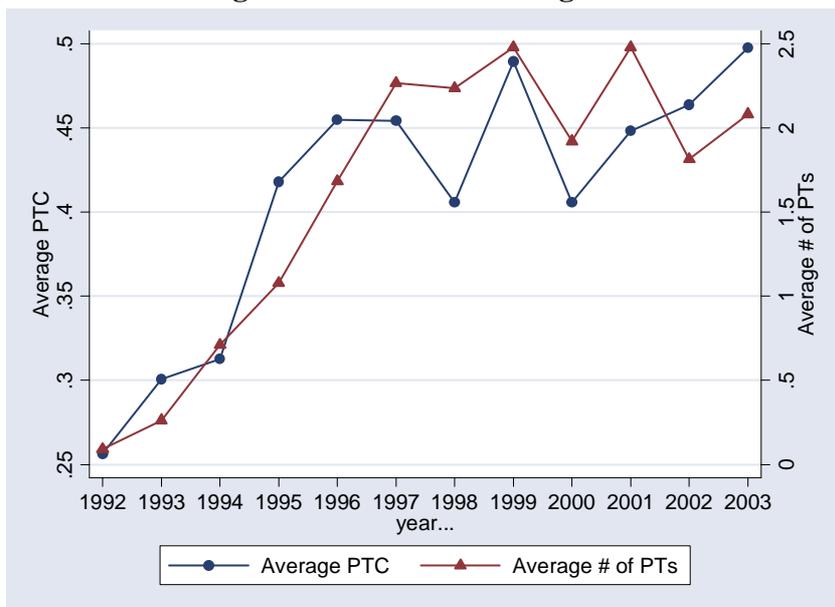
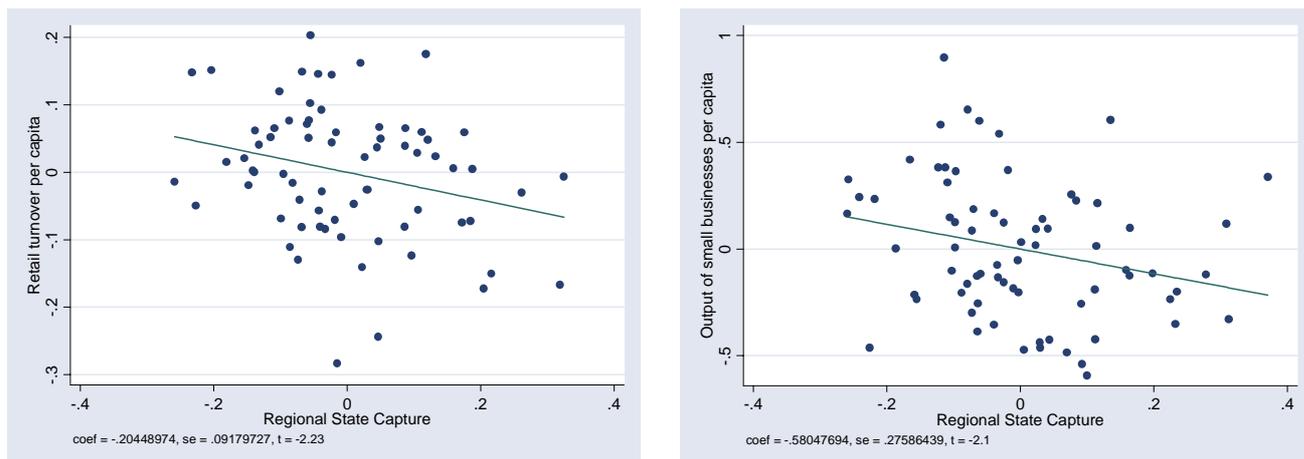


Table 1. Correlation between State capture (2000-2003) and other corruption indexes.

	# of PTs, 2000-2003	PTC, 1996-1999	# of PTs, 1996-1999	State Capture (INDEM&TI), 2000	Business Capture (INDEM&TI), 2000	Administrative corruption (INDEM&TI), 2000
PTC, 2000-2003	-0.37**	0.25**	-0.09	0.14	0.30*	0.43**
# of PTs, 2000-2003		-0.3**	0.48**	-0.10	-0.13	-0.24

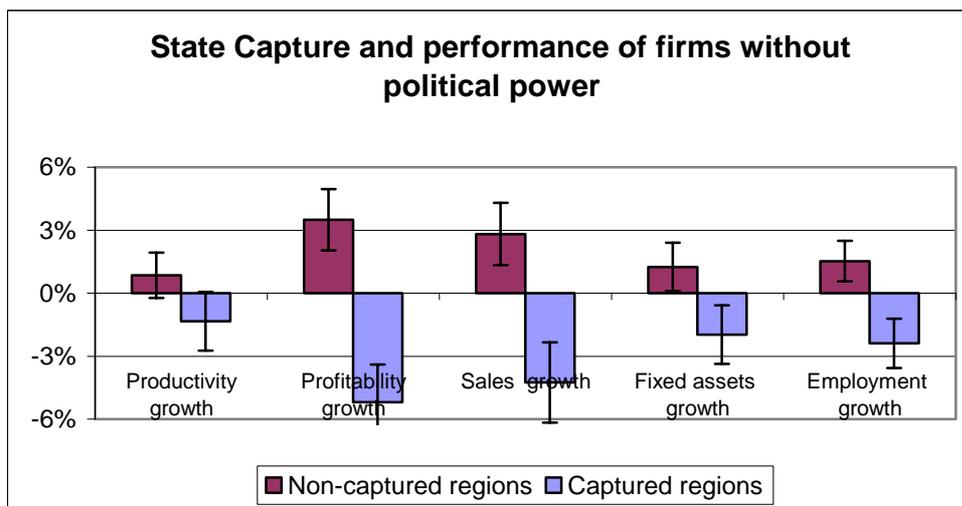
*Note: * significant at 10%; ** significant at 5%*

Figure 3. State Capture and small business growth.



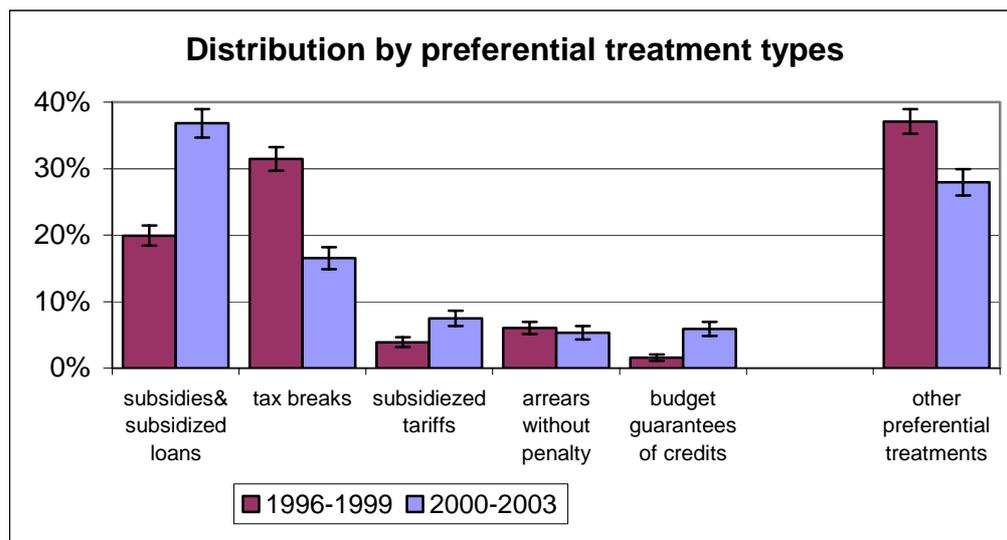
Note: Charts present residual correlation of indicators of regional performance and state capture after accounting for the following control variables. We control for total number of preferential treatments in a region, initial level of the dependent variable, initial level of regional education (with the share of labor force that attained higher education), dummy for a republic status of the region. Number of preferential treatments is instrumented by its initial level. The specification used is between-effects, i.e., regressions on averages across time.

Figure 4. State Capture and performance of firms without political power.



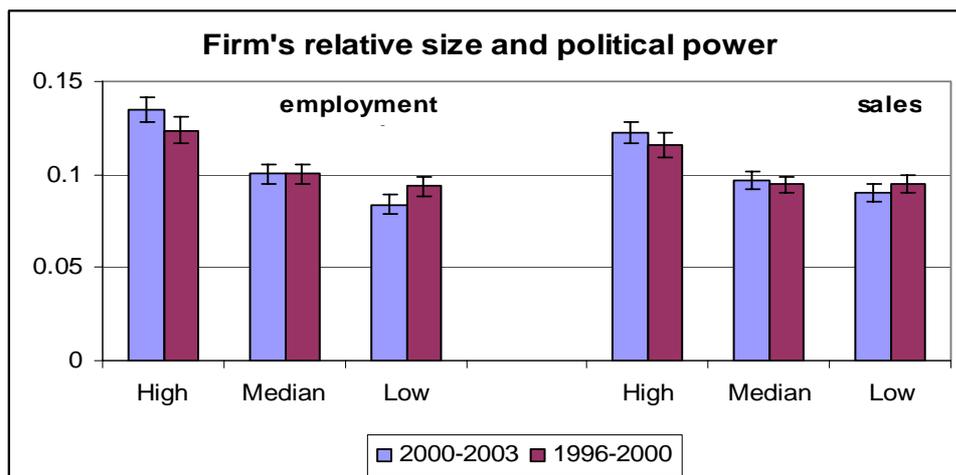
Note: In the figure the “captured” and “non-captured” regions are defined as regions in the top and bottom thirds of the distribution with respect to the value of the average residual preferential treatment concentration after accounting for the following control variables. We control for the total number of preferential treatments in a region, initial level of the dependent variable, initial level of regional education (with the share of labor force that attained higher education), dummy for republic, dummy for state enterprise. Columns indicate residual performance indicators after accounting for the same set of control variables. Black bars indicate 95% confidence intervals. In all corresponding regressions number of preferential treatments is instrumented by its initial level.

Figure 5. Distribution of preferential treatments by types



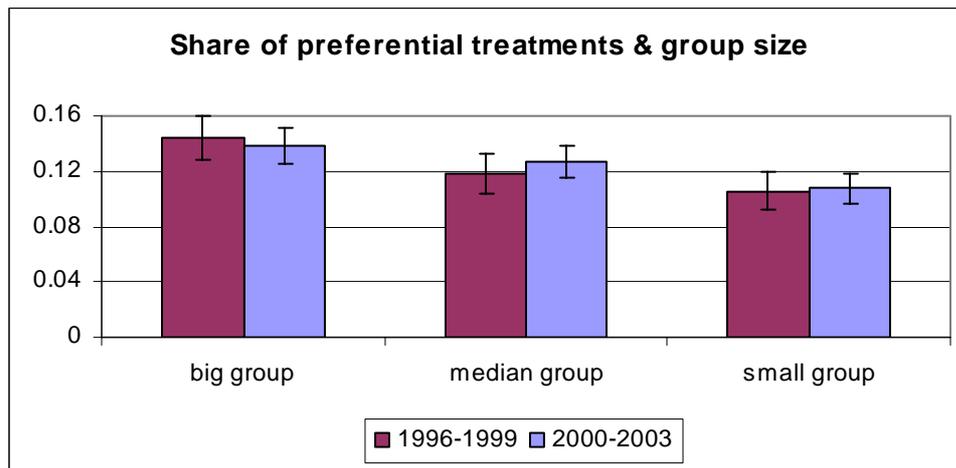
Note: The figure presents distribution of preferential by types. Columns indicate share of preferential treatment of this type in total number of preferential treatments. Error bars indicate standard errors.

Figure 6. Firm's size and political power



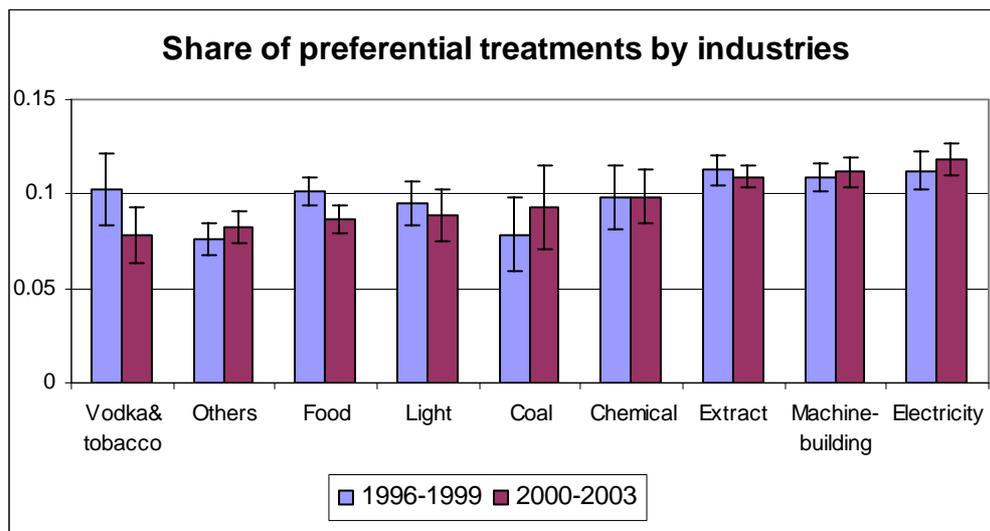
Note: The figure presents mean values of preferential treatment share by groups with high, median, and low employment and sales. Firms with high, median, and low employment and sales are defined as firms in the top, median, and bottom thirds of the distribution with respect to the average level of firm's employment or sales share in employment or sales of the five biggest regional firms, respectively. Error bars indicate standard errors.

Figure 7. Financial-industrial group's size and firm's political power



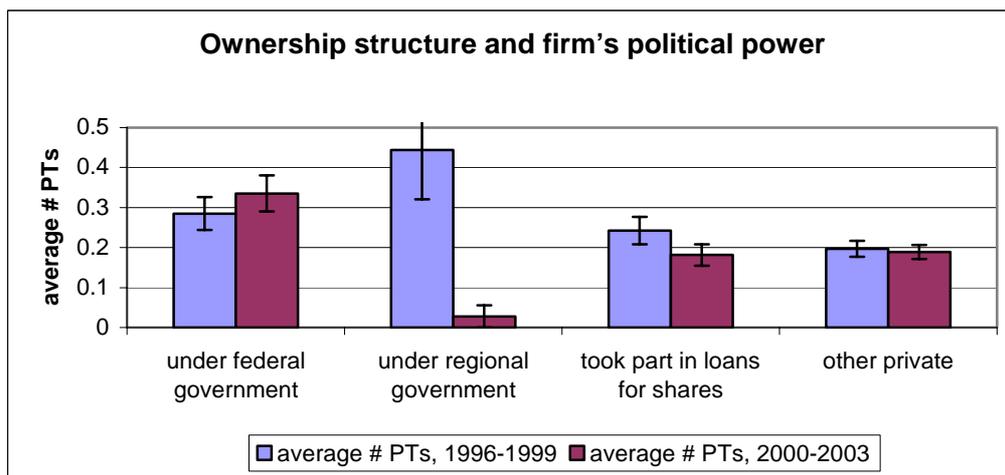
Note: The figure presents mean values of preferential treatment share by groups of firms which belong to big/median/small group. Firms which belong to big/median/small group are defined as firms in the top/median/bottom thirds of the distribution with respect to the group size, respectively. Error bars indicate standard errors.

Figure 8. Industry structure and firm's political power



Note: The figure presents mean values of preferential treatment share of firms from different industries. Error bars indicate standard errors.

Figure 9. Ownership structure and firm's political power



Note: The figure presents mean values of preferential treatments of firms with different ownership. Error bars indicate standard errors.

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