

The Political Costs of Western Investment in Russian Spin-off Companies

Kimberly Marten Zisk
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In recent years many American investors have targeted direct investments in Russia toward small start-up companies that are spin-offs from old Soviet enterprises. These investments have been encouraged by several US government programs, particularly the provision of political risk insurance by the US Overseas Private Investment Corporation (OPIC), and the sharing of business advice and Russian company information by the US Commerce Department.

The economic reasoning behind such investment is clear. These small companies tend to be managed by dynamic individuals who are savvy about the realities of the Russian market and about government regulation and taxation. Their overhead is low and their expenditures are easily monitored in comparison with larger factories remaining from the Soviet era, making due diligence background checks easier and more reliable. All of these things limit the business risks investors face.

Yet investment by American and other Western firms in Russian spin-off companies carries with it a set of negative political consequences for future Russian relations with the West which the foreign firms are unlikely to recognize. These political costs are unlikely to affect Western investors directly in the short term, since they are not reflected in the cost of doing business with any particular partner. Instead, they have begun to hurt investors in the long term by engendering distrust of Western motives (and of capitalism in general) among the Russian population as a whole.

Spin-offs are usually headed by mid-level or senior managers from old Soviet-era enterprises. This is not a coincidence. These are the only individuals who have the connections that are necessary in today's Russia to get a new business off the ground. The fact that real estate is at a premium means that local and provincial government agencies profit from making permit and licensing procedures for new businesses as byzantine as possible, increasing both the opportunity and the necessity to use connections to get a new business up and running. Since most of the agency personnel are hangers-on from the Soviet era, this means that managers who engaged in the economic bargaining typical of the Soviet era are the ones who are most likely to have those connections.

Furthermore, the paucity of available rental space often means that startups use the space and equipment of the old Soviet-era enterprises for their operations. In turn, this means that new businesses have to obtain the cooperation of large-enterprise managers in order

to succeed. Who better to accomplish this than a long-standing colleague from within the enterprise fold? Most of these old enterprises are technically bankrupt, but have been kept afloat anyway to avoid the local social consequences of mass unemployment.

Spin-off managers then select--either from their own friends and acquaintances, or from the workers they knew from their Soviet managerial days--whom it is that they want to employ. While this is perfectly reasonable from a business perspective, in practice it means that managers are being discriminatory in their hiring, and are leaving the vast majority of the old enterprise workers behind. Since there has been a huge outflow of talented workers from these enterprises, those left behind are also usually those least employable in the new economy, either because they lack marketable skills, or because of the rampant hiring discrimination practiced in Russia today against women and against workers over age 35. These unwanted workers then see the spin-offs using their floorspace to make large profits, while they themselves are suffering from unpaid back wages and poverty.

The collectives representing the remaining enterprise workers get especially angry when the spin-offs are being run by people who are simultaneously keeping their jobs as mid-level managers at the large enterprises. This dual employment is often necessary because senior enterprise managers want to keep the spin-offs "in the family," giving them the power to extract as many resources from the spin-offs as possible. Many dozens of cases have been reported in the Russian press throughout the reform era of enterprise labor collectives complaining that "their" resources are being "stolen" and used for private businesses that give them no benefit, but just line the pockets of their managers.

Local press reports document disputes regarding spin-offs at a wide variety of enterprises, including those that have attracted Western investment. One especially worrisome example is that of the All-Russian Scientific Institute for Experimental Physics (VNIIEF), the defense nuclear research institute located in the closed town of Sarov (formerly Arzamas-16). VNIIEF state funding has plummeted, but for those who work there finding another job is difficult given the distance of this closed town from major population centers. Many employees have apparently survived primarily by turning to subsistence farming on their dacha plots. In this situation, the VNIIEF labor council accused institute managers, who constituted around 5% of the overall workforce, of profiting as individuals from spin-offs that were at least partially funded by the institute budget. Somewhere around 20% of the institute's workforce was said to be employed in spin-off positions; while this provided jobs for a large percentage of institute employees in hard times, it left 80% of the workforce on its own. Managers' wages were reported to be huge compared to the available pay of the employees left behind, and the labor council complained that spin-off profits came from using institute resources (ranging from electricity and office space to computers and intellectual property) without just compensation being paid. A VNIIEF financial manager confirmed in an interview that many of these accusations were valid, but argued that in desperate times, it was more important to help as many people as possible use their skills for profitable employment than to ensure that rules were followed precisely.

The US government has recently targeted VNIIEF as a key investment site in order to stem a possible brain drain of nuclear scientists to rogue foreign countries. These investments will likely be centered on high-tech VNIIEF spin-offs. Given the background social conditions at VNIIEF, this means that US national security interests in preventing nuclear proliferation will likely come into direct conflict with the US national interests in encouraging Russian political support for the creation of webs of economic ties with Western firms.

When these spin-offs are run as joint ventures, this means that the remaining enterprise workers may start blaming foreigners and outside capitalists for their economic problems. In turn, this may increase popular support for the Communist Party and other movements who woo workers with promises of protectionism, economic nationalism, and a return to the days of the Soviet social safety net. The cost of this to foreign investors is visible in the events of September 1998, when a swing to the left in economic policy control aggravated Russia's currency crisis and overall sense of economic instability.

While no easy solution presents itself, the political consequences of American investment in spin-off enterprises should at least be considered an externality of doing business in Russia. Foreign investors who are made aware of the problem can take action on the ground to reach out to enterprise employees who resent the success of the spin-offs, perhaps by directing charitable contributions or employee volunteer work in their direction. In particular, this kind of activity might be made a requirement for the receipt of US government investment assistance in Russian spin-off companies. That way the United States can ensure that its combined goals in Russia--aiding economic stabilization to prevent the rise of authoritarianism, curbing the defense-related brain-drain to prevent technology proliferation, and supporting a friendly, liberal-democratic political regime to prevent the emergence of a new Cold War--do not come into conflict with each other.