

Russian Corporate Success and the Role of the State

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As is widely recognised, Russia's economy has been improving significantly from around 2000 onwards. While this is largely attributable to the increasing world price of oil, this paper argues that the reforms instituted under the Putin regime have also contributed. In particular, the strengthening of the legal system led to increased levels of production and investment. But more importantly, the introduction of the state-private co-partnership system, which serves as a substitute corporate governance structure in the absence of well-defined property rights, played a significant role in assuring investors of their expected returns. Such co-ownership system reduces potential hold-up costs arising from failures in market transactions, and is expected to be more efficient across industries which are characterised by large fixed investments and appropriable quasi-rents.

The obtained results show that the combination of state and private ownership acts as an effective mechanism to promote growth, which is captured by firm's Tobin's Q. Moreover, such mechanism is more efficient across natural resource and utility sectors, as these industries are fraught up with substantial hold-up costs, stemming from initial lump-sum investments.

Field of Research: Corporate Governance, Transition Economies

1. Introduction

In the early 1990s, Russia transformed the failed central-planned economy, which had prevailed for almost 60 years, to a free-market approach, ostensibly to allow private agents to determine their optimal level of production and investment. Once the restructuring process was completed, the new quasi-private owners emerged. Control over the commanding heights of much of Russian industry fell into the hands of old enterprise managers, government officials and those who had close political ties with the government and new breed of business leaders – the new elites became known as the oligarchs. These oligarchs exercised concentrated control over Russia's corporate assets. They tended to overlook investment opportunities, as they had a precarious property right claim over the assets they controlled. In fact, they are associated with asset-stripping, with the obvious effect of disinvestment and a corresponding fall in production.

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The main theme in this paper is that the oligarch period came to an end after 2000, and reforms were instituted that reintroduced the role of the state in corporate governance, but in a co-partnership role with private investors. The newly-instituted policy of state co-partnership with private investors can perhaps be associated with increased levels of production and investment. Also, beginning around 2000, several legislative and regulatory reforms were introduced to strengthen the Russian property rights system, particularly regarding the function of financial markets.

2. Literature Review

The initial period of Russian commercial restructuring was unsuccessful and it is widely accepted that in large part this was due to the absence of a legal system, which is deemed to have been incapable of imposing a well-defined property rights system. The absence of such a legal code is believed to have resulted in chronic asset stripping, which had a knock-on effect in a decline in production and investment activity.

Hoffman (2002) characterises the first decade of Russia's introduction to a more free-market approach as one plagued by insider dealings, theft and extensive hidden money flows. The initial stage of the process included the incorporation of the buyout of previously-owned state enterprises by employees and management. Managers attained a considerable stake in enterprises at subsidised rates (Shleifer and Vishny, 1998); and because of deteriorating living standards and workers' rising distrust towards the restructuring programme, managers were also able to consolidate their control as they were able to purchase shares from employees at lower prices (Broadman, 1999).

In addition, in 1995 "loans for shares" scheme was introduced, when banks and similar institutions provided government with loans in exchange for shares in enterprises (shares were treated as collateral in case of government's default on repayment of debt). Banks became the property of friends of the government, and the charters of such banks acquired licenses to print money, which they used to reallocate resources to their favoured industries, instead of acting as impartial intermediaries between borrowers and lenders (Spicer and Pyle, 2003; Thomson, 2003). They also provided government with credit, thus after the government defaulted, it was forced to auction shares of state industries in such a way that the only successful bidders were the rising oligarchs. Furthermore, the state industry shares were auctioned off at very low prices.

To enhance control over their legally suspect assets, the new de facto owners formed integrated firm structures, and used such structures to increase the private benefits of control (Kouznetsov and Myravyev, 2001).

The new controlling elites had insecure asset claims, which led to acute underinvestment, fall in production output (Getzler, 1996, Goldman, 2003), and extensive capital flight after the capital markets were opened (Ross, 2004). Stiglitz (2002) believes that as privatisation occurred without the essential prerequisites, such as property rights, it did not offer incentives for effective private ownership – instead it offered an incentive to "grab" the resources and engage in tunnelling of wealth.

Since 2000 economy has experienced strong growth. During the eight years of the Putin administration, Russia has witnessed a fourfold increase in its GDP. Industries have

registered growth of 75 percent, while investment has increased by 125 percent. In this paper it is argued that a significant factor of improved growth trend is attributable to not only the strengthened legal and property rights system (as only ill-defined property rights generate externalities, Coase, 1960; Alchian, 1977); but more importantly, the introduction of a state-private investor co-partnership system. The system has acted as an effective substitute for the absence of a Western-style legal system that assures expected profit claims, particularly in industries characterised by large lump-sum investment outlays, which tend to generate large appropriable quasi-rents (Alchian and Woodward, 1988).

3. Data Description

In order to capture the effect of economic restructuring on Russia's corporate sector, the study focuses on a nearly complete sample of firms trading on the Russian Trading Systems stock exchange (RTS) between 1998 and 2006. The paper examines annual performance and ownership trends of listed firms, as well as the effect of major changes in the legal system over that period. The sample contains market data (provided by RTS), key balance sheet figures (provided by SKRIN), ownership data, and other firm-specific information. Economic policy variables, such as changes in investor protection laws and trade policy, were obtained from the detailed business guides.

First, I attempt to determine whether firm specific characteristics play a significant role in firms' performance. Second, I examine how explicit country policy features (such as state-private co-partnership and investor protection), change over the given period, and whether they have a significant impact on firms' growth.

3.1 Description of Variables

1. Profitability

The essential determinant of firms' performance (the dependent variable) is Tobin's Q, which serves as a measure for company's value from investor's point of view (Wolfe, 2003). Tobin's Q proxy used in this paper is an indicator introduced by Chung and Pruitt (1994) - it is the market value of all shares plus long term debt and the difference between current liabilities and current assets, divided by the total value of firm's assets.

Another market determinant of profitability is also employed here – such is company's annual return to shareholders, expressed as a percentage (an independent variable in this paper).

2. Size

Size variable is used to note whether there is a relationship between firms' performance and its size. The most widespread proxy of firm's size is the natural log of total assets (Faccio et al, 2001), which is applied in this paper.

3. Long-term Debt

The significance of company's long-term debt has been noted in studies which measure profitability. While it is suggested to use a ratio of long and short-term debt to total

assets (Rajan and Zingales, 1995), short-term debt is omitted in this paper in order to eliminate the short-term effect and assess the implication of long-term loans, as such may represent subsidies used to enhance industry growth.

4. Age of Firm

A dummy variable is introduced to capture the effect of firms established in the new regime against previously state-owned Soviet enterprises. The value of 1 is assigned to the company if it existed during the Soviet era, while 0 corresponds to a firm which was created during or after the privatisation stage.

5. Ownership

In this paper, shareholder's assigned stake, represented by the fraction of capital owned is recorded, and the owner type (state, regional state and foreign) is also identified. Dummy variables are introduced to assess the effect of each owner type. To examine the effect of the state-private co-ownership policy, a value of 1 was given to firms which were partially re-acquired by the state, and 0 otherwise.

6. Energy Sector

Energy sector dummy variable is introduced in order to account for profits which can solely be attributed to a specific sector of the economy (wholly influenced by a rising world price of oil and gas).

7. Policy Changes

It is argued in this paper that significant policy changes were implemented since 2000. Such changes include amendments in the legal code and regulations that effect corporate entities. I am particularly interested to determine how the new legal system addresses issues such as shareholder protection, as well as the trade regime, and whether the introduced changes throughout the period have influenced companies' performance.

An investor protection index values were derived from the "strength" or "advancement" of the legal system with respect to shareholder protection, based on the changing legislation. The trade policy index was constructed applying the same technique, but with respect to the openness of the trade regime.

4. Discussion of Findings

Once the fundamental summary statistics were produced, they showed the changing means of performance variables throughout the given period. Market capitalisation, firm's growth, return to shareholders, as well as company's size were increasing, which signified Russia's improving economic conditions. It is, however, important to note that shareholder return in the 2004-2006 period has declined compared to 2001-2003 period. With Russia's growing market capitalisation and investment rate, it is reasonable to believe that lower returns could be explained by the induced saving strategy adopted by firms. Figures 1 and 2 below illustrate the differences in growth prospects and return patterns during the period of 1998-2006. Such pattern can be explained by firms

choosing to reinvest earnings, expecting a higher payoff in the future. Therefore, while investors settle for a lesser immediate profit, they are confident about future payoff.

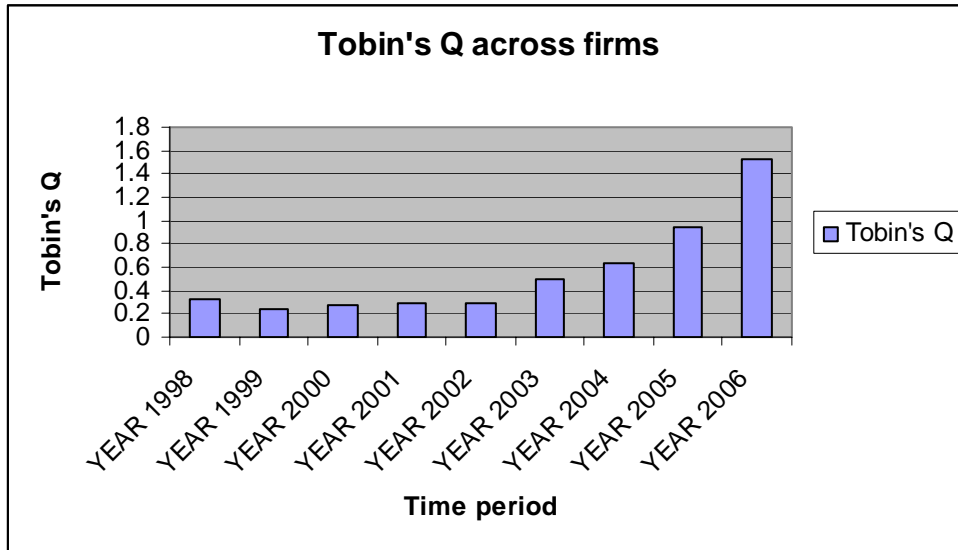


Figure1. Trend of firms' annual growth prospects

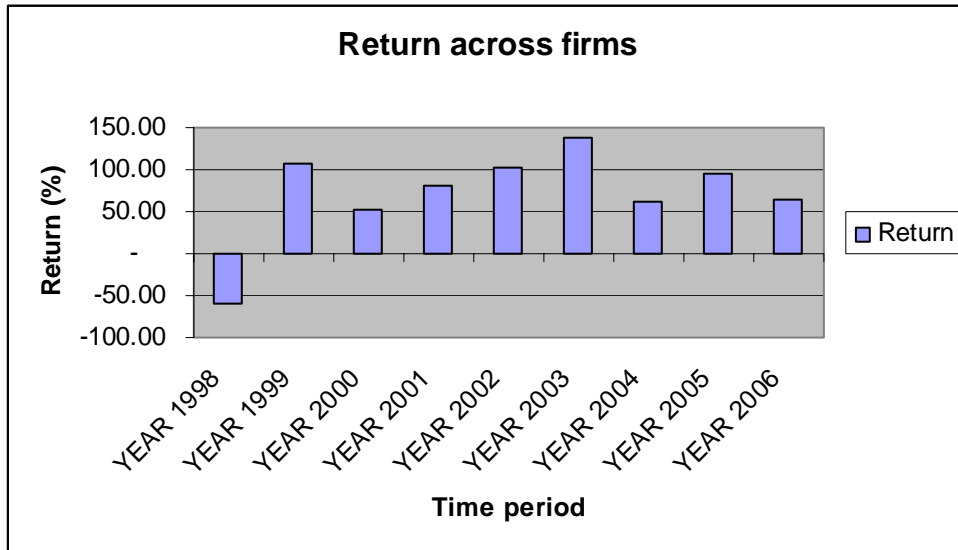


Figure 2. Trend of firms' annual return to shareholders

Table 1 displays the results obtained from panel random effects regressions for Tobin's Q during the period of 1998-2006.

The results show that long-term debt, age of firm and ownership concentration variables prove to be consistently significant. The coefficient of long term debt variable is positive, large in magnitude and is always significant at 1 percent level. It can be argued that firms choose to utilise debt, as it is provided on favourable terms by financial institutions.

In modern Russia financial intermediaries are often used as a tool to channel subsidies to industries to promote growth.

While the age of firm coefficient proves to be negative, a widely accepted theory, which states that “old” firms have exhausted their growth opportunities, hence one would expect a lower Tobin’s Q is rejected for the case of Russia. Many “old” Russian enterprises recently received subsidies from the state, which contributed to industry revival. The negative effect can, perhaps, be explained by the fact that new firms did not enter the market until economic conditions were favourable, hence the ineffective privatisation process, alongside with the August 1998 crisis effects were absorbed by the “old” firms, and reflected in the regression analysis.

The results display a positive relationship between ownership concentration and Tobin’s Q (although the size of the coefficient is small). Findings confirm that concentrated ownership acts as a safeguard mechanism against wealth diversion in developing economies with weakly-enforced property rights.

While the firm’s size effect proves to be insignificant, the influence of the return variable is somewhat ambiguous, as it only appears significant in one set of regressions. However, the coefficient is very small, and one can conclude that in most cases return to shareholders does not influence company’s growth prospects, as it is believed that reinvested earnings will amount to higher profits in the future.

From the regression results one can see that continuous state ownership, regional state and foreign ownership do not influence firms’ performance. However, the state-reacquisition variable, which captures the effect of state-private co-partnership, is found to be of substantial magnitude and is consistently positive and significant. State’s involvement in running the firms is viewed as a positive signal by investors, as it can assure them against potential wealth expropriation. To illustrate the above point, Figure 3 shows the divergence in Tobin’s Q patterns between firms which were partially acquired by the state, and those which were not. It can be seen that the state-private co-ownership induced higher Tobin’s Q growth.

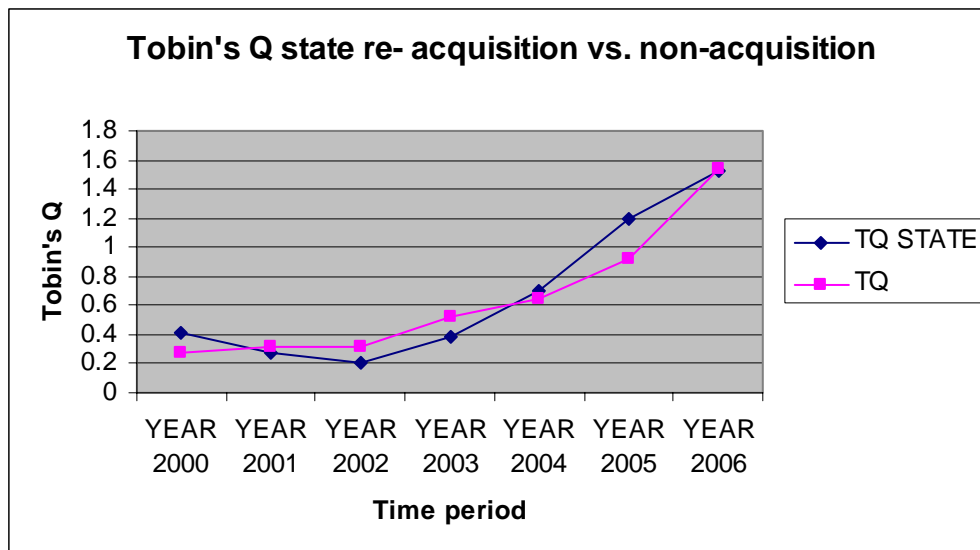


Figure 3. Difference in Tobin’s Q patterns for two types of firms

The alternative theory which can explain a significant improvement of the Russian economy is focused on the rising world price of oil, which increasingly benefits Russia. According to such theory, it is plausible to expect the energy sector effect contributing to a high Tobin's Q. Such results, nevertheless, are not observed and the coefficient for "energy firm" variable remains insignificant.

Finally, two separate indices were constructed to note the effect of government's changing policy with respect to investor protection and trade regime. It is believed that amendments to laws on joint-stock companies calling for better standards of corporate governance played an important role in companies' performance. The results show that investor protection variable carries a positive influence. As expected, once a country strengthens its legal system, and consequently, individuals' property rights, industries secure more investment and exhibit higher growth.

Similarly, the openness of the trade regime has a significant impact on firms' profitability. It is established that the reduction of trade barriers contributes to higher performance.

As stated previously, one expects the state-private co-ownership system to be more significant across industries characterised by large investment outlays, and thus potential hold-up costs. Separate regressions were run in order to determine the effect of the state re-acquisition variable across natural resources, manufacturing, banking and services, and utility sectors.

As can be seen from Table 2, the state re-acquisition variable is significant, and of a larger magnitude across natural resources and utility sectors. Natural resource industry represents a sector with large initial investments, which are insecure due to weak property rights. The utility industry is currently undergoing restructuring, requiring a lot of investment into infrastructure. Because such types of investments are always perceived as risky (due to asset specificity, which is combined with weak property rights in Russia), the government remains to be the largest shareholder, while also providing safety nets for private investors.

It can also be seen that the return variable is significant (although the coefficient is small) across the manufacturing sector. Because this sector does not exhibit potentially high hold-up costs, one expects to see high company formation, as barriers to entry are low. Also, the safety of investment is not the primary concern of shareholders; hence they turn their preferences towards an immediate return.

5. Conclusion

To summarise, one can argue that the new regime ushered under Putin, which introduced the corporate co-ownership structure between the state and private investors in response to minimise the possibility of hold-up costs, was successful. Such a co-partnership can act to assure investors against wealth diversion in the presence of a weak property rights system.

The effect is more evident in industries which are characterised by large fixed investments, and which generate large appropriable quasi-rents. In addition, legal changes which address investor protection have also contributed to firms' performance. It is furthermore noted that corporations are likely to receive debt from financial

institutions on favourable terms, as such have a policy to channel funds into industries to promote economic growth.

Table 1– Regressions of firm-specific and policy change variables on firms' Tobin's Q

Variable	1	2	3	4	5	6	7
Size	-0.008 (0.030)	-0.007 (0.030)	-0.007 (0.030)	-0.006 (0.030)	-0.016 (0.031)	-0.051 (0.030)	-0.011 (0.029)
Bank (long-term) debt	1.481*** (0.243)	1.510*** (0.242)	1.517*** (0.242)	1.503*** (0.242)	1.507*** (0.242)	1.311*** (0.240)	1.441*** (0.241)
Age of firm	-0.914*** (0.152)	-0.940*** (0.153)	-0.938*** (0.153)	-0.931*** (0.153)	-0.937*** (0.153)	-0.766*** (0.152)	-0.860*** (0.151)
Ownership Concentration	0.006*** (0.002)	0.005*** (0.002)	0.005*** (0.002)	0.005 (0.002)	0.005*** (0.002)	0.002 (0.002)	0.004** (0.002)
Return	0.0001 (0.000)	0.0001 (0.000)	0.0001 (0.000)	0.0001 (0.000)	0.0001 (0.000)	0.0001 (0.000)	0.0001* (0.000)
Continuous state ownership	-0.145 (0.090)						
State re-acquisition		0.295*** (0.112)	0.282** (0.113)	0.309*** (0.113)	0.296*** (0.112)	0.210* (0.110)	0.264** (0.111)
Regional state ownership			-0.101 (0.188)				
Foreign ownership				0.104 (0.122)			
Energy industry					0.270 (0.208)		
Investor protection						0.234*** (0.033)	
Trade policy							0.149*** (0.027)
Constant	1.336*** (0.481)	1.280*** (0.484)	1.293*** (0.485)	1.423*** (0.485)	1.393*** (0.492)	1.558*** (0.477)	1.175** (0.474)
R-squared	0.128	0.128	0.128	0.133	0.134	0.154	0.171
Wald chi-squared value	93.98***	98.39***	98.71***	99.28***	100.20***	154.22***	135.16***

*, ** and *** denote significance at the 10, 5 and 1 percent level

Table 2 – Regressions of firm-specific and policy change variables on firms' Tobin's Q across industry

Variable/Industry	Natural resource	Natural resource	Natural resource	Manuf	Manuf	Manuf	Banking and Services	Banking and Services	Utility	Utility	Utility
Size	0.076** (0.037)	0.032 (0.038)	0.053 (0.036)	0.079* (0.041)	0.042 (0.045)	0.056 (0.043)	-0.206** (0.084)	-0.109 (0.078)	0.100** (0.049)	0.078 (0.048)	0.126*** (0.048)
Bank (long-term) debt	0.718 (0.529)	0.555 (0.509)	0.563 (0.515)	2.047*** (0.222)	1.887*** (0.227)	1.979*** (0.222)	0.901 (0.729)	0.985 (0.740)	1.014 (0.862)	0.411 (0.849)	1.019 (0.858)
Age of firm	-1.238*** (0.244)	-1.114*** (0.240)	-1.188*** (0.234)	-1.270*** (0.301)	-1.316*** (0.313)	-1.380*** (0.305)	-0.500* (0.300)	-0.545* (0.300)	-0.953*** (0.166)	-0.642*** (0.169)	-0.802*** (0.165)
Ownership concentration				0.006*** (0.002)	0.003 (0.002)	0.004* (0.002)			0.038*** (0.005)	0.038*** (0.005)	0.038*** (0.005)
Return				0.0002** (0.0001)	0.0002* (0.0001)	0.0002* (0.0001)					
State re-acquisition	0.416* (0.235)								0.914*** (0.258)		
Foreign ownership				0.459*** (0.140)							
Investor protection		0.232*** (0.064)			0.125** (0.051)		0.389*** (0.106)			0.268*** (0.042)	
Trade policy			0.144** (0.061)			0.103*** (0.038)		0.209** (0.082)			0.191*** (0.037)
Constant	0.623 (0.650)	0.836 (0.629)	0.824 (0.614)	0.059 (0.708)	0.705 (0.735)	0.616 (0.725)	3.754*** (1.292)	2.770** (1.260)	-2.093*** (0.740)	-2.529*** (0.724)	-2.887*** (0.735)
R-squared	0.239	0.250	0.245	0.304	0.269	0.286	0.088	0.088	0.319	0.336	0.346
Wald chi-squared value	36.49***	46.75***	40.80***	128.52***	123.24***	124.10***	20.77***	13.75**	118.92	155.34***	141.71***

*, ** and *** denote significance at the 10, 5 and 1 percent level

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