TITLE: A Defense Sector in Disarray: Challenges to Russian Defense Enterprises

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THE NATIONAL COUNCIL FOR SOVIET AND EAST EUROPEAN RESEARCH

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Synopsis

The hard political and economic times in the Russian Federation today affect no institution more acutely than the defense industries. At the same time that defense enterprises have experienced a dramatic drop in demand for defense production, they have been forced to fend for themselves in an extremely hostile political and economic environment. At the heart of the defense sector’s problems is the continuing crisis in the economy and the Russian Federation government’s efforts to restart the economy through marketization. From this spring four critical problems for defense enterprise managers:

1. **A Dramatically Reduced Priority for Defense in the Russian Government.** Defense production, one of the highest priorities of the Soviet leadership, has fallen to the bottom of a long list of investment priorities for the Russian government. And the resources that the Russian government is willing to commit to defense will be devoted not to real defense investment, but to conversion or the paying of worker salaries.

2. **Limited Alternative Sources of Investment.** Without orders and resources from the government, the sources of investment for defense enterprises are few. Local banks cannot offer affordable loans, foreign investors have been scarce, and there have been few opportunities for arms sales abroad.

3. **The Organizational Legacy of the Command Economy.** Defense enterprises and their managers are poorly organized and positioned to make a transition to more market-like economic conditions. Many of the inefficiencies and dysfunctions of the Soviet command economy persist in Russia: in particular, supply and demand information is difficult to obtain and it is hard to create new commercial relationships. There is enormous excess capacity in the defense sector, and the average defense enterprise is a large, unwieldy organization that has little chance of being economically self-sufficient. Moreover, many defense managers lack the managerial experience and initiative to operate effectively under new conditions. Those managers that display initiative seem to be inclined to get out of defense production.

4. **The Defense Industries Cannot Look to the Ministry of Defense for Help.** Ironically, the Russian Ministry of Defense currently is a competitor for resources with the defense industries rather than an ally. The Defense Ministry is confronting several institutional crises of its own that take precedence over the state of the defense industrial base.

Under normal conditions, any one of these problems would pose a major challenge to the institutional health of the defense sector. Taken together these problems reinforce one another and threaten the continued survival of most defense enterprises. The means by which defense managers are coping with these challenges will be discussed in a follow-on paper to be distributed in a few days.
A Defense Sector in Disarray:  
Challenges to Russian Defense Enterprises

Kevin P. O'Prey

The hard political and economic times in the Russian Federation today affect no institution more acutely than the defense industries. In fact, in the process of transition between the old Soviet and the new Russian system, arguably only the Communist Party itself has had to endure a comparable loss in institutional wealth and political influence. The demand for defense output has dropped precipitously at the same time that defense enterprises find themselves confronting the increasingly chaotic economic, political, and social environment caused by the break-up of the Soviet Union and the Russian Federation’s attempts to build a new market economy.

These issues raise a number of questions with implications for future Russian security as well as the success of economic reforms. Most importantly, what obstacles confront Russian defense enterprises in the tasks of reconstituting a viable defense industrial base or affecting a real conversion of defense resources to the needs of the civil economy? In this paper I consider the conditions under which Russian defense enterprises are operating and the myriad of problems that they confront. In a second paper to follow I assess the means by which these enterprises have adapted, and evaluate their likely impact on the future of Russian security and political-economic reform.

The Economic and Political Environment

Managers of defense enterprises and design bureaus in Russia today are confronted with a hostile political and economic environment. Ironically, any one of the problems
described below would pose major challenges to the institutional health of the defense sector. Taken together these problems reinforce one another and threaten the continued viability of most defense enterprises. The driving force in all of this is the continuing economic crisis and the Russian government’s efforts to reenergize the economy through marketization. Following from this are four problems for defense managers: the low priority of defense spending in the Russian government, limited alternative sources of investment, the organizational legacy of the command economy, and the lack of political support from the Ministry of Defense.

Problem #1: Dramatically Reduced Defense Priority

At the heart of defense enterprise problems today is the primacy in the Russian government of economic recovery and related goals over security concerns. In contrast to the Soviet period, the Federation government neither has the resources nor the inclination to support a large defense sector. Defense is on the government’s list of priorities for the 1993 budget only insofar as it entails the conversion of defense enterprises to civil production and reducing the number of military plants. Even then, the defense conversion task ranks in importance behind investment in the energy, food, and transportation sectors.

Still worse for defense enterprises, not only is the planned 1993 defense budget very small relative to the budgets of the Soviet years, but the emphasis of the defense budget has shifted from building weapons to housing and feeding soldiers: only 10 percent of the budget is allocated to weapons procurement. The resulting cuts in weapons production by the defense sector have been enormous: following a drop in procurement of 50 percent during
the 1990-1991 period, procurement orders reportedly have declined another 67 percent during 1992.\(^4\) Research and development funds for defense design bureaus and research institutes reportedly were slashed by 40 percent in 1992.\(^5\) And although the defense industrial sector has been successful on a number of occasions in arguing for increases in the allocation of emergency resources to struggling enterprises and design bureaus, these government grants have been no more than life support to help pay salaries and provide for social benefits, not to maintain production.\(^5\)

**Problem #2: Limited Alternative Sources of Investment**

In the absence of state orders, the sources for financing defense enterprises and design bureaus are few. The nascent market economy is neither developed adequately nor strong enough to provide even innovative enterprises with sources of investment. Although a new network of commercial banks is developing, their interest rates are prohibitively high.\(^7\) Moreover, the much hoped-for wind-fall from weapons exports has not panned out as the demand for Russian weapons on world markets has been weak.\(^8\) The foreign investment picture has been no better. Given the declining economy and uncertain legal environment in Russia, foreign investors have not been clamoring to form joint ventures with or to invest in Russian enterprises.\(^9\)

**Problem #3: The Organizational Legacy of the Command Economy**

Beyond the need for finding their own investment, defense enterprises and design bureaus that recently operated in a highly stable, planned economy now must survive in an
extremely chaotic environment. In particular, while the government largely withdrew itself from the planning and management of micro-economic decisions in industry, a normal market has not yet developed to replace these functions. The sources of market information available to defense enterprise managers are generally quite limited. As a result, when an enterprise director is confronted with a shortage of supplies, finding a new, reliable source of resources or components can be a daunting task. In a telling example, in September 1992 the deputy commander of the Russian Strategic Rocket Forces expressed concern that enterprises producing for his service had lost over 40 percent of their suppliers.10

This situation is exacerbated by the fact that the grossly inefficient planned economy has provided a poor basis on which to build a market. For example, the manager of a Chelyabinsk defense plant complains that his existing production task relies on over 40 enterprises for supplies of component parts.11 Because key supplies often were produced by only one or a small number of plants, this manager was extremely sensitive to disruptions at far-flung enterprises. If a manager in any given plant chose to ignore his previous orders or contracts, it would almost inevitably cause a considerable cascade effect of unfulfilled orders throughout the taut supply networks. In order to develop new products, the Chelyabinsk manager must now establish new supplier relationships despite the shortage of information about who produces what. These problems are obvious to American participants in recent conversion conferences in Russia: whereas in the past, Russian and Soviet defense industrialists were eager to make contacts with Americans for foreign investment purposes, they now seem more interested in meeting each other to find out who produces what and is willing to trade.
Another major problem confronting defense enterprise managers is their own corporate culture. In particular, decades of managerial experience with meeting production targets and incremental adaptation of design has left managers ill-prepared for the initiative that market conditions will require. For example, efforts by the St. Petersburg government to coordinate regional conversion and defense production efforts foundered when few of the defense managers could come up with any ideas for new products. In many cases, defense managers have engaged in problematic efforts to derive commercial applications from military products. The ship-building industry has developed commercial concepts like submarines with windows for an anticipated tourist market as well as anti-submarine warfare acoustic sensors refitted for supposed use by logging crews to locate logs that have sunk in rivers.

Defense enterprise managers are also entering the market encumbered by enormous structural constraints. Not only is the defense sector generally over-capacity, but like state owned industries in other former communist countries, Russian defense plants are generally too large and unwieldy to compete effectively in the new environment. In contrast to defense plants in the U.S., Russian enterprises generally are responsible for a wide range of social services for their employees. A Russian enterprise usually provides housing and health care to its employees, as well as builds and maintains the infrastructure in its area. Coupled with a staff of employees that in many cases is measured in the tens of thousands, the average Russian defense enterprise can make Chrysler look like a lean and mean competitor.

Finally, it appears that there are a number of substantial disincentives to defense production. In fact, many defense enterprises are seeking to move away from defense
production to more lucrative commercial work.\footnote{Since late in the Gorbachev period, enterprises have had incentives to develop new products because the enterprise manager could set his/her own price for the output. This is even more so the case now that enterprises have become largely autonomous from the state. Defense production, however, continues to be subject to controls on the price of output and the profit levels that enterprises may demand.\footnote{Defense producers are further squeezed by the high rate of inflation: Because the government allocates tasks and prices at the beginning of the year and apparently does not adequately take inflation into account, an enterprise will be paid in January rubles for the tank that it produces in September. The enterprise, therefore, is forced to absorb the costs of over 1,000 percent annual inflation.}}

Although virtually all defense industries are facing these conditions, it is clear that there are significant variations in how different sectors are coping with them. In terms of enterprises seeking to convert their defense specialties to civil applications in the St. Petersburg region, for example, missile builders have had the worst time because of the difficulty in adapting their huge shops and finding customers. Enterprises involved in ship building have been able to convert more easily because of a flood of orders for components. The metal processing sector apparently has had the least difficulty of all.\footnote{It is also possible to differentiate between enterprises and design bureaus. Because the latter do not require vast resources to stay in operation -- R&D is generally cheaper than production -- arguably they have had to endure less stress than the more unwieldy enterprises.}
Problem #4: No Friends in the Military

Oddly, Russian defense enterprises cannot look to the Ministry of Defense for much support in their time of trouble. Given the social, political, and economic turmoil in the Russian Federation and the CIS, the Ministry of Defense is today confronting a number of institutional crises that take precedence over more strategic concerns like the stability of the defense enterprises. Indeed, Russian Ministry of Defense efforts to provide housing and salaries for the uniformed military, to keep active forces and equipment in a somewhat ready state, to staff the personnel slots of the newly formed ministry, and to protect Russian forces in zones of conflict throughout the CIS all seem to be priorities ahead of the defense industrial base. Within the ministry, only the civilian deputy minister, Andrey Kokoshin, and his small staff have made any statements regarding plans for the defense industrial base. Moreover, these statements suggest that future Ministry of Defense priorities will be the development of dual-use (defense-civil) technologies in order to aid the progress of the larger economy, rather than high technology defense tasks. In any case, Kokoshin’s influence on the ministry leadership -- the so-called "Afgansty," officers who developed close ties in the Afghan War -- is apparently limited.

Nor is it likely that the Ministry’s concerns will turn profoundly to the defense industries in the near- to medium-term. The Russian military currently possesses more weapons stocks than it needs. Foreseeable security threats to Russia, furthermore, involve lower intensity conflicts with CIS neighbors or ethnic groups, rather than the traditional high-tech threat from the West or the multi-million man Chinese Army. Finally, there is probably little love lost between the uniformed military and the defense industries. During the
Gorbachev period, Soviet Army officers increasingly complained that the defense industries had for many years been supplying them with weapons that did not work or that they did not want. Gaining control over the procurement budget, therefore, has been a Soviet-Russian Ministry of Defense goal for some time, so it is not surprising if the military does not try to help the defense industries in the near-term.

The economic, political, and social conditions in the Russian Federation today clearly pose a major threat to the continued viability of the majority of defense enterprises. Nor is this environment particularly conducive to an effective conversion of defense resources to civil needs. The institutional responses of Russian defense enterprises will be considered in a subsequent paper, to be distributed in a few days.
Notes


3. During the Soviet period, the procurement budget, which went to industry, was a separate account from the defense budget, which went to the Ministry of Defense. The U.S. Department of Defense estimated that even after sharp cuts, during the Gorbachev period procurement accounted for almost 40 percent of Soviet defense resource allocation. See U.S. Department of Defense, Military Forces in Transition: 1991, (US GPO, 1991).

   All procurement and military expenditures now appear to be in the same budget.


   In an indication of the relative non-priority of defense procurement, the 1992 allocation for financing conversion projects is approaching the size of the armaments budget. The figure for 1992 federal spending on conversion is 124 billion rubles. By comparison, the 1993 procurement budget is only 170 billion rubles. See Speech by Yegor Gaydar to the Supreme Soviet session on September 22, 1992 from the "All Russian Federation Supreme Soviet" program, Moscow Russian Television Network, 2000 GMT, September 22, 1992 in FBIS-SOV 92-186, pp. 25-35.


6. See, for example, the September 1992 Russian Federation government allocation of subsidies to the defense sector described in Ivan Ivanov, Itar-Tass, September 7, 1992, 0903 GMT in FBIS-SOV 92-174, p. 23.

8. In the odd cases where deals have been secured with foreign governments for sales of Russian weapons, the agreements appear to have been in part subsidized by the Russian government and do not include hard currency payments. For example, in the September 1992 sale of MiG 29 fighter aircraft to India, the Russian government promised to provide India with credits totalling approximately $830 million. See Interfax, 1454 GMT, September 17, 1992, reprinted in FBIS-SOV 92-182, pp. 9-10. In an earlier accord with the Indian government, the Russian Federation agreed that India could pay for its arms purchases with rupees, with which the Russians subsequently would be obligated to purchase Indian goods. See Nikolay Paklin, Radio Rossiya broadcast, 1100 GMT, March 26, 1992 translated in FBIS-SOV 92-060, p. 22.

9. Foreign investment to date is avoiding the defense sector, sticking to more likely growth industries such as communications, services, and mining. See "Interfax Business Report," Interfax in English, 1657 GMT, July 6, 1992 via Kyodo in FBIS-SOV 92-131, pp. 30-31.


15. For example, the cost of a BMP-3 fighting vehicle inflated by more than ten times between 1991 and June 1992. According to observers, however, the Russian Federation Ministry of Finance is slow to take account of this inflation and Ministry of Defense cannot afford to absorb the cost. See Oleg Vladykin, "Novaya armiya so starym oruzhyem. Nuzhna li Rossiy takaya perspektiva?" [A New Army With Old Weapons. Is This the Kind of Prospect Russia Needs?], Krasnaya Zvezda, August 19, 1992, p. 1.
