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“U.S.-Russia Economic Relationship:  
Implications of the Yukos Affair”

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### **Issues in the U.S.-Russia Economic Relationship**

1. My comments on the U.S.-Russian economic relationship will focus on the business climate in Russia, which exhibits some specific features that are important to understand. First, however, it is important to be realistic about what is at stake when we talk about U.S.-Russian economic relations.

#### **The U.S. Stake in the Russian Economy**

2. The direct US stake in Russia's economy is small. As a place to sell our goods, or a place with such exceptional advantages of cost, quality, and so on that we want to use it as a place to produce, Russia for the most part is close to marginal for American business as a whole. There are, of course, some exceptions, some specific industries and markets, that are highly important for US companies. To take one such example, Russia is the single biggest market for chicken in the world, outside of the U.S. itself. Russians consume 25 percent of all chicken exported by American producers.
3. The truly important part of the Russian economy that matters for the outside world, including the United States, is oil and gas. This is a complex topic and must be treated separately. Other than oil and gas and some other primary commodities, most of the Russian economy is not internationally competitive. Because the portion of the non-oil economy that is capable of participating in the international economy is so small, and because Russia is so far away from us, it is not surprising that the Russian market is not very significant for the U.S. economy.
4. We sell less of our products to Russia than we do to the Dominican Republic. In numbers, this means Russia accounts for less than half of one percent of total U.S. exports. Until quite recently we committed even

less of our money. For most of the past decade and a half since the fall of the USSR, our direct investment in Russia constituted about less than one-tenth of one percent of total U.S. direct investment abroad. (Again, countries like Dominican Republic or Costa Rica are good comparisons.) This has recently changed, however. Like so much else about the Russian economy, the reason for the change lies in oil and gas and the way the wealth from those industries has trickled down into the entire economy. From individual households to government coffers, many parts of society have benefited.

### **A Reversal of Financial Fortune**

5. The most dramatic change has been in the area of state finances. Here we have witnessed one of the most dramatic reversals of fate in recent economic — and geopolitical — history. In 1998 Russia was a country so impoverished and whose meager finances had been so mismanaged that it was essentially bankrupt. It was so depleted of foreign reserves that denial of a bail-out to the tune of \$15 billion or so could bring down a government.
6. When Vladimir Putin assumed the post of prime minister in August 1999, the country's foreign reserves were down to under \$8 billion and falling. By October, they were at \$6.6 billion. Meanwhile, Russia's debt to the International Monetary Fund was \$16.6 billion. Russia was thoroughly bankrupt and practically in receivership.
7. Fast forward now to this past summer. In August 2007, Russia's foreign reserves were well over \$400 billion. In addition, it had another \$130 billion in its so-called oil stabilization fund. (The IMF, in the meantime, had total lendable funds of less than \$250 billion.) Right now, the Russian government continues to add cash to the foreign exchange reserves and stabilization fund at a rate of \$170 billion a year.
8. Russia has thus come a long way since the days when it was desperately dependent on the financial largess of the West. Indeed, as holder of one of largest current account surpluses in world, it is one of the biggest financers of the U.S. current account deficit.

### **The Two Pillars**

9. The explanation for the reversal of fortune is hardly a secret. The Russian economy rests on two pillars: oil and gas. In exactly the eight years of Putin's tenure, the value of those commodities has soared. The increase in wealth flowing into Russia from oil and gas is staggering.
10. Consider the income from one component alone — crude oil exports. Roughly eight and a half years ago — on February 11, 1999 — the price of Urals oil was less than \$9.00 a barrel. Russia was producing barely 6 million barrels a day. Today, the price is \$87.00, and Russia produces

- nearly 10 million barrels a day. Almost every drop of the increased output has been shipped abroad to the world market. Look at the difference. In the first three months of 1999, crude oil export revenues totaled barely \$2 billion. Right now, Russia earns that much in crude exports in less than a week.
11. People say: "But there's more there than just oil." Indeed, there is — more and more each year. The pillars support more. The visual image is a platform resting on the pillars I mentioned. Piled on that platform, higher and higher, is business activity in retail, wholesale, consumer goods, construction, real estate. This is the "non-oil economy."
  12. So, yes, Russia's non-oil sectors are growing as a share of the total economy. Is oil then becoming less important for Russia? No. It is just the opposite. Oil becomes more important, because more businesses and more jobs depend on the flow from oil and gas.

### **How the System Works: Formal Taxes...**

13. Because this oil boom has coincided almost precisely with Putin's tenure as Russia's president, it is tempting to attribute all the economic success of his regime to world oil prices. And yet this would not be quite correct. Putin was graced with a windfall of gigantic proportions, true. But it was his achievement — his greatest achievement — that such a big share of the oil windfall was collected to the central government. Through an early and thorough overhaul of a dysfunctional tax system, Putin ensured that government, especially the federal government, collected the wealth needed to realize his stated goal of building a "strong state."
14. To illustrate the increased flow of oil wealth into Russia, I just now cited the dramatic increase in crude oil export revenues. But what is supporting the economy is more than just crude and more than just the cash earned from selling it abroad. It is the total rent from oil and gas.
15. This rent — popularly referred to as excess profits or windfall — is the aggregate market value of these commodities (whether exported, or even sold at all, at the market price) less the normal costs of extraction, including a normal rate of profit. The single most important thing to know about the Russian economy is how this total rent is distributed, or shared, throughout the economy. To understand this, one needs to look below the surface of the formal Russian economy.

### **... and Informal**

16. In theory, Russia's new oil stabilization fund is supposed to absorb the oil and gas windfall. In fact, because the fund is based only on income from oil exports — while Russia's oil and gas rent is much greater than just oil export revenues — the stabilization fund last year absorbed only about 14 percent of total rent.

17. The rest? It is distributed throughout the economy in other forms to different claimants. The owners of the resource companies — the oligarchs — keep a healthy amount as profits. Some of the rest is collected by government in taxes other than those that go straight to the stabilization fund. But an important part of the rent is distributed by the mechanism of “informal taxes.” These include price subsidies (on natural gas, not oil — very little oil is sold at subsidized prices), to bribes, kickbacks, and “voluntary contributions” to especially local governments.
18. The most important type of informal tax, however, is excess costs of production. Oil and gas companies order equipment and other inputs from local manufacturing enterprises, even if the products are not competitive. Such orders sustain activity at these local enterprises, which also means jobs, incomes, and tax revenues for local budgets. In other words, by placing the orders, the resource companies share some of the rents locally.
19. It is obvious why the recipients of the shared rents find this system attractive. But why do the original owners of the rents share them? The answer is that they have to. This is implicit in the word “taxes.” When I say that these are “informal” taxes, I mean that they are not prescribed by formal laws. In practice they are just as mandatory. Writing about the so-called voluntary contributions by businesses to local government “infrastructure funds,” “social funds,” and the like, one Russian scholar used the term “mandatorily voluntary.” The same goes for the excess costs. They are all mandatory in the sense that failure to pay them exposes the owner to serious risks.
20. Another term for what is going on is “protection racket.” In a protection racket, there is a threat against which someone offers to protect you. The catch is that the threat emanates from the protector himself. Here, the threat is the loss of property rights. Sharing rents locally is one way to pay the protection money. There is also a national version of the protection racket, designed primarily for the very largest companies. At that level the “payment” may be different. Companies are expected, for instance, to pursue certain policies in their foreign activity that further the geopolitical interests of the Russian state, even if they sometimes don’t quite make sense from a strict business perspective. In either case, local or national, the principle is the same: if you haven’t kept current on your protection payments, you won’t have friends when the threats mount.
21. It is very important to recognize the informal rent-sharing. This is the part of the iceberg that lies below the surface. That’s the part that is hidden, and the part that tends to be larger. It’s the part that can cause shipwrecks. One victim of the hidden iceberg was YUKOS. Khodorkovsky miscalculated. He refused to pay the excess costs. He tried to be a cost-minimizer (profit maximizer) in a system that dictated that he be a cost-maximizer.

## Putin as Rent Manager

22. In any protection racket, the person who threatens you and the person who offers to protect you from the threat are one and the same. The protection racket in Russia that I've described is one in which the contrived threat is the loss of property rights. Who then is the protector? Who is it in Russia that has the ability to credibly threaten the property rights of even the biggest companies in Russia? It is Mr. Putin. He is the chief protector. He is the overseer of the protection racket. More broadly, he oversees the entire rent sharing system.
23. The oil and gas rent gave Putin the power to achieve his main objectives: strengthening the state and maintaining social stability. However, the mere existence of the rent was not enough. The rent had to be managed. That required skill and purpose. In his capacity as manager of the rent, Putin has done three things and done them very well from the vantage point of his own goals. First, he has managed the collection of the rent. Second, he has defined priorities for the use of the rent. Third, he has managed the actual process of rent sharing.
24. (1) Collection: His management of rent collection spans both the informal and formal rents. Putin inherited a large and unwieldy system of informal rent sharing that my colleague Barry Ickes and I described as "Russia's Virtual Economy." Rent was distributed informally and mainly locally. Putin reformed this system. In fact, he continued and perfected reforms already initiated in the late Yeltsin era. While he permitted much informal rent sharing to continue, his main priority was to formalize and centralize rent collection. He collected the rent to the Center through formal taxes.
25. (2) Priorities: Putin defined clear priorities for the use of the formal rent. One main use has been to re-establish Russia's sovereignty. He learned a big lesson from the Gorbachev and Yeltsin experience. Putin's macroeconomic and fiscal stability measures have been exemplary. His number one goal was to get rid of the public foreign debt. Obsessively, he paid off Russia's entire remaining debt to the IMF in January 2005 — three and half years ahead of schedule. He did a similar thing in August 2006 with the Paris Club debt, retiring some \$23 billion.
26. (3) Manage the process: The third thing Putin has done is to successfully manage the rent sharing process itself. This is important because of the inherent tension in rent sharing. If not kept under control, it could tear the country apart. Putin kept the old protection racket that had been run by regional officials and elites. But he brought it under his central control. He made sure that governors would see their primary task as enforcing centralized rent collection. This was the reason for his reform of the political system with direct appointment of governors. Putin needed governors to serve as "regional rent managers" within a national structure of "Russia, Inc."

27. Putin's model for managing Russia, Inc. comes from his study, beginning in his KGB days, of the concept of "strategic planning." His 1997 dissertation for a graduate degree in economics focused on that theme. Under his scheme, Putin plays the role of chief executive officer of Russia, Inc. He manages the organization on the strategic level. Others — his "division managers," some of whom we know as oligarchs, others as governors — implement the strategic directives within well-defined bounds.
28. The rent-management model helps us understand why discussions of state versus private ownership in today's Russia can be confusing. Renationalization is not necessarily an objective for Putin. In his scheme, what is important is not who has formal (legal) ownership of a company — property rights are always contingent in Putin's model — but rather who controls the rent flows, to what ends.
29. Secure control of rent flows by players loyal to the Kremlin is essential, regardless of whether the company in question is privately owned or state owned. As discussion of the protection racket shows, private ownership of a company is not necessarily an obstacle to its performing its function in the rent sharing system. Conversely, state ownership alone may not be enough to ensure that the rents are properly distributed. There must be loyal agents in the right positions in those state companies.

### **Doing Business in Russia: Knowing the Rules**

30. The system I have described provides for a very specific business climate that places extra burdens on any company, but especially foreign companies.
31. In any investment situation, business wants the highest possible returns and lowest possible risks. Russia is a place where returns are high, and there is good reason to think they will continue to be high. However, the risks are high as well.
32. As in any country, Russia has two kinds of risks for businesses. One type of risk is inherent to any market. This is competitive risk, that is, the risk that companies may, for instance, have misjudged customers' tastes and their own ability to compete. It therefore depends on the companies' own abilities and those of its rivals.
33. The second type of risk, usually referred to as political risk, relates to the institutional or environmental factors that impact the security of the investor's property rights. The investor asks: Will the money I commit and the earnings I make be secure from appropriation by other parties — criminals or the state?
34. The discussion above about informal taxes suggests a first specific feature of political risk in Russia. Just as failure to pay formal taxes in any country exposes the company to penalties, including possible loss of property,

nonpayment of informal taxes is risky in Russia. The difficulty is to know exactly what is expected. In contrast to formal taxes, informal taxes are not prescribed by law and specified in detail. They may be highly discretionary. The informal taxes — and therefore the property rights that are contingent on paying those taxes — depend on the judgment of individual political officials.

35. The implications of this fact for businesses are profound. It means that success on the Russian market depends not just on the amount and quality of your company's physical capital (machines and equipment), on the abilities of its work force and management, but also on your connections with the right people — what can be termed your “relational” capital.
36. The point of referring to this as relational *capital* is that it can be accumulated. You can invest in it. This, however, is bad because it diverts scarce time, effort, and money away from investment in the other factors of production. (For American firms it may also have them run afoul of laws here such as the Foreign Corrupt Practices Act. Although that is not certain: many, if not most, of the practices would not fall under FCPA.) But if you don't invest in relational capital, you will be at a competitive disadvantage.

### **Lowering the Costs of Business in Russia**

37. Knowing that you must pay informal taxes and invest in relational capital, knowing what those informal taxes and how to pay them, how much to invest in relational capital and where (“in whom”) to invest — all this is essentially knowledge of the rules of the game in Russia. You cannot read these rules in a book. But they are knowable. And the costs they entail are calculable. For the business person, this is all that's needed to make a business decision. The business person weighs all the costs, the expected returns, and the risks. The businesses can and should make these decisions on their own.
38. U.S. businesses would of course like for the costs of doing business in Russia be lowered. Even more important, they want the competition be fair — they want a level playing field.
39. The need to pay informal taxes and invest in relational capital imposes extra costs on businesses. But is it a barrier to fair competition? That is not clear. It does seem that it is more difficult for outsiders than Russians to acquire adequate information about the rules of the game. But that can be overcome. One common way is to partner with a Russian company that already has the right contacts, knows the rules, and has the skills to play by those rules. (You acquire some relational capital, if you will.)
40. That leaves the question of whether the outside world can influence this system so as to reduce the cost of doing business. There is no magic bullet. Although it might seem that this is a straightforward case of

excessive corruption in a country, the Russian situation is not so simple and an anti-corruption crusade might not be as desirable as it might seem.

### Corruption in Russia

41. Although I have referred to a system that includes bribery, kick-backs, sweetheart deals, and rackets, I intentionally avoided using the term "corruption." The term is confusing. We are all against corruption. But corruption serves a purpose. We need to understand the purpose in Russia. The notion of rent sharing offers such a context.
42. Corruption is omnipresent in Russia. Some of the protection rackets are for personal enrichment; others are part of the system of rent sharing for the purpose of social stability (providing jobs and incomes), or for state interests. The fact that the same behavior can have different motivations reminds us of the classic observation by the journalist Yuliya Latynina when writing of theft in the Russian economy in the 1990s. It is a mistake, she wrote, to think that Russian enterprise directors are divided into those who steal and those who don't steal. They all steal. It's just that some steal *from* the plant and others steal *for* the plant. That is, in the later case, their theft helps keep the plant alive and thus preserves jobs and incomes for workers.
43. Latynina was writing during the pre-oil boom era of the 1990s. But it's very much the same today. From the standpoint of the manager of the rent sharing system and *all those who benefit from that system*, there is "good" corruption and there is "bad" corruption. Good corruption greases the wheels and broadens support for the system. Bad corruption allows personal greed to undermine the system. The job of the system manager (Mr. Putin) is to limit the bad corruption while encouraging the good corruption.
44. It should be evident that there might be a problem with an anti-corruption campaign in this context. The rent sharing system has millions of beneficiaries. You may conduct a survey to ascertain whether the Russian people are against corruption. When asked this way, it is like asking whether they like being ripped off, harassed, and humiliated by people more powerful than they. They hate corruption by that definition. But you will find a different answer if you ask, say, the thousands of workers at noncompetitive "dinosaur" manufacturing factories in Tomsk oblast' whether it was bad to demand that the YUKOS subsidiary Tomskneft' place orders with those plants, even though those orders were part of a local protection racket involving extortion, kickbacks, bribes, and other corrupt practices. Khodorkovsky said he was against corruption and refused to play that game. He made many enemies in Tomsk.
45. It all depends on who benefits from corruption, and to what purpose. Most people who benefit from the excess costs mechanism of rent sharing — a form of corruption — are ignorant of what is going on. They are involved in



- a form of what Gregory Grossman in the context of the Soviet economy described as the “loot chain.” At the bottom of the chain were a diverse group of individuals who shared some of the loot without necessarily being aware of where their income came from. Most did not see themselves as beneficiaries of corruption at all. On the contrary, they saw themselves as honest, hardworking people who deserved what they got. Today’s “rent chain” operates in the same way.
46. Moreover, an anti-corruption campaign is itself likely to be incorporated into the protection racket. Consider this: to operate a business in Russia, you’re forced to pay protection. If you do, you break the law. You are guilty of corruption. Your only recourse to avoid prosecution is to pay off the right people, to participate in another protection racket. It’s a classic Catch-22.

### **Will This System Last?**

47. Although Russia faces many challenges and pitfalls on the path to long-term sustainable economic development, its short and medium-term performance will continue to depend mainly on the volume of oil and gas rents and how they are used. If we therefore want to know whether the system I have described — Putin’s system — can outlive his term in office, we must ask two questions: (1) will world oil prices allow the rents to continue; and if so, (2) can a successor continue to manage the rents as well as Putin has done so far?
48. Let us look first at the oil price. A price of around \$60 a barrel or above for 2008 and beyond would provide Russia with a strong flow of rents. But then we must turn to the second question: how well can a successor manage the rents? One way to examine that is to recall my statement about Putin’s three great accomplishments: (1) he centralized collection of the rent; (2) he centralized use of the rents for strategic state purposes; and (3) he managed the tensions inherent in the rent sharing process itself. Of the three, the first is the most robust. Centralized rent collection — essentially, the formal system of tax administration and enforcement — has been institutionalized and should therefore endure. As for the use of the rents, Putin defined the priorities well. A successor is likely to stick with them. It is the third task, that of managing the rent sharing process, that is the difficult one. A successor must understand Putin’s concept of “Russia, Inc.,” subscribe to it, and be capable of putting it into practice. He cannot allow rent sharing to devolve into personal enrichment to the detriment of state interests. A fratricidal rivalry among the elites could threaten use of the rents for state interests. Here is where corruption is relevant. The bad corruption — venality — can take over. If that happens, Russia will not be nearly as stable as it now appears to be.