Russian Regions after the Crisis: Coping with Economic Troubles Governors Reap Political Rewards

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The severity of the Russian financial crisis of August 1998 came as a surprise to many foreign investors and Russia watchers. Its roots and inevitability, however, were detectable to anyone who cared to look beyond Moscow and observe closely the state of economic deterioration in Russian regions. An unreformed domestic industry, loss-making agricultural sector, and dysfunctional financial system were clear signs of what was to come. An ineffective tax system was not the only cause of the fiscal crisis that brought about the 17 August devaluation of the ruble, default on government short-term debt, and a moratorium on commercial foreign debt service. The crisis was the natural result of an unreformed and politically unstable economy that did not turn out taxable profits.

The extent of Russia's irresponsible politics and deteriorating economic conditions was most apparent in the regions. The financial crisis of summer 1998 exposed and exacerbated social and economic problems that had been mounting since the collapse of the Soviet Union. Prices for imported goods increased, collapsing banks halted wage and pension payments, suppliers ran low on food and medicine, and inflation corroded people's real income. Each region reacted differently, but none was able to shield itself completely from the crisis. The economic turmoil and Moscow's weakness encouraged governors' ambitions. As regional leaders reached for more political power, however, they inevitably confronted their own economic dependency on the shrinking federal budget. Thus, the crisis abruptly upset the precarious balance of power that had been evolving from the tug-of-war between center and periphery. At the same time, no serious threats to the integrity of the federation materialized, separatism remaining an unsustainable policy for most regions, which still depend heavily on federal subsidies.

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Regions in Pre-Crisis Distress

Since the beginning of market reforms in 1992, regional economies have been subjected to structural changes that ripped apart the old functional and trade ties supporting the Soviet economy. The abolition of central planning, the liberalization of prices, and privatization were expected to create market conditions that would spur entrepreneurial activity and transform backward production facilities into competitive and modern firms. That did not happen. A misconstrued mass privatization scheme, a debilitating tax system, and delayed institutional and financial sector reforms created perverse incentives for economic agents across the regions. Enterprise and farm managers as well as private entrepreneurs were forced to or chose to focus on short-term gain and survival, instead of corporate restructuring, investment in production, and growth.

The government and the banking sector did little to help industrial reorganization. Taxes were kept high to provide subsidies to politically important, but unprofitable factories. Most banks financed energy exports (and vice versa), instead of production and preferred to speculate in government securities rather than engage in corporate lending. As a result, industrial production fell 60 percent since 1992 (to put things in perspective, during the Great Depression output fell 35 percent in the United States). Regions dependent on heavy industries, such as Sverdlovsk, Chelyabinsk, Vologda, Kemerovo, Krasnoyarsk, Orenburg, Volgograd, Omsk, and Lipetsk, suffered the most. Small and medium enterprises were choked by heavy and arbitrarily assessed taxes and by an oppressive and frequently corrupt bureaucracy.

The fate of the agricultural sector was even more distressing. Delay in land reforms, lack of financing for agricultural equipment and fertilizers, and depressed producers' prices (often manipulated by corrupt rings of middlemen) caused a 50 percent drop in agricultural produce. According to Agriculture and Foodstuffs Minister Viktor Semenov, the utilized arable land in the country declined by a quarter since early 1990s, the number of cattle was halved, mineral fertilizer use dropped to 15 percent of its former level, and the fleet of agricultural machinery decreased between 45 and 55 percent.[1] Making the situation even worse, a severe drought in 1998 brought the worst grain harvest since 1953 and left regions in the Far East, notably Chukotka, Sakhalin, and Khabarovsk, with limited food supplies for the winter.

Some Regions Open to the West, with Mixed Results

Several regions made an effort to attract foreign investments and tap into international capital markets to finance domestic economic growth. St. Petersburg established a special council on foreign investment, where the city's leaders and investors met to discuss everyday problems. In 1997, the city's government developed a package of legislation providing tax holidays for companies with large investments in the city economy. Property and other city taxes were lowered, and the city pledged not to raise tax rates in the next three years. Special support was promised to investors in the industries that were on the St. Petersburg government priority list: export-oriented production and import-substituting sectors (food and light industries), energy production, tourism, and the service sector. Other regions followed similar strategies to attract foreign investments. In Novgorod oblast, a holiday was declared on the payment of regional and local taxes until investors earned profits, and in 1997 four tax-free districts were created in which non-trade enterprises would be reimbursed for federal profit taxes. As a result of such policies and the climate they created, in 1996 and 1997 foreign investment constituted approximately 40 percent of all capital investment in the region.[2]

With the domestic banking system largely incapable of providing investment capital, several regions turned to the international capital markets to finance infrastructure and other development projects. St. Petersburg issued a five-year, 9.5 percent Eurobond in June 1997. The Republics of Komi, Tatarstan, and Sakha and the cities of Moscow and Nizhny Novgorod also borrowed on the international financial markets, with the explicit permission of the federal government.[3] The Republic of Komi adopted a law on foreign borrowing in August 1997, and in October it signed a $35 million credit agreement with Bank Societe Generale Vostok, a Russian subsidiary of the French bank. The money was then distributed among enterprises that had submitted business plans for investment. In January 1998, Komi received its second credit in the amount of $50 million for six months, with a 15 percent annual interest rate, from the German bank Schweizerischer Bankverein AG.[4]

"The chronic federal government deficits made the country increasingly dependent on external borrowing . . . and short-term government securities."

When the financial crisis struck, many of the Russian regions and cities defaulted on their obligations. The Republic of Komi was supposed to pay $2.3 million to Societe Generale Vostok and $1.8 million to SBC Warburg, a representative of Schweizerischer Bankverein, before the end of 1998.[5] However, the ruble devaluation in August made it difficult for the enterprises that have received the foreign funds to pay back their hard currency debts, and the republic, which had taken the foreign loans in the first place, asked the banks to restructure the debt. In early December 1998, Moscow oblast defaulted on its 2.1 billion ruble ($60 million) debt and asked to restructure a 600 million ruble payment due on 10 December. Tatarstan defaulted on its short-term loan from ING Barings, and the city of Novosibirsk illegally restructured its foreign debt.[6] Regions such as Chita, Saratov, and Chelyabinsk defaulted on their agricultural bonds as early as the beginning of summer 1998.

In many aspects, regions offered a better environment for foreign investments than the center. Because the federal government had failed to pass a law that would permit the purchase and sale of land, many regions decided to fill in the legal vacuum with their own land laws. Saratov was a pioneer, adopting the first such land law in 1997 and subsequently holding land auctions.[7] Although Saratov's law was challenged by the procurator general in the Supreme Court, over twenty other regions followed its lead, including Samara, Tatarstan, and Novgorod. Primorsky kray was planning to hold a referendum on land rights, while legislatures of Kurgan and Kaliningrad oblasts were considering adopting their own laws. When a federal Land Code that banned the sale and purchase of land-was finally passed by the State Duma, Yeltsin vetoed it as too conservative.[8] In response, Saratov oblast, backed by other regions, proposed an amendment to the federal statute on mortgages in February 1999. Although the amendment will not allow for private ownership of land per se, it will enable landowners to treat their land as any other kind of property, thus circumventing restrictions on property enshrined in the Land Code.[9]

Even with a few successful economic stories, based on pro-business and pro-investment regional leadership, Russian regions remained largely unreformed and dependent on federal support. With the federal government unable to raise the tax revenues to service its obligations, wage and pensions arrears in the regions began to accumulate. Primorsky kray, in the Russian Far East, suffered from chronic energy shortages, mostly because federal and regional agencies had failed to pay their utility bills to the local power producer, Dalenergo.[10] In response to the harsh economic conditions, people of various occupations protested throughout the country, demanding payment of their back salaries. Teachers, medical doctors, nuclear scientists, and pensioners were striking and blocking traffic in regions such as Chelyabinsk, Perm, Irkutsk, and Nizhny Novgorod. Coal miners from Sakhalin and Primorsky kray to Kemerovo and Komi were especially active in May 1998, blockading railways and causing millions of rubles in losses from delayed cargo and passenger trains, until the government appeased them with short-term federal handouts and promises of future payments.[11]

Economic Crisis Unfolding

The chronic federal government deficits made the country increasingly dependent on external borrowing (mostly from the International Monetary fund [IMF] and the World Bank) and short-term government securities (GKOs). In June 1998, the total value of outstanding GKOs reached 436 billion rubles ($70.3 billion). Foreigners, who were admitted to the GKOs market in 1996, partly under the pressures from the IMF, held 29.4 percent of the outstanding short-term government debt. The financial crisis in East Asia, however, made foreign investors increasingly wary of Russia's ability to pay its debts and maintain a stable ruble that would protect the value of their GKOs holdings. Falling world energy prices compounded their fears. Russia, which depended on energy exports for 70 percent of its foreign exchange earnings, saw its foreign exchange reserves fall to $13.6 billion in early July, from a high of $24 billion in April 1997.

To continue financing Russia's budget deficits, foreign investors in GKOs required higher interest rates, which added to the cost of government debt service and led to the need to issue additional treasury bills. This vicious circle received fresh impetus in late spring, when the Russian government and the IMF failed to reach agreement on a 1998 austerity plan and the fund delayed the next $670 million disbursement of a three-year, $9 billion IMF loan. Worried about the prospect of ruble devaluation and the possibility of default on short-term government debt, investors launched a massive sell-off on Russia's stock and GKOs markets in late May and early June 1998. By the end of July, foreign holdings of GKOs were reduced from about $20 billion to $13 billion. This development put heavy pressure on the ruble, as investors quickly converted their ruble earnings into dollars.

With limited foreign currency reserves to defend the ruble, the Central Bank raised the interest rate to commercial banks to 150 percent. The Ministry of Finance offered yields on government securities of 110 to 120 percent, but failed to find buyers even at these sky-high rates. The government, facing a severe payments crunch, turned to the international financial institutions for help. Anatoly Chubais was appointed special negotiator and traveled to Washington for talks with the U.S. Treasury Department and the IMF. After around-the-clock negotiations, the two sides announced on 13 July 1998 that Russia would receive $14.8 billion in loans from the IMF, the World Bank, and Japan in 1998. The IMF would loan $12.5 billion for the year, of which $11.2 billion was in the form of a new stabilization loan, approved on condition that the Russian government adopt a tough anti-crisis program, including significant changes in the tax system. The new stabilization package also included a combined $7.8 billion in loans for 1999. Thus, Russia was set to receive $22.6 billion of international financial support before the end of 1999.

On 20 July, the IMF board of executive directors approved the rescue package and authorized the first disbursement of $4.8 billion—$600 million less than originally planned, as a penalty for the Russian parliament's failure to pass all of the tax measures required by the IMF. One million dollars of the IMF funds was immediately used to pay off short-term government debt. The remaining funds went to boost the Central Bank's foreign exchange reserves. A second IMF tranche of $4.3 billion was to come in September, and a third one of $2.1 billion in November 1998. The IMF program assumed, however, that restored investors' confidence would bring down interest rates and induce foreign investors to roll over their GKO holdings, thus alleviating immediate pressure on the federal budget. Foreigners were expected to roll over $3.5 billion of the $4.8 billion they held in GKOs maturing by the end of 1998. Russian banks were expected to roll over an additional $7.7 billion. In a deal managed by the U.S. investment bank Goldman Sachs, foreign and local investors agreed to exchange $6.4 billion of GKOs for seven- and twenty-year Eurobonds, priced 9.2 percent over the benchmark U.S. treasury bills.

After the swap, $10.7 billion of GKOs remained to be redeemed by the end of September 1998. The Russian Finance Ministry, at the same time, estimated that taxes collected in the second half of the year would be 106 billion rubles ($17 billion at the time), markedly less than the 146 billion rubles ($23 billion) in total debt service. The announced finance gap intensified speculations of imminent ruble devaluation and sparked a massive sell-off in the stock market in early August 1998. During the week of 10 August, the Russian stock market plunged 25 percent. The ruble was pushed out of the Central Bank–set range of 6.2 to 6.5

per dollar, and GKOs yields soared to 125–140 percent. At those prices, the Finance Ministry cancelled three consecutive GKO auctions, dashing hopes that it could roll over its debt. On 13 August, George Soros wrote a widely publicized letter to *The Financial Times*, claiming that the meltdown in Russia's financial markets had reached its "terminal phase" and urging a 15–25 percent ruble devaluation and the introduction of a currency board. President Boris Yeltsin and the Russian government were quick to dismiss the idea of devaluation, claiming that currency exchange policies already in place would return stability to the financial market. They changed their minds over the weekend of 15–16 August, when it became clear that another G-7 bailout was not going to materialize. In a joint statement on 17 August the government and the Central Bank announced a de facto devaluation of the ruble, default on the government short-term debt, and a moratorium on service of foreign obligations by Russian banks.

Regional Economies Seek Coping Strategies

The devaluation of the ruble and the collapse of the payment system caused considerable pain in the regions. The ruble lost 70 percent of its value from August to December 1998. Inflation for the same period topped 75 percent. Real incomes fell by 12 percent, according to the World Bank, and Goskomstat figures show that the crisis pushed 30 percent (about 43 million people) of the Russian population below the poverty line measured by a monthly subsistence wage of 522 rubles. The decline in living standards was much more drastic in the regions, which depend heavily on imported foodstuffs, medicine, and supplies. Kaliningrad, for example, imports 85 percent of its food from outside Russia, and 100 percent of its electricity from Lithuania. The city of Moscow, which imports more than 70 percent of its food supplies, lost much of its glitter as an island of consumer prosperity amid a sea of shortages in the regions.

As the ruble lost its value, prices of imported and some domestic consumer goods rose sharply. In the period 17 August–9 September, prices of imported foodstuffs increased by 100–500 percent, and prices of Russian products went up by 50–100 percent, before falling toward the end of the month. In Khabarovsk, in the Russian Far East, basic goods such as butter, salt, and sugar increased four times in price in the first week of September and remained scarce even at those levels. Shortages of essential foods and medicines appeared in Sakhalin, Kamchatka, Dagestan, and the Russian Far North. Striving to survive in the face of food shortages, Chukotka residents resorted to hunting whales and walruses for sustenance.[12]

To prevent humanitarian collapse and assert their power, some regional governments imposed price controls and prohibited export of certain goods outside their territory. On 27 August, Governor Alexander Lebed prohibited price increases of more than 10 percent in Krasnoyarsk kray. The next day, more than thirty other regional governors met to consider similar price controls, although few followed through. Lebed and Kemerovo oblast governor Aman Tuleev imposed restrictions on the export of food to other areas of Russia—an action explicitly banned by federal law. Tatarstan and Altai introduced restrictions on the export of milk and meat. The governor of Kaliningrad oblast, Leonid Gorbenko, declared an emergency for a short time in September, before backing down after Moscow warned that such a move was unconstitutional. As some of the governors' measures to control prices and exports were rescinded under pressure from Moscow and local producers (who refused to sell at the low prices), regional authorities began adopting different tactics to assure adequate local supplies of essential goods. Complicated registration of exports, sanitation inspections, and strengthened administrative controls were applied as de facto trade barriers. Local governments in Volgograd oblast, for example, ordered railroad authorities not to provide grain traders with railroad cars for the export of grain.

Domestic producers were expected to take advantage of the ruble devaluation and fill in the gap left after falling imports. That did happen in some sectors of economy in the first quarter of 1999: machine building and processing industries, for example, increased their production as Russians turned to cheaper domestic goods. This upward blip, however, could not last long and could not become a trend that drives the economy to positive overall growth. The majority of enterprises remained starved for working capital in a demonetized economy and continued to depend heavily on barter (it is estimated that more than 50 percent of inter-enterprise transactions were settled by barter in 1998). The companies' outdated and badly run production lines could not turn out more products on a steady basis, without significant investment in modernization. The average age of equipment in Russian industry exceeded fifteen years, while the share of newly installed equipment had fallen substantially (the share of equipment in industry aged under five years dropped to 8 percent of total equipment in 1996, from nearly 40 percent in 1970).[13] Russian manufacturing could not increase production in the long run without massive replacement of technologies in most sectors.

"The collapse of the banking sector significantly debilitated regional economies."

The collapse of the banking sector significantly debilitated regional economies. Wages, pensions, and business transactions were frozen in insolvent banks. People could not withdraw their savings and, even after transferring accounts to the state-supported Sberbank, lost much of their money. Some regional banks that had not invested in the collapsed GKOs market stayed afloat, but lacked sufficient resources to serve as locomotives for regional economic revival. Those mostly small and medium-sized banks did not have the funds or the expertise to service corporate loans and finance agriculture.

To address the problems of the banking sector, the Central Bank pledged to provide assistance to about 200 regional banks that would become the backbone of a regional banking system. On 22 March, the newly formed Agency for Restructuring of Credit Organizations (ARCO) released a listing of sixteen regions targeted for assistance. Surprisingly, the list included Moscow and Moscow oblast. Observers saw the gesture as a concession to Moscow's "banking oligarchy." The Central Bank of Russia saw support and reform of oligarchic banks as an unavoidable task in assuring the future of the Russian banking system. According to the Central Bank, Moscow banks account for 86 percent of all payment transfers frozen in the banking system. ARCO was planning to help (*a*) all banks that have broad importance in their region, (*b*) certain Moscow banks, and (*c*) one or two banks critical to the payment system.[14]

Instead of waiting for official support, many regional banks began to take steps to provide for their own future. After the regional branches of several Moscow banks (Inkombank, MENATEP, and SBS-Agro) collapsed, the regional banks took over their corporate clients. Prime examples of this trend are small and medium banks in Samara (Gasbank, KB Solidarnost, Tolyattikhimbank, and Bank Volga-kredit) and Novosibirsk (Bank Akzept, Sibakadembank, and Bank Alemar).[15] In Yekaterinburg, bank Severnaya Kazna punished Inkombank by refusing to give it hard currency in exchange for rubles that had already been transferred. Regional banks opened numerous correspondent accounts and began transferring money from one to another in order to avoid nonpayments.

Large regional enterprises also developed survival strategies in the aftermath of the financial crisis. Many opened accounts in several banks simultaneously, increasing the number of corporate clients in regional banks. Some established their own banks to service their payment needs. The giant Samara car maker AvtoVAZ founded its own bank on the basis of Rosestbank and Avtomobilnyi Bankirskii Dom. According to *Profil's* rating (23 November) Avtomobilnyi Bankirskii Dom soon became the twelfth-most-reliable of the small and medium-sized banks in Russia.

Center Reasserts Waning Authority

Moscow's regional policy in 1998 was severely undermined by the economic crisis and the frequent government reshuffles orchestrated by Yeltsin. The Kremlin started the year with hope of bringing regional separatism to heel when the Presidential Administration threatened to scrutinize all regional laws for their compliance with federal statutes. The Ministry of Justice estimated that between one-third and one-half of all regional laws were unconstitutional. Meanwhile, the center continued signing power-sharing agreements with regions, bringing the total number to forty-six out of eighty-nine regions. On the other hand, a protocol outlining tax benefits for Tatarstan, a part of the republic's power-sharing treaty with the center, expired, and Moscow was resolved to renegotiate special privileges granted to the republic in the original document. President Yeltsin met with leaders of ethnic republics in June 1998 and criticized them for passing laws in contradiction of federal legislation.[16]

The Presidential Administration, previously the sole purveyor of federal subsidies to the regions, slowly yielded initiative for regional policy to the cabinet of ministers. After Yeltsin appointed Viktoriya Mitina in November 1997 to be his regional policy aide, the Kremlin's grip on the regions weakened.[17] Mitina was not able to keep assertive regions in line, and the election of a former convict as Nizhnii Novgorod mayor, along with Lebed's victory in Krasnoyarsk, was the last straw before she was fired in May 1998. A former KGB officer, Vladimir Putin, replaced Mitina and took a much more hard-line approach to delinquent regions. His staff collected meticulous information about the ways governors spent federal subsidies. After Putin was named head of the Federal Security Service in July 1998, Yeltsin appointed another weak aide, Oleg Sysuev, to run the regional policy.[18] A former mayor of Samara and deputy prime minister in Kirienko's government, Sysuev openly admitted in October 1998 that the Kremlin has transferred the responsibility for regions to the government. Although there was some talk in Moscow about reducing the number of federation subjects to make the country more manageable, at no point did the idea receive serious consideration.

__"The Russian constitutional and supreme courts have had to rule on several cases that mayors must be popularly elected and not appointed by regional leaders."__

In its struggle to preserve authority over regional governments, Moscow found important allies in mayors and municipalities. (Because they are not considered part of the state hierarchy of power, cities lack independent source of income, which makes them dependent on regional governments. However, they are expected to provide education and healthcare services.) Additionally, some regional leaders used the vague legal status of municipalities in an attempt to consolidate their power. The Russian constitutional and supreme courts have had to rule on several cases that mayors must be popularly elected and not appointed by regional leaders. North Osetiya's president Ruslan Aushev largely ignored this ruling. On 29 May 1998 Yeltsin set up a Council on Local Government to coordinate efforts to reform the country's lowest level of government.

Governors and mayors were locked in battle in many regions across Russia, most notably in Primorsky kray, Sverdlovsk, and Nizhny Novgorod. Mayors of regional capitals often became potent challengers to the governors at election time. In Primorsky kray, the fight between Governor Yevgeny Nazdratenko and Vladivostok mayor Viktor Cherepkov culminated when the latter was removed from the ballot at the last moment during the 27 September 1998 elections. Outraged voters refused to back any of the other candidates, leaving the city in political limbo. Subsequently, the city held a local Duma election on 17 January 1999, in which Cherepkov's supporters won again and elected him mayor. The validity of the election, however, was challenged in court, and the election was rescheduled again for May 1999. In Nizhny Novgorod, protest voters carried to victory a criminal figure, Andrei Klimentev, in March 1998, much to the embarrassment of regional and central authorities. Moscow promptly removed and jailed him on charges of embezzlement, and a new mayor, also an oponent of the governor, was elected in October 1998.[19] In an attempt to unite their efforts against governors' authoritarianism, mayors created several associations. Valery Kirpichnikov, who headed one of them, later became Primakov's minister of regional policy.

Finally, Moscow flexed its law enforcement muscle, cracking down on corruption among regional officials, both former and current. In Tula, Vologda, Kemerovo, and Vladimir oblasts, former governors were arrested, tried, or charged with various degrees of bribery, embezzlement, or abuse of power. In Perm, a former deputy governor was detained for abusing state property. Federal agents also arrested deputy governors in Tver, Voronezh, and Kursk oblasts on charges ranging from bribery to embezzlement to improper conduct. In Kursk, Governor Aleksandr Rutskoi's brother and son were both charged with violations, and the entire region was exposed for its leader's corruption and nepotism.[20] Auditors found misuse of public funds in Nizhny Novgorod and Leningrad oblasts. Finally, a special team of federal agents conducted a thorough investigation of corruption and crime in the highest echelons of Dagestan after armed groups temporarily took control of the republican administration building on 21 May 1998.[21]

Masters of Their Domains

The financial crisis and resulting governing paralysis in the center presented regional leaders with vast opportunities to strengthen their power. The so-called oligarchs were badly battered by the collapse of their financial empires, which relied heavily on the government's GKO pyramid scheme. Similarly, oil and gas barons were weakened by the slumping prices on international markets. At the same time, regional governors secured greater federal concessions and took control of many regional banks, industrial enterprises, and media companies. Thus they emerged as a dominant, although not entirely cohesive, political group.

Even before the 17 August 1998 collapse, Russian regional leaders were increasingly using the country's economic decline and subsequent erosion of Moscow's authority to gain leverage. For instance, Kemerovo's Aman Tuleev used miners' strikes to force more subsidies and autonomy out of Moscow, while Sakha (Yakutiya) sought to establish its own gold reserve independent of Moscow.[22] The only outright separatist threat came from Kirsan Ilyumzhinov, the eccentric president of Kalmykiya, who said he would declare his republic an associate member of the Russian Federation if the center did not fulfill its financial obligations. Ilyumzhinov retracted his threat, however, as soon as Moscow reprimanded him.[23] Other ethnic republics also relied on nationalist and separatist threats to assert their authority. Tatarstan passed a citizenship law on 16 April that allowed residents to be citizens of Tatarstan without being citizens of Russia.[24] Bashkortostan, Ingushetiya, Sakha (Yakutiya), North Osetiya, Tatarstan, Tyva and Adygeya all required that their presidents speak the native language of the republic in question, although the Russian Constitutional Court ruled these requirements illegal in April 1998.[25] Moscow mayor Yuri Luzhkov ignored the court's decision to outlaw residential registration requirements. Nizhny Novgorod defied the Constitutional Court's authority in February by ordering local companies to pay salaries before paying taxes, directly contradicting an earlier court ruling.[26] Finally, the economic crisis challenged the loyalties of local military commanders, who found their ill-fed and poorly clad troops increasingly dependent on regional authorities for supplies and utility services.

The August 1998 financial crisis and resulting governing paralysis in the center presented regional leaders with vast opportunities to further strengthen their positions. In the wake of the crisis, many governors, such as Khakasiya's Aleksei Lebed, openly declared that they would stop paying taxes to the federal treasury,[27] while many others exercised their authority to declare a state of emergency (Kaliningrad and Sverdlovsk) and to institute price and export controls by decree. Nizhny Novgorod even considered virtual separation of the regional banking system from the national structure to keep the countrywide financial contagion out.

One of the most significant methods of power consolidation for regional governors was acquisition of partial regional ownership in various enterprises during the crisis. In some cases, such as Sverdlovsk and St. Petersburg, the governors offered banks tax breaks and licenses to service regional budgets in exchange for a controlling stake. (The success of such plans has yet to be demonstrated.) Rostov oblast gained control of Rostselmash, a giant producer of agricultural machinery,[28] and Bashkortostan created a state-run monopoly in the revenue-generating energy sector.[29] Samara's governor Konstantin Titov persuaded the federal center to transfer ownership of several large enterprises to the oblast in exchange for forgiving federal debt to the region.[30] Nizhny Novgorod did the same, taking advantage of the chaos surrounding the financial crisis. Perhaps the biggest coup for regional leaders was Yeltsin's decision to transfer 33 percent of the ownership of Unified Energy System (UES), the national electric power grid monopoly, to regional governments.[31] This move greatly inhibited the company's ability to collect payments from delinquent regional governments and enterprises as well as its capacity to raise electricity prices.

One important area of expanding regional control over the economy was the restructuring of the fuel and energy industry. Local tax authorities seized Rosneft's controlling stakes in its Sakhalinmorneftegaz, Termneft, Stavropolneftegaz, and Krasnodarneftegaz subsidiaries for unpaid debts. Sidanco's Udmurtneft subsidiary also came under attack from regional authorities, which weighed the options of bankrupting the company or attempting to merge it with other regionally based producers. The governors consider the withdrawal of field licenses another effective tool for controlling local oil companies. In Samara, regional officials threatened to bankrupt a Yukos subsidiary, Samaraneftegaz, but recently began seeking a compromise.[32] Regional governors, most prominent among them Alexander Lebed of Krasnoyarsk kray, called for radically expanding the powers of the Russian regions in managing federal property as well as energy and coal facilities. Kemerovo oblast governor Aman Tuleev has concluded an agreement giving the regional authorities no less than half of the seats on the panels of government-appointed representatives on the boards of local coal companies.

Another measure of the growing power and influence of the regions is their increased control over the media. Governors used their authority and the difficulties posed by the economic crisis to dominate regional newspapers and broadcasters. The economic crisis led to a dramatic rise in paper and printing costs and significant loss in advertising revenues. The problem was compounded by the loss of federal subsidies and tax breaks that the media used to enjoy. In 1995, Russia adopted a series of tariff breaks to allow Russian newspapers to print their products in Finland. However, in 1998, the State Duma and the Federation Council refused to extend the breaks, in fact increasing costs of production of newspapers.[33] At the same time, governors could arrange affordable paper and printing for publications they favored, effectively gaining censorship power over local newspapers. An opposition newspaper in Tatarstan was shut down by a local court on the grounds that its articles subverted the republican government.[34] Perhaps the most shocking event of the year was the mysterious and gruesome murder of journalist Larisa Yudina in Kalmykiya, a staunch opponent of authoritarian president Kirsan Ilyumzhinov. Accusations were made that the president was connected to the murder, although the perpetrators were never apprehended.[35]

Governors also pursued greater control over electronic media in the regions. Moscow mayor Yuri Luzhkov and Sverdlovsk governor Eduard Rossel both used public funds to set up television companies under their personal control. In Nizhny Novgorod, local authorities refused to provide information to an independent broadcaster, Seti-NN, whose coverage they did not like.[36] Finally, the governors successfully resisted Moscow's attempt to consolidate regional television broadcasters into a nationally run holding. President Yeltsin ordered the State Television Company to consolidate regional TV broadcasters into one state-run holding, but only nine of ninety regional broadcasters had complied by late 1998, for example in Tver.[37] By and large, the governors refused to let the center control the regional media and in many cases directly appointed the heads of local television stations. Given the importance of media for campaigning, the governors have positioned themselves both for easy reelection and to influence the upcoming State Duma and presidential elections.

Both Kirienko's and Primakov's cabinets clearly recognized the growing importance of the regional leaders. Newly appointed prime minister Sergei Kirienko told Federation Council head Yegor Stroev in March that he plans to consult governors on policy decisions. Tellingly, Yeltsin told his staff that "we must work with the regions. We must work in contact with the governors. We must bring them closer to ourselves, to our hearts."[38] Subsequently, both Kirienko and Primakov attempted to cajole leading governors into joining the federal government. Most of the governors, however, rejected federal overtures and chose to remain popularly elected officials, rather than ministers appointed at the president's whim. Only Vadim Gustov, governor of Leningrad oblast, gave up his elected seat to become first deputy prime minister in charge of regions, CIS, and youth affairs in Primakov's government.[39] Primakov also invited leaders of the eight regional associations into the presidium, or inner circle, of the cabinet of ministers, theoretically allowing them to participate in the highest level of policymaking.[40] Despite the high-sounding title, the inclusion of the governors in the presidium gave them little additional power. At the same time, willingness of the center to include the governors in decision making likely contributed to the overall endorsement of Primakov's anti-crisis plan by the regional elites.

Bargaining for Their Fair Share

Fiscal federalism remained the focal point of center-periphery relations during the crisis, as Moscow and the regions battled over tax revenue allocation. It has become common for regions to complain that the center never transferred promised funds for wage and pension payments, and for Moscow to counter that the money had been sent long ago. The center also tried to keep tight control over how governors spent federal subsidies. For instance, the federal Audit Chamber prevented Sverdlovsk oblast from creating its own regional bank with federal money.[41] Because of the poor transparency of fiscal transfers, however, many governors managed to use funds for purposes other than those outlined in the federal conditions attached to grants. To address this problem, the Kirienko government began signing special treaties with regions requiring them to comply with federal standards in revenue allocation, tax collection, and debt restructuring in exchange for access to further federal subsidies.[42] Chelyabinsk and Khakasiya signed such agreements, making their relations with the center more transparent, whereas St. Petersburg, Perm, and Krasnoyarsk refused to comply. The effort apparently was abandoned after Kirienko's removal.

"Russia's economic crisis has illustrated that in addition to its enormous economic problems, the country has yet to establish an effective federal structure."

The 1999 federal budget became another contentious issue between Moscow and the regions. Despite the increased share of tax revenues earmarked for regions in the draft budget, governors seemed to fear that as a result of the overall reduction in taxes, regions' income would actually decrease.[43] One of the demands of the regional governors was that Russian corporations pay local taxes in their region of operation, not in the location where they are registered. The current arrangement has naturally benefited the city of Moscow, which collects local tax payments from companies operating nationwide but headquartered in the capital. Federation Council chairman Yegor Stroev threatened to block the draft 1999 budget over allocation of federal financing and subsidies to the regions. Two regional associations, the Siberian Accord and the Urals Economic Association, met in January 1999 to discuss the budget, and in both cases the consensus was that federal measures do not go far enough to help the country out of the crisis and are actually harmful to the regions.[44] Specifically, regions complained that proposed tax reforms, including the option to levy a regional sales tax of up to 5 percent (already introduced in some forty regions), would shift the tax burden from producers to consumers and decrease the already low living standards of the population. According to the leaders of Chelyabinsk, Udmurtiya, and Bashkortostan, the federal budget also largely ignores the social sphere. Even guaranteed federal programs have been cut, including a whole host of environmental rehabilitation programs. The speaker of the Altai kray parliament even declared a hunger strike in protest of federal budget arrears to his region.[45] This standoff illustrates the continuing importance of federal subsidies for the regions, only a handful of which are net contributors to the national budget.

Regions Seek Ties Abroad

Trade relations with foreign countries and foreign policy have been areas of both contention and compromise for the Kremlin and the regions, emphasizing the growing independence of governors' actions. When rumors began circulating that Yeltsin might transfer the Kuril Islands to Japan to normalize relationship between the two countries, governors of Sakhalin and Primorsky kray vocally defended the islands as traditionally Russian territory.[46] Saratov's governor Dmitry Ayatskov said that he would unilaterally close the oblast's border with Kazakhstan to halt illegal flow of alcohol, arms, and narcotics.[47] Ayatskov also visited Ukraine in July and November 1998 to sign trade agreements and talk with the Black Sea Fleet leadership.

Foreign activities of Russian regions sometimes touched on sensitive international issues and went directly against Moscow's policies. Several regions, for example, developed trade ties to Georgia's rebellious province of Abkhaziya. Others sent representatives to a conference that recognized the Turkish government on Cyprus. Some private farmers from Dagestan clashed on the border with their neighbors in Azerbaijan.[48] Krasnodar's governor expelled several trainers of the National Democratic Institute, accusing them of spying for the CIA.[49] Driven by the desire to keep regional foreign activities limited to economics, the Russian Ministry of Foreign Affairs created a special department to coordinate the regions' foreign policies. The center also signed a special agreement with Chelyabinsk, delineating respective jurisdictions in international economic activities.

Many regions have successfully forged commercial ties with foreign countries. Leaders of the Komi Republic and Sverdlovsk oblast visited Iran in December 1998 to sign trade agreements.[50] Volgograd sold tractors to Iraq. Chelyabinsk and Arkhangelsk developed trade relations with provinces of Bulgaria and Finland, respectively. Perm sent a large delegation to explore the South American market for its products, and Saratov's governor visited Azerbaijan to sign a number of cooperation agreements.[51] Vying to attract foreign investors, Krasnoyarsk leaders traveled to Japan, and governors of Saratov, Arkhangelsk, and Murmansk accompanied Yeltsin to the G-8 summit in Great Britain. Nizhny Novgorod and Saratov opened trade representations in Germany

Several contentious foreign affairs issues affected the regions in 1998. China remained an important trading partner for the bordering Russian regions of the Far East; Irkutsk planned to export its surplus energy to China.[52] Farmers from the Jewish Autonomous Okrug and Chelyabinsk oblast employed migrant Chinese labor to harvest their crops. At the same time, Khabarovsk shuttle traders opposed the possible influx of Chinese retailers, and Primorsky kray authorized Cossacks to patrol the border to prevent illegal crossings by the Chinese. Latvia's unfavorable treatment of ethnic Russian minorities caused governors of Yaroslavl, Saratov, and Kaliningrad to call on the Russian government to boycott Latvian goods and services.[53] Finally, Belarus president Alexander Lukashenka worked hard to develop bilateral relations with Russian regions. He visited Primorsky kray and Murmansk oblast, and the governors of Orenburg, Krasnodar, Tula, Yaroslavl, Stavropol, Kostroma, and Vladimir visited Minsk. Although the Kremlin does not like Lukashenka's active networking in the regions, to date Belarus has signed cooperation agreements with fifty-five of them.

Conclusion

Russia's economic crisis has illustrated that in addition to its enormous economic problems, the country has yet to establish an effective federal structure. Fiscal federal relations remain opaque and asymmetrical. The weakness of individual regions, however, and Moscow's enduring capacity to redistribute revenue among them suggest that the overall integrity of the Russian Federation is not in danger. At the same time, governors emerged from the crisis with more control over regional economies, the media, and foreign economic ties, which makes them indispensable in addressing the fundamental causes of Russia's economic crisis.

Russia's industrial base will continue to decay and its economy will wither until meaningful industrial restructuring puts the regions' economies on an internationally competitive footing; until legal, regulatory, and tax reforms are implemented to nurture an entrepreneurial revolution at the local level; and until a real banking sector emerges. The experience of successful transition in Central Europe demonstrates the critical importance of small and medium enterprises (SMEs), especially in the service and light industrial sectors, for generating a broadly based economic growth and employment. A vibrant SME sector is important not only for its direct contribution to economic expansion and enhancement of tax revenues, but also for its ability to absorb labor shed in the processes of corporate restructuring. The federal government's economic program of fall 1998 promised to aid small innovative enterprises and simplify registration procedures, pledges frequently defaulted on in the past.

Given the increasing influence of regional authorities over the economy, programs in support of private sector development and enterprise restructuring are more likely to succeed if they are designed and implemented at the regional level. Foreign investments and technical assistance would best contribute to Russia's economic revival by leveraging such locally based development initiatives. Russia's federal government would be well advised to continue the controlled devolution of authority to the provinces and allow regions to employ their indigenous resources and comparative advantages to seek creative ways out of the economic crisis.

NOTES

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