
Authoritarianism and Recentralization: 2004–07

Moscow was shining on a wonderful Indian summer evening. My good friend, Michael McFaul, took me along to Gleb Pavlovsky's private reception, the Kremlin's foremost political consultant. Everything was stunning. Pavlovsky had rented the Hermitage Theater and Park in central Moscow, entertaining 600 guests with dinner. Three orchestras played throughout the night.

The affluence reflected how profitable Kremlin politics had become. Pavlovsky himself was dressed in all black, a T-shirt under an Armani suit and round glasses, trying to look like Mephistopheles or Voland in Mikhail Bulgakov's novel *The Master and Margarita*, and quite successfully so. The composition of the guests showed how the elite had changed. The guests of honor were from the top of the presidential administration. Gone were the businessmen, elected politicians, and independent journalists, who had been replaced by bureaucrats and propagandists. The golden youth had taken over, and they were hardened cynics focusing on power and money. The Great Gatsby would have felt at ease.

This vignette shows how Russia had changed toward the end of Vladimir Putin's first term. Putin had tried to satisfy all kinds of constituencies to consolidate power. As Lilia Shevtsova (2005, 262) put it: "Putin was simultaneously a stabilizer, the guardian of the traditional pillars of the state, and a reformer. He was a statist and a Westernizer. He appealed to all strata in the society. . . ."

During his second term, however, Putin was going to show what he really stood for. The tipping point was the arrest of Mikhail Khodorkovsky, the

wealthiest oligarch, on October 25, 2003. The crusade against Yukos constituted the campaign for the Duma elections in December 2003 and the presidential election in March 2004, which enabled Putin to consolidate power.

By the fall of 2004, however, everything seemed to turn against Putin. In September 2004, a school hostage drama in Beslan ended in a horrendous massacre. Later in the fall, Ukraine's presidential elections turned against him and became the Orange Revolution. In January 2005, an attempt to reform the social benefit system caused unprecedented popular protests. Frightened, the regime halted all reforms.

Putin exploited these events to justify further centralization of power and deinstitutionalization and allowed his underlings to indulge in large-scale renationalization. His economic policy veered toward state capitalism and he condoned corruption among his KGB friends. Putin's foreign policy was upset by the colored revolutions in Georgia, Ukraine, and Kyrgyzstan, and his policy toward the West turned hostile.

The Yukos Affair: The End of the Oligarchy

The last time I saw Mikhail Khodorkovsky was in Washington nine days before his arrest at an airport in Siberia on October 25, 2003. With extraordinary elegance and force, Khodorkovsky spoke at the Carnegie Endowment, advocating liberal democratic and economic reforms in Russia without antagonizing its ruler. The question everybody asked was: Are you not afraid of going back to Russia? Khodorkovsky denied that, but the large, spellbound audience breathed in sympathy: You should be afraid! I sat down with Khodorkovsky and asked him to elaborate. As the ultimate Russian chess player, he replied: "I do not understand how they can win, considering how many mistakes they make." In my dark mind, I thought of Nikita Mikhailov's film "Blinded by the Sun" about the Stalin terror in the 1930s. The issue was not the number of mistakes, but pure power.

One week earlier, I had seen Putin speak at a business conference in Moscow, but he was delayed. Khodorkovsky was sitting in the center of the hall, and I was a couple of rows behind him. Suddenly, he picked up his mobile phone and rushed out. Then, Putin finally arrived. Later, I heard that Khodorkovsky had departed because prosecutors had raided a children's home run by his corporation, the Yukos oil company, as well as a school attended by Khodorkovsky's young daughter. The purpose of these raids seemed to be to get him out of the hall.

Putin read a stereotyped speech in favor of private business and foreign investment, which went down well. Only Western investors were allowed to pose questions, leaving journalists and Russians without a voice. Contemptuously, Putin poured scorn on Alexei Venediktov, the legendary head of the independent radio station Ekho Moskvy, refusing to accept any question from him. It was chilling.

The collision between Putin and Khodorkovsky was fundamental. It involved all the major issues of Putin's second term. Would Russia be democratic or authoritarian? Would it be dominated by state enterprises or private capital? Would it turn to the West or the East? Would Russia be ruled by law or by the vertical power of the Kremlin? Would civil society develop or would the authoritarian state prevail? All these profound questions were resolved through the Yukos affair.

Khodorkovsky had appeared to be the cleverest of all the oligarchs. A man of unlimited ability and adaptability, by 2003 he was the richest man in Russia with an assessed fortune of \$15 billion and more than 100,000 employees. His Bank Menatep had failed, and he had sold off most of his industrial conglomerate Rosprom, but from 1999 his team started turning around Yukos, which they had acquired in the loans-for-shares privatization. Khodorkovsky was the foremost example of the gentrification of Russian capitalism.

The Yukos affair is best understood if we scrutinize its origins. In October 1999, I was called to Yukos' beautiful city palace in central Moscow for a lunch with one of Khodorkovsky's deputies, Leonid Nevzlin, whom I had never met. His direct question stunned me: What should Yukos do to become respectable in the West? I answered that it had to make an amicable deal with its Western minority shareholders. Nevzlin objected that these shareholders posed completely unreasonable demands. I responded that Yukos had committed so many sins (share dilutions, low transfer prices, and giveaways to offshore companies) that it could not win in any international court. Their only plausible escape would be friendly agreements. Grudgingly, Nevzlin accepted.

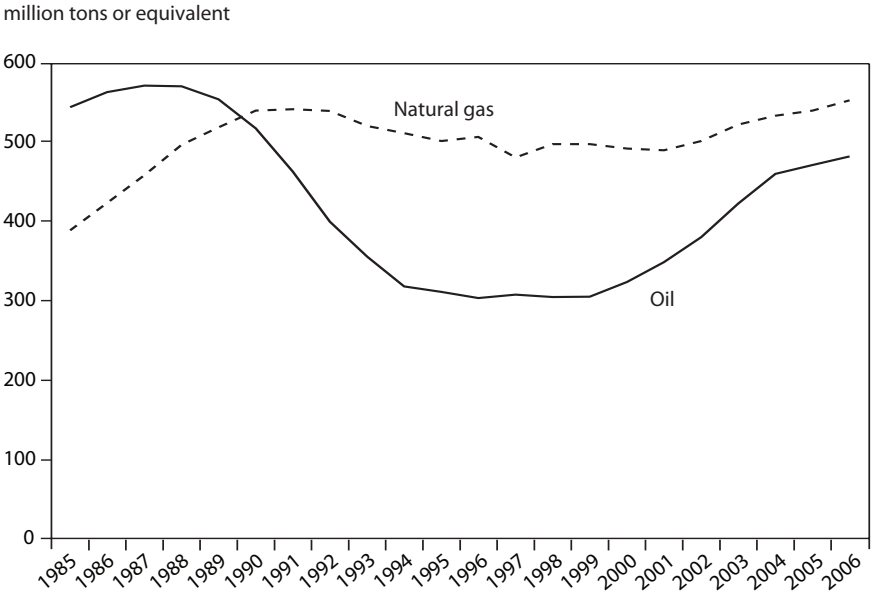
His next question was: What should Russia do to become respectable? I said that you cannot have a government in which virtually all ministers are corrupt and most massively so. You must sack a few senior ministers, sentence them to several years in prison, and keep them there. Nevzlin seemed to agree and asked: "Would Berezovsky be enough?" Admittedly, Berezovsky was no state official at that time, but I responded that it would be a good start. Suddenly, Nevzlin seemed relieved.¹

Two months later, Yukos settled with its minority shareholders and launched all conceivable reforms. It introduced corporate transparency, adopted Western accounting standards, hired Western top management, and brought in independent directors on its board. It used international auditors and international consultants to improve its business and image. The owners of Yukos revealed their actual ownership and their corporate structures. Yukos stopped using transfer prices and paid substantial taxes from 2000.

Yukos led the revival of the country's old brownfields drawing on international technology and expertise that boosted Russia's oil production

1. Personal notes from Moscow, October 10–14, 1999.

Figure 7.1 Oil and gas production, 1985–2006



Source: BP historical data, www.bp.com (accessed on June 27, 2007).

by 50 percent from 6 million to 9 million barrels a day between 2000 and 2004. Meanwhile, the state gas production was nearly stagnant (figure 7.1). Yukos was one of the greatest success stories in the Russian economy.

Khodorkovsky made high-profile charitable donations and set up the nonprofit Open Russia Foundation in 2001. He promoted civil society, democracy, transparency, the rule of law, education, and economic development in Russia. He pursued numerous campaigns. Initially, Khodorkovsky demonstrated how Yukos had increased production and efficiency, while paying its taxes. He proceeded to advocate the construction of a private oil pipeline to China and another to Murmansk at Barents Sea, which would break the state-owned Transneft's monopoly. He criticized state-dominated Gazprom for its inefficiency and advocated a bigger role for Yukos in gas, complaining that Yukos was forced to flare billions of cubic meters of associated gas because of Gazprom's refusal to grant Yukos access to its monopolized gas pipeline system. In 2003, he conducted advanced negotiations with ExxonMobil about selling a majority of Yukos.

On February 19, 2003, an incident occurred that many think sealed Khodorkovsky's fate. Putin held his annual meeting with a score of oligarchs. The topic was administrative reform and corruption. Putin declared that his aim was "to liquidate the very basis of corruption." "During the last two years, new laws were adopted to de-bureaucratize the

state apparatus. Unfortunately, so far we see no real improvement. . . . And today I would like to hear your views” (Putin 2003c). Khodorkovsky took Putin’s words at face value. As Russian television viewers could hear, Khodorkovsky brought up the state-owned oil company Rosneft’s purchase of the small oil company Severnaya Neft for \$600 million, suggesting corruption, because Severnaya Neft had bought its main concession for \$7 million two years earlier.

The talk of Moscow was that the Rosneft management, which was led by CEO Sergei Bogdanchikov and Putin’s closest aide, Rosneft Chairman Igor Sechin, had extracted an unprecedented kickback of \$200 million from the former owner of Severnaya Neft. Furiously, Putin explained that Khodorkovsky had no business to complain about corruption.²

Rosneft’s purchase of Severnaya Neft was the first example of a new model for Putin’s men to tap money from state enterprises. They realized they could pay high prices for private companies and ask for a substantial kickback. Putin’s explosion made the Moscow elite wonder whether he was part of the deal. In any case, he evidently knew and approved of it (Baker and Glasser 2005, 282–83).

In May 2003, a Moscow think tank, the Council of National Strategy, published a report called “Russia on the Eve of an Oligarchic Coup.” It accused the oligarchs in general and Khodorkovsky in particular of trying to buy Russia’s politics. Since this small think tank was close to Putin, its report was seen as a Kremlin warning to Khodorkovsky.

Oligarchs had long bought a few deputies each for their lobbying in the Duma. Usually, Gazprom had about 100 deputies of its own placed in different factions. In early October 2003, I heard the allegation that Khodorkovsky had put up \$100 million for the parliamentary elections, which should have rewarded him with about 100 deputies (out of 450). Khodorkovsky was financing the Union of Right Forces (SPS), Yabloko, and the Communist Party, receiving slots on each party list, but he was also paying substantial amounts to Putin’s United Russia. The going price for a safe seat on a party list was \$5 million, and the minimum was \$2.5 million.³ It was much cheaper to buy a seat in a single-mandate constituency because the average political campaign for one such seat cost \$500,000 to \$800,000, though seats in big cities were more expensive. Deripaska of Russian Aluminum was rumored to buy a similar number of seats, but in close cooperation with the Kremlin.⁴

2. Baker and Glasser (2005, 282). Private information from Moscow businessmen in March 2003.

3. My personal information in Moscow in early October 2003. Baker and Glasser (2005, 281–83) reported the same amount of \$100 million but 130 seats. They reported the price of a guaranteed seat as \$3 million to \$4 million.

4. Personal information in Moscow in early October 2003.

In early July 2003, the Yukos executive Platon Lebedev was arrested and, on October 25, Khodorkovsky himself. He could have stayed abroad, but evidently he trusted Putin's judicial reforms. The actual accusations were long nebulous, but eventually he was charged with tax fraud. Yukos was the largest private taxpayer in Russia, and only Gazprom paid more taxes. Yukos minimized its profit taxes by legally registering its companies in low-tax regions in Russia, but so did many other companies. Putin's favorite, Roman Abramovich, did it much more aggressively in Chukhotka, where Abramovich is governor. The authorities reopened audited tax returns and denied the legality of the tax shelters. Initially, they slapped Yukos with \$3.4 billion in back taxes, penalties, and interest for 2000. Then the biased tax authorities did the same for later years as well, ending up with the startling number of \$28 billion, most of which was penalties (Baker and Glasser 2005, 345).

While denying that he had instigated Khodorkovsky's arrest, Putin explained to Western visitors that it was necessary because Khodorkovsky was buying up Russian politics. Putin's actual key motive was to enhance his political control by jailing the most politically active oligarch, while some of his aides wanted to seize Yukos assets.

In the ensuing process against Khodorkovsky and Yukos, Russia's legal authorities violated every rule in the book. No credible legal tax case existed to begin with. The Russian authorities dismissed the first two judges because of their impartiality. The offices of several defense counsels were raided, and they were harassed and punished. All rules regarding arrest, confiscation, and communication were violated. Khodorkovsky was denied bail, which was otherwise customary in nonviolent cases.

In the end, Khodorkovsky was sentenced to eight years in jail and sent off to East Siberia. Many other Yukos employees were condemned to lengthy prison sentences on the flimsiest of grounds (Amsterdam and Peroff 2007). Yukos' main asset, Yuganskneftegaz, was sold off in a fire sale in December 2004 to an unknown shell company, Baikal Financial Group, in an uncontested bid for \$9.35 billion. This sale was premature; noncore assets did not go first as they should in an executive auction; no competitor was allowed; the bidder was a temporary shell company representing Rosneft; the sale price should have been about twice as high; and state banks financed Baikal's bid. The obvious purpose was to confiscate Yukos' finest oil field and give it to Rosneft. After the auction, Putin was the first to clarify that he knew who the owners of the shell company Baikal were.⁵ His economic advisor Andrei Illarionov called this sale "the scam of the year," which caused his ouster (Baker and Glasser 2005, 352).

In a series of public statements throughout this process, Putin continued to deny any involvement. On October 27, 2003, two days after Kho-

5. "President Putin's Remarks on Results of Yuganskneftegaz Auction," NTV Segodnya, December 21, 2004, Federal News Service.

dorkovsky's arrest, he responded to protests: "There will be no meetings and no bargaining over the law enforcement bodies and their activities, so long, of course, as these agencies are acting within the limits of Russian legislation. . . . Neither the executive authorities nor even the Prosecutor's Office can deprive someone of their freedom, even for the period of pre-trial detention. Only the court has this power . . . and before the court, as before the law, all should be equal" (Putin 2003a). Yet he ignored the repeated declarations of the Moscow Collegium of Lawyers that the prosecutors violated the procedural norms in the investigation against the Yukos managers (Rumyantsev 2003).

In early November, Putin declared that the state did not want to destroy Yukos: "I am categorically against re-examining the results of privatization. . . . This is why there will not be a deprivatization or a re-examination of the results of the privatization, but everyone will have to learn to live according to laws" (Putin 2003d). In Rome, he stated with implicit reference to Khodorkovsky: "Having made their billions, they spend tens, hundreds of millions of dollars to save their billions. We know how this money is being spent—on what lawyers, PR campaigns and politicians it is going, and on getting questions like these asked" (Putin 2003b). The last words referred to the French journalist who posed the question.

On June 17, 2004, Putin told reporters: "The Russian administration, government and economic authorities are not interested in bankrupting a company like Yukos . . . the government will try to ensure that this company does not go bankrupt."⁶ On September 6, he said: "I don't want to bankrupt Yukos. . . . Give me the names of the government officials who want to bankrupt Yukos and I'll fire them" (Belton 2004). On September 24, he reiterated: "We shall do this in strict accordance with the law. I want to stress it—in strict accordance with the law. . . . The state did not set before itself the task to nationalize this company or lay hands on it. And there is no such aim now . . ." (Putin 2004e).

In spite of his many unequivocal declarations to the contrary, Putin disregarded the law, successfully bankrupting and confiscating Yukos. He hardly ever said a true word about the Yukos affair. He insisted that the state must not interfere in the judicial process, but all the details indicated that prosecutors and judges received daily instructions from the Kremlin to be ruthless and lawless. He behaved exactly as he had done during the Gusinsky affair.

The Yukos case was Putin's most important political act, which framed his second term. In the summer of 2007, the last pieces of Yukos were auctioned off. Almost the whole of Yukos, which would now be worth over \$100 billion, ended up with Rosneft, a poorly managed and nontransparent state company. This was confiscation through lawless taxation.

6. Interfax, Tashkent, June 17, 2004.

Khodorkovsky and Lebedev are sitting in prison in East Siberia and have been maltreated in numerous ways. All Khodorkovsky's appeals for the application of ordinary judicial rules have been dismissed. The other major Yukos owners and many managers wisely fled abroad around the time of Khodorkovsky's arrest. With characteristic vindictiveness, Putin made no concession. This legal case made a joke of his judicial reform and the supremacy of the state was reinforced. Like the CPSU, Putin's Kremlin acts with impunity and cannot be taken to court. Putin has demonstrated his strong approval of this miscarriage of justice by promoting many of its protractors. Now, the Kremlin is preparing the prosecution of Khodorkovsky for multibillion-dollar money laundering.

Khodorkovsky's arrest changed Russia's political system. Both Putin's chief of staff, Aleksandr Voloshin, and Prime Minister Mikhail Kasyanov, who had belonged to the Yeltsin "family," protested Khodorkovsky's arrest. They were relieved of their duties soon afterward. All other oligarchs heeded Putin's warning and withdrew from politics. The Russian Union of Industrialists and Entrepreneurs lost most of its influence. Putin's KGB officers had won over the oligarchs.

Although the Yukos affair attracted considerable international publicity, no major government tried to defend its shareholders. Foreign investors' belief in Putin's declarations was so great that the Yukos stock price held up well for nearly a year after Khodorkovsky's arrest, but then it collapsed. The stock price vacillated sharply with prosecutors' public statements, suggesting that insiders speculated on the basis of these allegations (Baker and Glasser 2005, 346). Foreign investors, who were naïve enough to believe in Putin's words, lost billions of dollars, but the biggest losers kept quiet not to reveal their folly to their shareholders. Russia's stock market took a break in 2004, but then it surged again.

Senior US officials intervened once—in October 2004—but only to say that they feared that Russia's oil production would decline during the then expected confiscation of Yugansk. Instead of condemnation, on October 18, 2004, US Secretary of State Colin Powell uttered his forceful support for Putin: "The Russian people came out of the post-Soviet Union era in a state of total chaos—a great deal of freedom, but it was freedom to steal from the state and President Putin took over and restored a sense of order in the country and moved in a democratic way."⁷ Amazingly, Western governments accepted the confiscation of billions of dollars of their citizens' assets.

The Yukos affair also changed Russia's economic policy. The once-promising tax reform had become a joke as well. After all, the accusation against Yukos was that it followed the letter of the new tax code and utilized one of its loopholes. That the president let Yukos be confiscated through arbitrary taxation in kangaroo courts severely undermined Rus-

7. "Interview with the USA Today Editorial Board," October 18, 2004, US Department of State website, www.state.gov (accessed on July 15, 2007).

sia's property rights. Putin's program of structural reform came to a screeching halt. The Yukos affair showed the KGB men around Putin that they could seize Russia's biggest private companies if they just lied patiently. The road to large-scale renationalization through lawless government interference lay open.

In the spring of 2004, I asked Gusinsky over dinner how he could explain Khodorkovsky's daring challenge to Putin. Gusinsky answered with a sad smile: "It was the same with all of us: Hubris."

Elections of 2003 and 2004

According to the constitution, Russia was scheduled to hold Duma elections on December 7, 2003, and presidential elections on March 14, 2004. Considering Putin's persistent approval rating of around 70 percent, his victory in the presidential elections was a foregone conclusion. Because of the limited role of the Duma, the parliamentary elections were regarded as little more than primary elections.

The party of power was United Russia. It had been formed in December 2001 through a merger of Unity, Putin's hastily created party in 1999, and its erstwhile centrist rival, Fatherland-All Russia, which had been led by Yuri Luzhkov and Yevgeny Primakov. United Russia was a Kremlin party run by puppet-master Vladislav Surkov, deputy head of the presidential administration. Its formal leader was Minister of Interior Boris Gryzlov, one of Putin's KGB friends from St. Petersburg. Early on, in September 2003, Putin endorsed United Russia, which followed its precedent from 2003, presenting no program and refusing to debate other parties (Baker and Glasser 2005, 295–96; Shevtsova 2005, 287).

The Kremlin was experimenting with different new party projects to split the opposition. On the right, SPS and Yabloko did so themselves. On the left, however, the communists remained quite strong. The Kremlin put together a new party, with two attractive young politicians, communist Sergei Glaziev and nationalist Dmitri Rogozin, who formed the left-wing and nationalist party Motherland. The Kremlin ordered the oligarch Deripaska to finance its new creation and organized favorable official television coverage (Baker and Glasser 2005, 298–300).

The Kremlin needed some drama to excite the population about these elections, which looked both given and controlled. The Yukos affair became the election campaign of United Russia and Putin in the same way as the second Chechnya war was in 1999 and 2000. This was a political war against the oligarchs. Government media exposed Yukos' funding of SPS, Yabloko, and the Communist Party, but said nothing about its gifts to United Russia. Anybody who complained about the treatment of Yukos was accused of being paid by Yukos by the Putin propagandists, who ruled supreme on state-controlled television. The population was fed up with the oligarchs,

Table 7.1 Results of election to the State Duma, December 7, 2003

Candidate	Percent of votes
Communist Party of the Russian Federation	12.6
United Russia	37.6
Motherland	9.0
Liberal Democratic Party of Russia	11.5
Others or against all	29.4
<i>Voter turnout</i>	55.8

Source: Central Election Commission of the Russian Federation, www.cikrf.ru (accessed on July 10, 2007).

whom they blamed for the considerable corruption. Three-quarters of the public supported the Kremlin's antioligarchic campaign. Big businessmen understood that they could not win over the public, so they turned quiet and nurtured their personal relations with Putin. Moreover, no party could afford to stand in full opposition to Putin, because each of the existing parties harbored a majority supporting him (Shevtsova 2005, 281, 295).

The Duma elections worked out exactly as the Kremlin had planned. Participation was low as usual. United Russia received 37.6 percent of the votes cast, while the Communist Party lost half of its support and received merely 12.6 percent. Zhirinovsky's erratic but Kremlin-loyal LDPR gathered 11.5 percent, and new Motherland received 9.0 percent (table 7.1). The real losers were liberal SPS and Yabloko. Each received 4 percent, less than the 5 percent hurdle, and fell out of the Duma. In the one-mandate constituencies, "administrative resources," meaning manifold repressive measures, such as large-scale but brief arrests of election workers, gave United Russia almost all those seats (Fedorov 2004). Altogether, United Russia received a total of 305 out of 450 seats, that is, more than two-thirds majority.

Both the Council of Europe and the Organization for Security and Cooperation in Europe (OSCE) concluded that the elections were "free but not fair." The elections themselves were not notably falsified, but the election process was utterly biased. In particular, state-controlled television news was heavily tilted to the advantage of United Russia, Motherland, and LDPR, and against the communists, SPS, and Yabloko. These elections confirmed that Russia had become mildly authoritarian. The Duma ceased to play any essential role. Soon, Glaziev and later Rogozin were thrown out of Motherland by the Kremlin because they had become too independent. Demands of obedience were ratcheted up all the time (Baker and Glasser 2005, 311; Shevtsova 2005, 288).

In early February 2004, I had lunch with Moscow Mayor Luzhkov in Washington. I asked him about the Duma elections. Luzhkov, who was

one of the leaders of United Russia, said that he had talked with the president, who was “concerned.” That is how Russian officials now talk, letting their worries be reflected in the president. Luzhkov said that the new Duma was like a bird with too big and fat a bottom, a decrepit left wing and no right wing whatsoever. “Such a bird cannot fly.”

After the Duma elections, Putin’s victory in the presidential elections was a given. Surkov had problems persuading plausible candidates to run. To oppose Putin was both foolhardy and dangerous. Gennady Zyuganov and Grigori Yavlinsky refused to run to save themselves from another humiliation. Zhirinovskiy, the outstanding standup comedian, nominated his bodyguard as presidential candidate. One of Putin’s close FSB friends from St. Petersburg, Sergei Mironov, who was speaker of the Federation Council, became formally a candidate but declared his support for Putin. Eventually, the Kremlin managed to persuade the communists to put up a candidate, Nikolai Kharitonov, a decorated KGB colonel.

Yet, the Kremlin did not appreciate that Berezovsky supported a prominent politician, Ivan Rybkin. After Rybkin named three men he accused of being Putin’s bagmen (Gennady Tymchenko, and the brothers Mikhail and Yuri Kovalchuk, all from St. Petersburg), he alleged that he was drugged and surfaced in Kiev under mysterious circumstances, and his candidacy was never registered.

Glaziev, who had broken with the Kremlin, became an independent opposition candidate. The liberal right could not agree on a candidate, as usual, but one of the leaders of SPS, Irina Khakamada, one of Russia’s leading female politicians, put herself forward with the support of Leonid Nevzlin of Yukos, who had escaped to Israel. Khakamada ran a courageous and energetic campaign. The final list of registered candidates was short, only six people, of whom only Glaziev and Khakamada qualified as opposition (Shevtsova 2005, Baker and Glasser 2005).

As in the 2000 presidential elections, Putin thrived on the postrevolutionary contempt for politics and refused to debate any competitor. Still, this time he made a public policy declaration on television, surprising with a Jeffersonian declaration of freedom:

We must continue work to create a genuinely functioning civil society in our country. I especially want to say that creating a civil society is impossible without genuinely free and responsible media. . . .

I firmly believe that only a developed civil society can truly protect democratic freedoms and guarantee the rights and freedoms of the citizen and the individual. Ultimately, only free people can ensure a growing economy and a prosperous state. . . .

I would like to stress once more that the rights and freedoms of our people are the highest value that defines the sense and content of the state’s work.

Finally, we will most certainly complete the transformations currently underway in the judicial system and the law enforcement agencies. I think this is a truly

important area that is decisive for building up real democracy in the country and ensuring the constitutional rights and guarantees of our citizens. (Putin 2004d)

Putin did none of this. As usual, when Putin said something, he was preparing to do the opposite. More tellingly, on February 24, only two and a half weeks before the elections, he sacked his competent and strong prime minister, Kasyanov, possibly to emphasize his struggle against oligarchs and arouse some interest in politics.

The presidential elections amounted to the expected cakewalk for Putin, who received 71.2 percent of the votes. Participation in the elections was much higher than in the Duma elections (table 7.2). In Ingushetia, Putin received 98 percent and in war-torn Chechnya 92 percent, reflecting that the less the freedom the higher the vote count for Putin (Baker and Glasser 2005, 333). Russia's democracy which, had never been full-fledged, was finished.

Inauspicious Start of Putin's Second Term

Putin's second term had an unfortunate start. Suddenly, everything seemed to go wrong. The government was caught in chaos because of poor reorganization. The most severe of all Chechen terrorist attacks, the Beslan school massacre, shook Russia. Toward the end of 2004, Ukraine turned against Russia in its democratic and West-oriented Orange Revolution. A mismanaged reform of the social benefit system led to massive popular protests.

Even before his own election, Putin had appointed Mikhail Fradkov as new prime minister. He had KGB connections and was considered close to Sechin. His appointment signified the victory of the *siloviki* over the oligarchs. Fradkov cut a most unimpressive figure, being bald, even shorter than Putin, and famously indecisive. He had made his early career as an expert on the WTO, when Russia did nothing about it. In 1993, he was appointed deputy minister for external economic relations with responsibility for the WTO, but he was completely passive.⁸ Even so, he advanced to become minister for external economic relations in 1997. After one year, his ministry was abolished, which was celebrated as a major attack on bureaucracy and corruption. After another year, Fradkov became minister of trade. In 2000, that ministry was also eliminated because it blocked Russia's WTO entry and merged with German Gref's new Ministry of Economic Development and Trade. In 2001, Fradkov was given a new chance as head of the tax police, which had arisen out of the KGB. But the tax police was closed down two years later, because it was considered the most

8. His minister, Sergei Glaziev, told me that Fradkov was his only deputy who never prepared a single decision in the course of one year.

Table 7.2 Results of presidential election, March 14, 2004

Candidate	Percent of votes
Vladimir Putin	71.3
Nikolai Kharitonov	13.7
Sergei Glaziev	4.1
Irina Khakamada	3.8
Oleg Malyshkin	2.0
Sergei Mironov	0.8
Others or against all	4.3
<i>Voter turnout</i>	64.4

Source: Central Election Commission of the Russian Federation, www.cikrf.ru (accessed on July 10, 2007).

lawless and corrupt government agency. Finally, Fradkov was demoted to ambassador to the European Union in Brussels. On a visit to Brussels in early 2004, Gref publicly scolded Fradkov for being the most incompetent Russian ambassador he had ever encountered.⁹ One month later, Fradkov became prime minister and Gref's boss.

Putin's choice of prime minister said everything about his second term. He wanted a weak and passive government that would not undertake major reforms. The *siloviki* were to dominate over the reformers (Gref and Kudrin). In one single appointment, Putin transformed his reform government into a nonreform government, although Kudrin and Gref remained ministers. Putin replaced Yeltsin's old chief of staff Voloshin with his close collaborator Dmitri Medvedev, who was considered as indecisive as Fradkov. Medvedev belonged to the St. Petersburg liberals, but that concept was about to lose relevance.

As Putin's second administration was formed, a substantial administrative reform was attempted. It was spearheaded by Dmitri Kozak, the liberal lawyer from St. Petersburg who had led the judicial reform. It had been prepared for two years by a working group led by Putin himself, and it was largely a revival of Yeltsin's government reform in November 1991. Its guiding principle was to organize the state administration by functions as in the West, and not by industrial branches as in the Soviet Union. Once again, the number of ministries was reduced—this time to only 15, as in a normal Western government. The many deputy prime ministers were reduced to one. Each ministry was supposed to have only two deputy ministers (Remington 2006, 63–64).

This reorganization caused lasting chaos. The deputy ministers were usually the real policymakers, while the heads of departments were sheer

9. This was the common view among eurocrats and diplomats in Brussels.

administrators. The reorganization squeezed out the policymakers, who tended to be young, bright reformers, whereas the older, more conservative heads of departments were left in place. The few remaining deputy ministers were overwhelmed with routine administration, and the reform agenda was effectively killed. The weakening of the government led to a big transfer of power to the presidential administration, where Putin's KGB men had reinforced their nontransparent and unaccountable administrative control.

On September 1, 2004, the traditional festive start of the school year, a new shock hit Russia. A band of heavily armed Chechen fighters seized a school in Beslan in Russian Northern Ossetia near Chechnya. They held more than 1,200 adults and children hostage, although the official government spokesman insisted there were only 354 hostages. Militants herded them into the school gymnasium, which they mined with explosives, threatening to blow it up if government forces attacked.

Russia's foremost special forces were sent there within hours, but the disarray was palpable. At no time was the school cordoned off. The regional governors of North Ossetia and neighboring Ingushetia, both recent Putin appointees (though formally elected), refused even to go to Beslan. The federal government ignored the crisis and minimized news coverage. On the third day, the special forces attacked the school with heavy arms, maximizing the losses. Brave local Ossetians were so exasperated with the incompetence of the federal troops that they took out *Kalashnikovs* from their closets and stormed the school themselves. The fire fight lasted for at least nine hours, although the government claimed that only 33 hostage takers participated, of whom all but one were killed. No fewer than 330 hostages, including 155 children, were killed. Chechen warlord Shamil Basayev claimed responsibility.

Again, the Russian government demonstrated itself both incompetent and callous, being most concerned about minimizing media coverage and concealing the real number of hostages. The government had no relevant intelligence. Once more, policemen accepted bribes to let the terrorists through. The refusal of the regional governors to show up illustrated how calcified Russia had become as a result of overcentralization. Putin, however, refused to accept any criticism for the catastrophe. He sacked none of the culprits, only the excellent editor of the private newspaper *Izvestiya*, Raf Shakirov, who committed the crime of accurate reporting.

Although the Beslan tragedy showed how poorly the overcentralized and authoritarian Putin regime reacted to crises, Putin's reaction was to roll back democracy even more. On September 13, he announced that he would eliminate the direct election of governors and appoint them himself. In his interview book *First Person*, Putin (2000, 183) had stated the opposite: "I think we have to preserve both local self-government and a system of election for governors." Since the governors' resistance had al-

ready been broken, this radical decision aroused no opposition. In effect, Russia was no longer a federal state but a unitary state, where all officials were appointed by the president officially or informally. Mayors are still elected, but their appointments are being contemplated (Petrov 2007).

Complex social reforms had been relegated to Putin's second term, and the priority was to change the misconstrued and costly social benefit system. Russia had myriad old social benefits primarily for the privileged, many of which were never paid out. Numerous nontransparent social benefits in kind needed to be transformed into cash payments, which was politically controversial because the beneficiaries suspected they would lose their benefits.

In January 2005, the social benefit reform was launched, but its implementation was remarkably inept. The reform was presented as the monetization of in-kind benefits, but in reality many benefits were abolished. Full compensation was promised for the actual in-kind benefits, but initially only about one-third of them were compensated for, because as usual the federal and regional governments did not agree on who should pay what. Although these reforms affected about 40 million people, they were not explained.

To add insult to injury, the 35,000 highest officials, including the president, had their salaries quintupled at the same time, and none of their substantial in-kind benefits were taken away. The social benefit reform seemed directed against the poor in the midst of Russia's oil boom, when the budget surplus reached record heights. To great surprise, widespread, spontaneous popular protests dominated by pensioners erupted against this reform in large parts of the country. For the first time, Putin was the center of public scorn.

To cool down the protests, the government reversed most of its actions and raised pensions substantially. The Kremlin got frightened and stopped most reforms in Putin's second term. The spectacular failure of the social benefit reform was another reason why liberal reformers lost out. There would be no more reforms worth mentioning during Putin's second term.

Consolidating Authoritarian Rule: Deinstitutionalization

Putin had already done much to turn Russia into an authoritarian country during his first term, and now he completed his accomplishments. He reinforced central control over law enforcement by appointing new regional heads of the ministry of interior, the prosecutor's office, and the security police throughout the country (Remington 2006, 234–35; Petrov 2004).

Whereas Yeltsin had split up the old KGB to weaken it, Putin put it together again to strengthen it. In March 2003, he decreed that the Federal Agency for Government Communication and Information (FAPSI) and

the Federal Border Guard Service (FSP) were merged with the Federal Security Service (FSB) (Remington 2006). The old repression apparatus was now reassembled, and it proudly indulged in all the old KGB activities. The FSB was headed by Nikolai Patrushev, one of Putin's KGB friends from St. Petersburg.

In late 2004, the Ukrainian Orange Revolution shook the self-confidence of Putin and he hastened to fill all the holes in his authoritarian regime. In late 2005, he promulgated a restrictive law on nongovernmental organizations, which was impossible to comprehend, freeing the government to deprive at will any organization of its right to exist. Foreign grants were severely restricted and many required explicit government permission. The tax authorities were mobilized to audit and raid nongovernmental organizations. Public protests and demonstrations were restricted and often prohibited. Criticism of public officials was proscribed as "extremism." Electoral legislation was amended to give the government full control over the vote count and to minimize independent electoral monitoring. Almost all opinion poll organizations were brought under Kremlin control, and the last independent dailies were purchased by helpful businessmen close to the Kremlin.

The regime was legitimized by Putin's popularity, which stayed above 70 percent, bolstered by the strict prohibition of any public criticism of him. As the nuanced Russia analyst Thomas Remington (2006, 61) observed: "Vladimir Putin has quietly fostered a cult of personality through such methods as the use of official portraits that officials are encouraged to hang in their offices, and signals to the mass media to portray him in a flattering light." Russia had become a dictatorship (Fish 2005, Freedom House 2006).

One day as I walked along Arbat Street, a pedestrian shopping area, I realized that most of the sculptures in the stands were of four men: Lenin, Stalin, Putin, and Feliks Dzhherzhinsky, founder of the secret police! But Russia is not ridden by any extreme nationalism, even if xenophobic Russian skinheads murder foreign students all too often. On the contrary, ideology is absent. This is posturing rather than extremism.

The Kremlin was not only repressive, but also proactive. In 2006, hard-line KGB officers established a pro-Putin party called "A Just Russia" to capture dissatisfaction with corruption and inequality, providing a left-wing alternative to the purportedly center-right United Russia. The Kremlin formed a few youth "movements," notably *Nashi* ("Ours"). The common denominators of these popular initiatives were that they were populist and nationalist, based on careful studies of opinion polls and focus groups, and directed from above by the Kremlin. Nationalist, populist, and anti-Western commentators, such as Mikhail Leontiev and Alexei Pushkov, were promoted on state television.

Nor did Putin let up in the second Chechen war. His strategy was three-pronged. First, Russia continued a ruthless war and gradually killed off

all the major warlords. In March 2005, former Chechen President Aslan Maskhadov, the last moderate leader, was killed by FSB special forces. In July 2006, Russian troops claimed the ultimate success killing of Shamil Basayev, after which the war slowed down.

A second strategy was “Chechenization,” relying on the former mufti and warlord Akhmad Kadyrov. After 17 attempts on his life, he was finally assassinated on Victory Day, May 9, 2004, while watching a parade honoring the USSR’s victory in World War II. He was succeeded by his ruthless son, Ramzan Kadyrov, whom Putin promoted to Chechen president in 2007. Kadyrov maintains a truly despotic regime.

The third strategy was to pour vast funding into Chechnya and rebuild it. Although violence continues, the calm is sufficient for the Kremlin to claim victory in the war in Chechnya. Ramzan Kadyrov is what Mancur Olson (2000) called a “stationary bandit,” exploiting his republic but caring about its growth.

Most of the time, Putin’s authoritarianism has been relatively soft. Because of its vast oil revenues, the Russian government can afford to tempt potential troublemakers with money rather than force them into silence. Putin has extended the concept of espionage to cover also innocuous contacts with foreigners, and seemingly innocent Russians have been sentenced to prison. But political prison sentences are rare. Far more common are beatings by unknown people, which may or may not be instigated by the authorities, since Russia’s crime rates are so high.

Most chilling are the many murders of Russian journalists and opposition politicians. Russia ranks among the highest in the world in terms of murders of journalists (Fish 2005). Many murders have taken place in lawless Chechnya and most are probably connected with revelations about shady business dealings, but quite a few appear to have been purely political. Several bona fide politicians have also been murdered. On April 17, 2003, the impeccably honest liberal politician Sergei Yushenkov was murdered, presumably for having dug into military corruption in Chechnya, as did the Yabloko politician and investigative journalist Yuri Shchekochikhin, who was poisoned to death on July 13, 2003. On July 9, 2004, American journalist Paul Klebnikov, the editor of *Forbes Russia* magazine, was murdered in Moscow. He is a major source for this book. They all knew too much.

On February 13, 2004, Zelimkhan Yandarbiyev, the former president of the Chechen republic, was assassinated with a bomb in Qatar’s capital of Doha.¹⁰ The Qatar authorities sentenced two Russian agents from GRU, Russia’s military intelligence, to life imprisonment for the murder, which they claimed was ordered by Russian top officials. Under heavy Russian pressure, the culprits were soon extradited to Russia, where they were

10. Steven Lee Myers, “Qatar Arrests Russian Agents for Murder of Exiled Chechen,” *New York Times*, February 27, 2004.

supposed to serve their prison sentences, but they were released. This was the first time since the murder of a Ukrainian nationalist (Stepan Bandera) in Munich in 1959 that Russian agents were caught red-handed murdering people abroad on official orders.

Most shocking was the murder of the renowned journalist Anna Politkovskaya in the fall of 2006. She was one of Putin's fiercest domestic critics and her integrity was unsurpassed. Like Shchekochikhin, she worked for Russia's last independent newspaper, *Novaya gazeta*. Her murder took place on Putin's 54th birthday, which was noteworthy because Russian gangsters have a macabre tradition of making a birthday present of a murder. Putin's deprecating comment after her death was: "I think her impact on Russian political life was only very slight. She was well known in the media community, in human rights circles and in the West, but her influence on political life within Russia was very minimal" (Putin 2006d).

In November 2006, a KGB colonel who had defected and worked for Berezovsky, Aleksandr Litvinenko, was slowly poisoned to death with rare radioactive polonium in London. British magistrates requested the extradition of a suspect former KGB officer from Moscow, but the Russian government refused, while giving the accused ample TV time to defend himself. Putin commented:

Aleksandr Litvinenko was dismissed from the security services. . . . But there was no need to run anywhere, he did not have any secrets. Everything negative that he could say with respect to his service and his previous employment, he already said a long time ago, so there could be nothing new in what he did later. (Putin 2007c)

As the oligarchs had done before them, Russia's liberal intelligentsia shivered. Had the Kremlin declared open season on them?

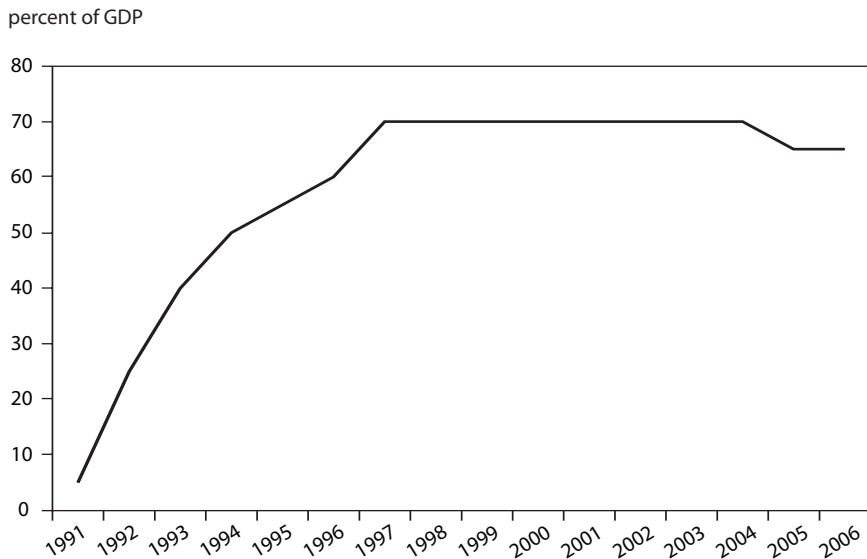
Renationalization: The Creation of Kremlin, Inc.

Throughout his first term, Putin spoke out loudly and clearly in favor of a free market economy and private enterprise. A typical statement of his was:

A competent macroeconomic policy remains one of the state's most important regulatory functions. But . . . , the amount of direct administrative intervention in the economy must be reduced. Despite all the steps that have been taken to cut back bureaucracy in the economy, there is still too much intervention. We also need to optimise the amount of state-owned property. In any event, state-owned property should not exist simply to be a source of prosperity for the people running it in the state's name. I want to say once again that the state should manage only the property it needs to carry out its public functions, ensure state power and guarantee the country's security and defence capacity. (Putin 2004b)

Remarkably, the first sentence of this statement reflected Putin's actual policy, while the rest did not. Even at his big annual press conference in

Figure 7.2 Share of GDP from private enterprises, 1991–2006



Sources: EBRD (2006, 168; 2000, 204).

January 2006, Putin (2006c) stated: “We have about ten quite large private oil companies . . . Nobody is going to nationalize them, nobody is going to interfere with their activities. They are going to develop according to market conditions like private companies.”

Putin’s policy sounded like a standard West European liberal-conservative policy, oriented toward gradual deregulation and privatization, but it was not after the Yukos affair. I have quoted Putin at length because of the great contrast between his words and actions. Despite his assurances, privatization stalled. The privatization of Rosneft had been discussed for years, but now it was abandoned. Although virtually all growth came from the private sector, while the state sector underperformed, state corporations were gobbling up successful private firms. According to the European Bank for Reconstruction and Development (EBRD), the share of Russia’s GDP produced by private enterprise plummeted from 70 percent in 2004 to 65 percent in 2005 (figure 7.2).

Putin’s economic policy statements did not embrace any socialist or nationalist ideology before renationalization was accomplished. The economic superiority of the private sector was just astounding, so the natural conclusion is that renationalization has been driven by state officials’ interest to extend their power and wealth.

Renationalization occurred in steps. To begin with, Putin’s men took charge of the main state enterprises in energy, transportation, military in-

dustry, and banking. Most of them were old KGB hands from St. Petersburg. This was the essence of the new Kremlin, Inc.:

- The non-KGB “liberals”—Dmitri Medvedev and Aleksei Miller—became chairman and CEO, respectively, of Gazprom, the jewel in Russia’s industrial crown.
- Sergei Bogdanchikov, who was already CEO of Rosneft, linked up with Igor Sechin, Putin’s closest collaborator, who became Rosneft chairman.
- Vladimir Yakunin, a KGB friend of Putin from St. Petersburg, became CEO of the new state company the Russian Railways.
- Viktor Ivanov, another KGB friend of Putin from St. Petersburg who was responsible for personnel in the Kremlin, became chairman of the arms manufacturer Almaz-Antei in 2002, after which three of its top executives were mysteriously murdered in the course of one year.¹¹ He also became chairman of Aeroflot, the Russian airline, in 2004.
- Minister of Defense and Deputy Prime Minister Sergei Ivanov, a former lieutenant-general in the Foreign Intelligence Service (SVR) and KGB schoolfriend of Putin, became chairman of the newly-amalgamated United Aircraft Corporation in 2006.
- Deputy Prime Minister Sergei Naryshkin, yet another KGB friend of Putin from St. Petersburg, was appointed chairman of the newly merged United Shipyards Corporation in 2007.
- Sergei Chemezov, who had served in the KGB in East Germany with Putin, was asked to lead the state arms trade agency Rosoboronexport.
- Leonid Reiman, another Putin friend hailing from foreign intelligence in St. Petersburg, is in charge of several telecommunication companies, some private and some state-owned.
- The KGB banker Andrei Kostin succeeded in getting close to Putin and is CEO of Vneshtorgbank (VTB).

Russia had a habit of appointing top officials to the boards of large state companies, and the new crop simply replaced ousted officials. Officially, public servants are not allowed to receive any fees as board members of state companies, but the law does not mean all that much in Russia. Most ministers appear to own corporations, which they do not declare as their property.

FSB friends of Putin do not have a monopoly on chairmanships of big state corporations. Chubais remains CEO of UES, with Voloshin as chair-

11. *Kommersant*, May 24, 2004.

man. Kudrin is chairman of Sberbank, the state savings bank, and Alrosa, the state diamond company. Minister of Industry and Energy Viktor Khristenko is the long-time chairman of Transneft, the oil pipeline company. Yet, non-FSB people are increasingly marginalized and their companies tend to be less predatory. UES even undertook a major regulatory reform in 2007, splitting it up in many competing corporations.

The first renationalization was Rosneft's purchase of Severnaya Neft in early 2003, which looked like a kickback. The biggest renationalization was Rosneft's seizure of Yukos, which added a net value to Rosneft of perhaps \$60 billion.¹² Gazprom wanted to keep up with the competition. In September 2005, it bought the oil company Sibneft, paying a high market price of \$13.1 billion for Kremlin-friendly Abramovich's dominant stake. Gazprom also forced Royal Dutch Shell and its partners to sell its 51 percent of the Sakhalin-1 project, and it compelled TNK-BP to give up its large gas field Kovykta in East Siberia for a symbolic price. A new medium-sized oil company, Russneft, appeared to be about to be given the Yukos treatment with prison sentences for its owners and managers and then confiscation, but its owner wisely escaped abroad.¹³

As a consequence of all these nationalizations, the private share of Russia's oil production fell from 90 percent in 2004 to 45 percent in the second half of 2007. The impact on Russia's oil production was immediate and drastic. From an average output growth of 8.5 percent a year from 1999 to 2004, the increment fell to about 2 percent a year for the ensuing three years (figure 7.1). Sibneft's production fell sharply, while the remaining big private companies (TNK-BP, Lukoil, and Surgut) understood the danger of investing significantly, or boosting production, and moderated their investment.

VTB has been particularly aggressive. Russian banking is still dominated by state banks, and therefore it is less developed than in Kazakhstan and Ukraine, as reflected in its low ratio of money supply (M2) to GDP. Rosoboroneksprom seized the unstructured car giant Avtovaz for a nominal amount, and it forced the excellent titanium producer VSMPO-Avisma to give up ownership at a price amounting to one-quarter of the market price (Finn 2006b).

After Kakha Bendukidze, the owner of the large machine-building company OMZ, became minister of economy of Georgia in 2004, Gazprom forced a purchase at a price that was a mere 40 percent of the market price, according to what an insider told me.

The pattern is clear. State enterprises are buying good private companies either at a high price in a voluntary deal, which is accompanied by

12. Yukos would in all likelihood have been more highly valued because it was more transparent and better managed than Rosneft.

13. Irina Reznik, "Lichnoe delo Gutserieva (Gutseriev's Personal Matter)," *Vedomosti*, July 30, 2007.

rumors about sizable kickbacks, or the sale is forced and the price is low. No economic rationale is evident. The most likely purpose of renationalization is corruption.

As renationalization has evolved, a need has arisen to justify it. One idea is a purported need for “national champions,” emulated from France, which means inefficient national monopolies. Gazprom is the model. A new national champion was the United Aircraft Corporation with three-quarters state ownership, created in 2006. Russia’s oversized aircraft industry needed restructuring, but merging the few successful private companies with big dying state enterprises threatens to kill them all. Similarly, in 2007, the United Shipyard Corporation and the Atomic Energy Industry Complex were formed and monopolies are rarely beneficial for economic development.

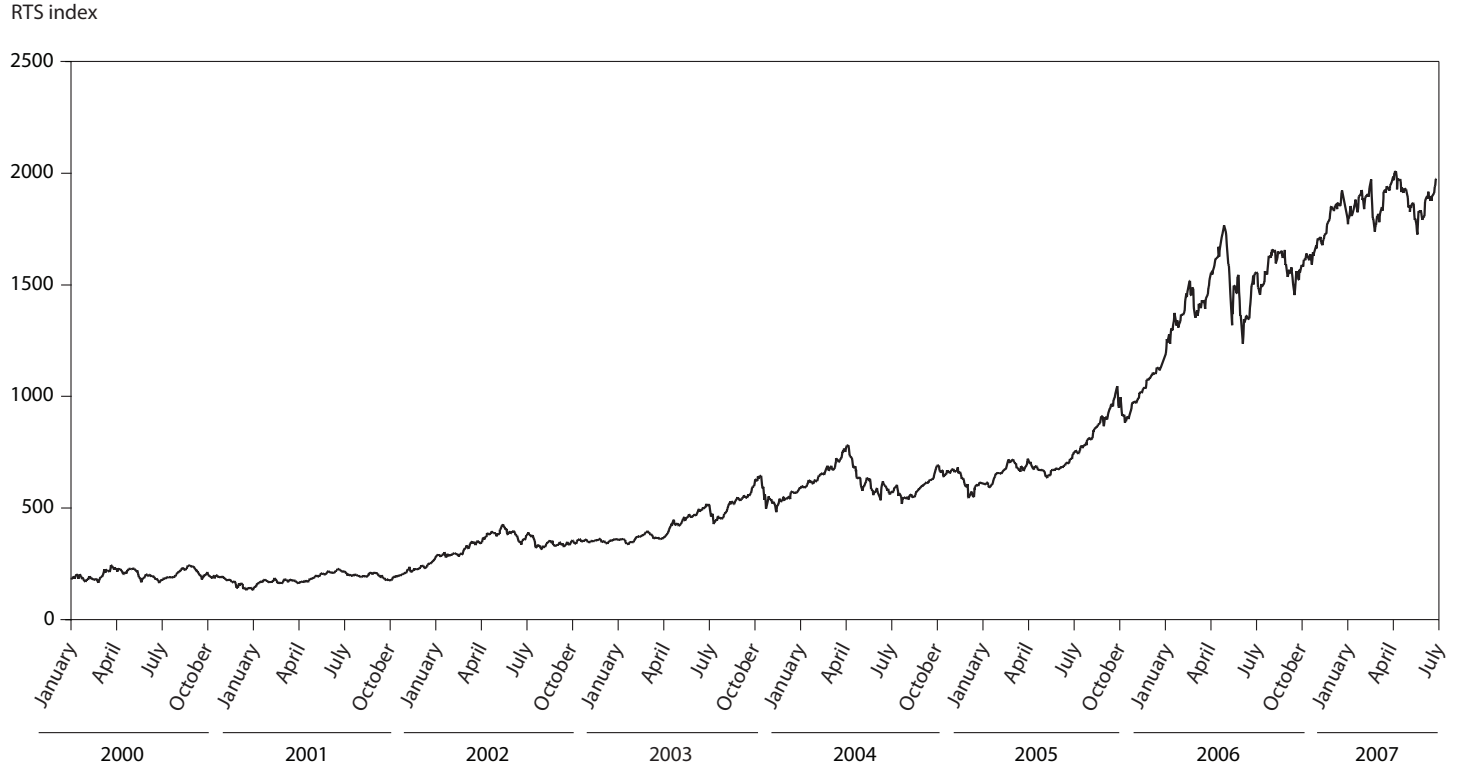
Another official argument is that major national resources should be domestically owned. Russia has produced a number of drafts of a law on strategic assets that should be majority-owned by Russians, but it has not as yet adopted such a law. The most obvious examples are major oil and natural gas findings, but major infrastructure and the military industry are also included.

The ideological motive for nationalization is absent. Two of the most aggressive predators, Rosneft and VTB, carried out large international initial public offerings (IPOs) in London in 2006 and 2007, respectively. The purpose was not to privatize them but to endow them with new funds for enterprise acquisitions. Once more, Gazprom with its 51 percent public ownership was the model. Foreign investors happily buy these stocks, because they are reassured that companies with excellent Kremlin contacts can purchase valuable Russian assets cheaply. They pay little attention to limited transparency, corporate governance, or even poor economic results. The asset values are just too attractive.

The Russian state-dominated companies are remarkably focused on their stock prices. During the Yukos affair, Putin met repeatedly with foreign portfolio investors to reassure them. Apart from false promises about Yukos, he pledged that Gazprom’s domestic stocks would become freely tradable. After Putin promised that in September 2004, it finally happened in January 2006. Putin (2006a) bragged in his annual address: “We already feel confident in the mining and extraction sector. Our companies in this sector are very competitive. Gazprom, for example, has just become the third biggest company in the world in terms of capitalization. . . .” Gazprom was helped by benign taxation. For oil companies, 88 percent of the oil revenues over \$27 a barrel were taxed away, which depressed their stock prices and investment, but Gazprom suffered no such tax.

The main Russian stock index (RTS) rose no fewer than 11 times between January 2000 and July 2007, being one of the best performing stock markets in the world year after year, although 2004 was a lost year because of the Yukos affair (figure 7.3).

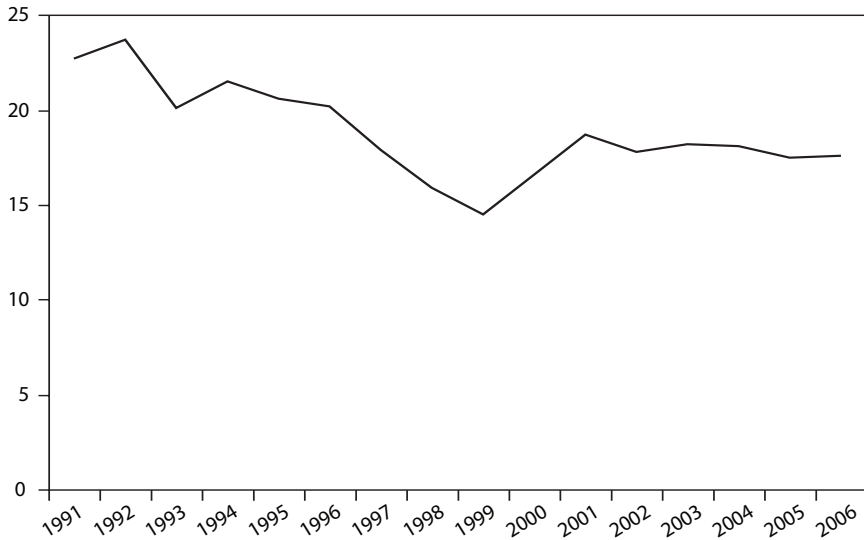
Figure 7.3 Russian stock market index (RTS), 2000–2007



Source: Russian stock market website, www.rts.ru (accessed on July 6, 2007).

Figure 7.4 Gross fixed investment, 1991–2006

percent of GDP



Source: UN Economic Commission for Europe online database, www.unece.org (accessed on May 30, 2007).

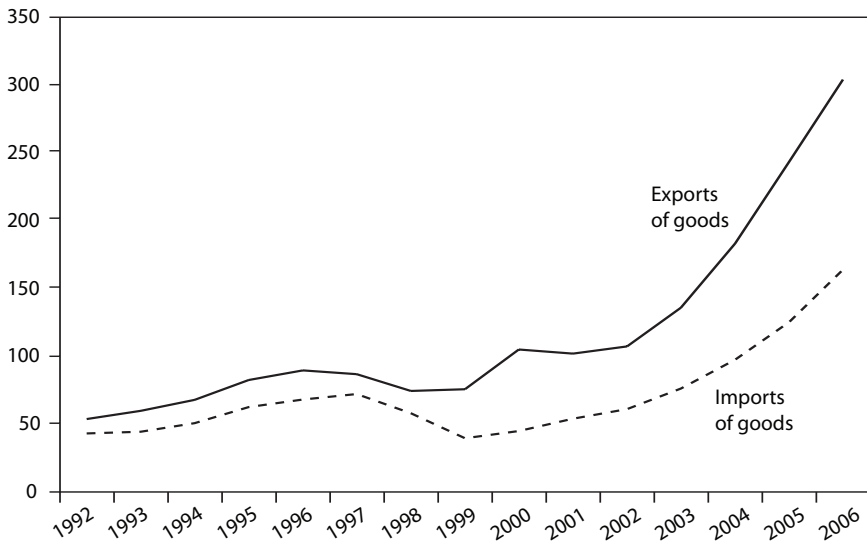
The Russian renationalization has had a limited negative impact on the economy. It has been evident only in oil and gas production, banking, and possibly machine building. Most of the Russian economy is still in private hands, including the metals, retail trade, and construction sectors. The aggregate indicator that has suffered the most is investment, with Russia's official investment ratio remaining rather low at 18 percent of GDP despite the economic boom (figure 7.4). Other successful transition countries have much higher investment ratios, with ratios as high as 35 percent of GDP in Estonia and Latvia (UN Economic Commission for Europe 2007).

SPS leader Boris Nemtsov did not mince his words when commenting on renationalization: "It is offensive that under Putin the state has taken on the role of plunderer and racketeer with an appetite that grows with each successive conquest. . . . But the greatest calamity is that nobody is allowed to utter a word in protest regarding all this. 'Keep quiet,' the authorities seem to say, 'or things will go worse for you. This is none of your business' " (Nemtsov 2007).¹⁴

14. He could publish this in the *Moscow Times* because it is not censored since it appears in English.

Figure 7.5 Exports and imports of goods, 1992–2006

billions of US dollars



Sources: Bank of Finland Institute for Economies in Transition, Russia statistics, www.bof.fi (accessed on May 30, 2007); EBRD (2000, 205; 2003, 187).

Toward State Capitalism?

In 2004, the international oil prices took off (figure 6.4), filling the Russian state treasury. Russian exports started skyrocketing, mainly because of the rising commodity prices. In 2006, Russia's exports reached \$305 billion compared with the pitiful \$29 billion of Soviet exports to the West in 1990 (figure 7.5 and figure 2.2). Imports could not keep up with exports, leading to a steady current account surplus of about 10 percent of GDP (figure 6.5).

The government maintained an impressively conservative fiscal policy, with a budget surplus of 7.5 percent of GDP in the oil boom years of 2005 and 2006. The government established a stabilization fund on the pattern of Norway and Kazakhstan, in which windfall taxes from high oil prices were accumulated. By July 2007, its balance exceeded \$120 billion. Russia was flooded with easy money, which made it difficult to justify arduous reforms. The huge revenue flows endowed Russian leaders with a deleterious sense of hubris.

The reformers no longer set the trend in Russian economic policy, having been muscled out by big state-dominated companies and the *siloviki*

who controlled them. Time and again, Putin emphasized that his two key economic goals were macroeconomic stability and high economic growth of 7 percent a year, which were regularly achieved. No economic reforms were needed to accomplish the desired growth rate. Yet, even populist statements by the Russian officials specified remarkably small additional expenditures. Public expenditures showed no tendency to rise as a share of GDP, although revenues surged (figure 6.1).

By 2006, Putin's unrelenting advocacy of sound market economic policy suddenly wavered. His televised question-and-answer session with the nation on October 25, 2006 (on the third anniversary of Khodorkovsky's arrest), marked a radical departure from his prior rhetoric (Putin 2006b). He restored much of the old Soviet rhetoric.

The essence of Putin's three-hour marathon exposition was industrial policy, extensive state intervention, centralized micromanagement, state investment, subsidies, trade and price regulation, protectionism with higher customs tariffs, export taxes, and import substitution, as well as ethnic discrimination. As in the old days, the patriarchic state had authority over everything but responsibility for nothing. Conspicuously absent were his prior ideas of deregulation, the rule of law, and private property rights.

Putin's starting point was ethnic discrimination. Ethnic strife over market trade had flared up in the small Karelian town of Kondopoga in August 2006, and local Chechens had killed two Russians. Putin fanned the racist flames by siding with Russian farmers who complained that (Chechen) merchants paid them too little. Putin wanted to "categorically protect the priorities and interests of Russia's indigenous (*korennoi*) population both in the labour market and in trade." The Kremlin had long allowed aggressive Russian nationalism to rule the media. Here Putin himself came out as a Russian nationalist.

Putin also advocated more regulation. When a farmer complained about poor market access, he suggested further restrictions on the already heavily regulated *kolkhoz* markets. Traders should not be allowed "to sell processed goods such as smoked salamis" or "clothes brought in from China." For the first time since the battle against "unearned incomes" in 1986, a Russian leader raged against the sale of the "wrong products" in the collective-farm markets.

The president displayed a similar fondness for price regulation. He condemned "unprincipled manufacturers" who raised prices because of shortages. This was Soviet orthodoxy, the classic Marxist labor theory of value in the first chapter of Karl Marx's *Das Kapital* (1867/1981). Putin also called the disparity in prices between agricultural and industrial products the "most serious problem today," repeating, unwittingly or not, the Bolshevik argument about the "scissors' crisis" for collectivization that brought an abrupt end to the happy New Economic Policy in the 1920s (Nove 1969).

Putin's most dramatic turnaround concerned the WTO. In his annual address on May 10, 2006, Putin (2006a) had advocated accession to the

WTO because of the need for “more rational participation in the international division of labor” to make “full use of the benefits offered by integration into the world economy.” This time, he omitted the WTO but proposed measures contradicting the organization’s rules: increased subsidies for animal husbandry, higher customs duties for automobile production, and higher export tariffs for lumber. He proposed industrial policy, import substitution, and state subsidies for priority industries.

The only Soviet economic tenet missing was nationalization of the means of production, which was already well advanced. Not with a single word did Putin reassure private investors. A retired St. Petersburg actress complained about the condition of her retirement home, which a major company wanted to take over. Putin readily named that corporation, Sistema (owned by Kremlin-friendly billionaire Vladimir Yevtushenkov), and called on it to provide \$5 million in financing to solve the pensioners’ housing problem. “For this company this would represent a minimal amount of money,” he said. This little show was designed to demonstrate Putin’s concern for the elderly. What it revealed, instead, was his disrespect for private property rights.

To judge by his words, Putin reverted to the Brezhnev tradition, which had led to the Soviet economic collapse. Yet, as we have seen Putin tends to say the opposite of what he is intent on doing. The two tenets of Russia’s economic policy appear to remain macroeconomic stability and 7 percent annual economic growth. The easier it is to achieve these two targets, the more leeway Russia’s government has in its economic policy. If the price of oil were to fall precipitously, the regime would likely improve its economic policy, rendering the oil price the main determinant of Russia’s economic policy.

Corruption: Rationalized but Pervasive

Throughout Russia’s transition, corruption has been a major theme. Corruption is defined as “the misuse of public power for private gain” (Rose-Ackerman 1999, 91). It means the malfunctioning of the state, with politicians and civil servants selling public goods for private benefit rather than working for the goals of society. In the last decade, empirical studies have generated substantial empirical information, allowing us to assess how corruption has evolved in Russia.¹⁵

15. Transparency International was the pioneer, initiating its Corruption Perceptions Index in 1996 (Transparency International 2007). The most authoritative and specific studies have been the surveys by EBRD and World Bank (2002, 2005)—Business Environment and Enterprise Performance Surveys (BEEPS)—but they were done only for three years, 1999, 2002, and 2005. A third major source is the Russian INDEM Foundation run by Yeltsin’s former political advisor Georgy Satarov (e.g., INDEM 2001). INDEM is best at establishing actual payment habits, but its aggregate numbers are too high to appear credible.

During the collapse of communism, corruption presumably exploded in parallel with crime. The Soviet Union had a strong tradition of corruption (Zemtsov 1976, Simis 1982). When the threat of the communist police and party state disappeared, the potential benefits of corruption greatly increased. Most corrupt practices involved in rent seeking were not even illegal. No conflict of interest rules existed, and during the final throes of the Soviet Union ministers boasted about owning enterprises to show how progressive they were. This tradition of ministers owning and running enterprises persists.

At the beginning of the transition, corruption attracted surprisingly little public attention, but the interest has increased sharply. Andrei Shleifer and Robert Vishny (1993) published a seminal article on corruption in Russia, comparing it with Africa: people paid bribes but they did not receive the requested services. Corruption was bad, but unreliable and anarchic corruption was worse. Moscow Mayor Gavriil Popov, a leading democrat at the end of communism, even proposed that public officials be allowed to charge a commission for their services since they did so in any case.

Extortion was exceedingly cumbersome because the bureaucrats did not know what to charge. They haggled forever, costing time and discomfort and often failing to conclude an agreement (Kaufmann 1997). The popular view arose that since all politicians were corrupt, it was better if the leaders remained the same, because new hungry office holders would demand more bribes. Yet, few Russian leaders ever seem to become satisfied.

Over the years, the Russian government has instituted many measures to regulate, control, and outlaw corruption. The early deregulation reduced officials' right to sell permits and licenses. Privatization took a major source of corrupt revenues out of their hands (Kaufmann and Siegelbaum 1996). Stabilization helped to cleanse the financial system. Cutting off enterprise subsidies reduced discretionary deals. Various forms of corruption have been outlawed. Since the mid-1990s, candidates for political offices have been forced to make public their incomes and fortunes, although their declared wealth has often been ludicrously small, and Russian officials talk freely about their foreign bank accounts. One proposal was that public officials would have to reveal the wealth of family members as well, but Moscow Mayor Luzhkov (with a billionaire wife) famously claimed that such a requirement would violate human rights. Transparency remains pitiful.

Fiscal reforms undertaken by Ministers of Finance Kasyanov and Kudrin in the wake of the financial crash of 1998 have probably been most effective in limiting corruption. These measures were designed to increase transparency, simplify the tax system, minimize discretion, eliminate competitive tax collection, but also to centralize the financial system. The elimination of offsets and barter was a fundamental breakthrough, because businessmen and officials could no longer make corrupt, discretionary

deals about tax rebates. Another huge step forward was the tax reform, especially the introduction of the flat personal income tax of 13 percent that made it possible to be an honest taxpayer. Competitive tax collection was eliminated when the tax police were abolished and extrabudgetary funds were prohibited from collecting taxes (Åslund 2004).

A major problem was so-called unfinanced mandates, that is, government agencies were obliged to carry out certain tasks but did not receive state financing to do so. The agencies' standard solution was to invent new revenue sources, typically fees and penalties, which were extracted through cumbersome inspections. Naturally, inspectors put some of the poorly regulated revenues into their own pockets. The tax reforms prohibited most such inefficient nuisance taxes. Simultaneous budget reforms attempted to centralize additional revenues and provide full financing for required expenditures. Although not everything succeeded, the change was huge (Åslund 2004).

The overhaul of registration, licensing, and inspections in 2001–02 changed the business environment in Russia profoundly (see chapter 6). It primarily benefited small and medium-sized businesses. Millions of individual entrepreneurs had been shielded by simplified taxation all along, often in the form of lump-sum taxes that protected them from extortion by officials. Moreover, corruption tends to fall with rising incomes and expanding foreign trade (Treisman 2000).

All of these reforms had four positive effects. First, the average “bribe tax,” that is, the percentage of annual revenue a firm pays in bribes, declined from 1.4 percent in 2002 to 1.1 percent in 2005 in Russia, according to the EBRD and World Bank Business Environment and Enterprise Performance Surveys (EBRD and World Bank 2002, 2005).

Second, corruption was rationalized. The frequency of bribery declined, prices were standardized, and people received what they paid for.

Third, nuisance extortion in taxation, customs, business licensing, and all kinds of inspections declined, although corruption increased in courts and government procurement.

Fourth, businessmen saw corruption as an increasing problem (Anderson and Gray 2006, 8). Yet, corruption has become standardized and more rational. Low-level officials are often asked to deliver a specified share of their booty to higher officials, rendering corruption more pervasive and lucrative.

These observations suggest that Russia is “just as corrupt as one would expect it to be, given the prominence of natural resources in its exports” (Fish 2005, 130; see also Treisman 2000, Shleifer and Treisman 2004). Russia's corruption is normal for a post-Soviet country, and it has always been less than in Central Asia and the Caucasus.

Especially, top-level corruption seems to be getting worse. During a trip to Moscow in September 2004, I was struck to hear from several senior Russians in private conversations: “I thought that corruption could never get

as bad as it was under Yeltsin, but now it is far worse.” The bribe frequency in Russia was the third highest among all postcommunist countries, and Russian businessmen reported that corruption increased significantly as a problem for business from 2002 to 2005, while the dominant postcommunist tendency was improvement (Anderson and Gray 2006, 8, 11).

It is hardly an exaggeration to say that everything is for sale in Russia. People pay bribes to enter university, to escape military service, to stay out of prison, and to land a good job. Until the late 1990s, the selling of top offices was not an issue, but then it took off, and by 2004 it had become endemic. One former senior official who had been fishing for a high appointment was told by friends in the administration that he could not possibly hope for any senior job since he was not ready to pay.

A senior Russian politician told me that one of the worst struggles in the Kremlin over Putin’s appointment of governors was which top official in the presidential administration would be allowed to sell these offices. Transparency International in Russia found that deputy ministerial posts were sold for \$8 million to \$10 million.¹⁶ Gubernatorial and ministerial posts must have been traded for multiples of this amount. In table 7.3, I have compiled some newspaper citations of prices, but they appear low.

Russian business is divided into four different administrative categories depending on which level of the state they need to deal with. Oligarchs deal directly with the Kremlin, that is, the federal administration. Businesses of regional importance do their business with regional governors, and enterprises of up to 250 employees only with mayors. Individual entrepreneurs without employees are free from the administrative yoke.

The lower down on the administrative ladder, the happier businessmen seem to be, and big businessmen are no longer anxious to become oligarchs. In September 2004, I heard one oligarch being quoted: “Nowadays, you do not really feel that you own anything but just have your money at your disposal for a limited time.” The oligarchs were being forced to pay billions of dollars in extortion to the Kremlin that year, and they were increasingly afraid of saying that. With the centralization of power, corruption was centralized as well.

Although often complaining about corruption in public, Putin has allowed his own administration to become pervasively corrupt. Not a single member of his inner circle of KGB people from St. Petersburg, which is sometimes called the “Politburo,” has ever been demoted, and even less prosecuted for corruption. Their legal immunity is complete. Top-level corruption has become extraordinary, and the lifestyle of the top officials hardly differs from that of the oligarchs.

The best documented case is Minister of Communications Leonid Reiman, a close friend of Putin from foreign intelligence in St. Petersburg.

16. Statement by Elena Panfilova, Transparency International, Russia, at the World Economic Forum Russia Summit in Moscow in October 2005.

Table 7.3 Prices of corruption in Russia, 2004–06

Good for sale	Going price	Source
Minister's post	\$10 million	Mereu (2006)
Governor's post	\$8 million	Mereu (2006)
Parliamentary seat	\$2 million	Mereu (2006)
Senate seat	\$1.5 million to \$5 million	Belkovsky (2006)
Job in customs	\$1 million	Mereu (2006)
Release in a criminal investigation, GUUR (Main Department of Criminal Investigation)	\$100,000 to \$150,000	"Main Graft" (2004)
Initiating or terminating a case, GUBNP (Main Department for the Combating of Tax Crimes)	\$30,000 to \$100,000	"Main Graft" (2004)
Admission to most prestigious universities	\$30,000 to \$40,000	Lee Myers (2005)
Terminating a case, GUBEP (Main Department for the Combating of Economic Crimes)	\$25,000	"Main Graft" (2004)
Avoiding service in the military	\$1,500 to \$5,000	Lee Myers (2005)

In May 2006, Reiman lost a civil case in Zurich, Switzerland. The court established that Reiman had committed major crimes in Russia, that he owned large chunks of Russia's telecommunications that he oversaw as minister, and that he created a vast international money-laundering scheme to conceal his diversion of state assets.¹⁷ The news was suppressed in Russian media and Reiman remains on his post. In 2007, his apparent assets were assessed at \$5.9 billion, when Reiman capitalized his booty by selling it to a friendly oligarch.¹⁸

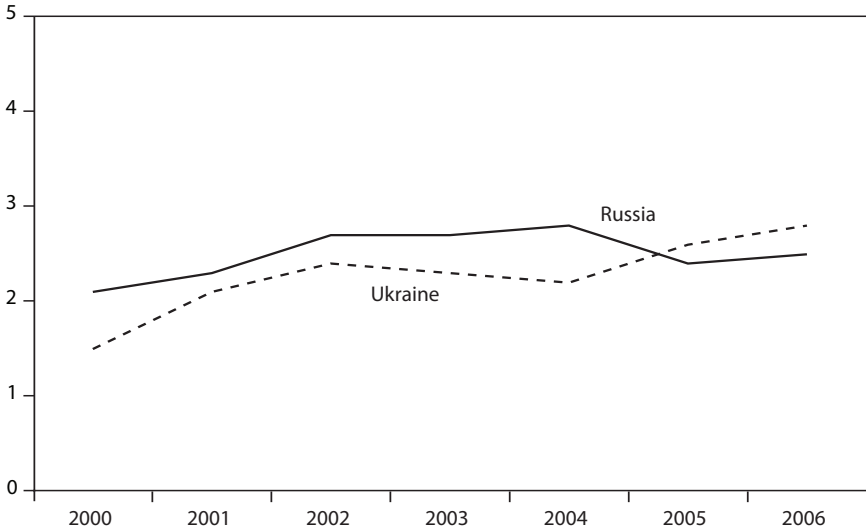
The overall evolution of corruption in Russia in the last decade is captured by a comparison of its Corruption Perception Index, empirically established by the independent and authoritative Transparency International (2007), with that of Ukraine (figure 7.6). Both countries are quite corrupt, but after a significant improvement in Russia from 2000 to 2004, its corruption has grown worse. Ukraine, by contrast, has become less cor-

17. Gregory L. White, David Crawford, and Glenn R. Simpson, "Why Putin's Telecom Minister is in Investigators' Sights Abroad; German and Swiss Probes Tag Leonid Reiman as Owner of Businesses He Oversees; Commerzbanks's Unusual Role," *Wall Street Journal*, October 17, 2006.

18. Neil Buckley, "Russian Phone Feud Is Settled," *Financial Times*, July 30, 2007.

Figure 7.6 Corruption Perceptions Index in Russia and Ukraine, 2000–2006

index (from highly clean = 10 to highly corrupt = 0)



Source: Transparency International, www.transparency.org (accessed on May 30, 2007).

rupt than Russia after the Orange Revolution in 2004. The difference is that the Ukrainian media expose corruption and Ukrainian senior officials cannot be sure that they are exempt from punishment.

Colored Revolutions

All along, Putin expressed nostalgia about the Soviet Union. In *First Person* Putin (2000, 81) stated: “We would have avoided a lot of problems if the Soviet had not made such a hasty exit from Eastern Europe.” He even expressed sympathy with the putschists in August 1991: “In principle, their goal—preserving the Soviet Union from collapse was noble . . .” (Putin 2000, 93). In his annual address in April 2005 Putin (2005) went all out: “the collapse of the Soviet Union was the biggest geopolitical disaster of the century. . . . Tens of millions of our co-citizens and compatriots found themselves outside Russian territory . . . old ideals [were] destroyed.” Putin had declared himself a neoimperialist.

In his first term, Putin’s policy toward the Commonwealth of Independent States (CIS) countries was passive. After September 11, 2001, he accepted that the United States established substantial air bases in Uzbekistan and Kyrgyzstan for the war in Afghanistan. In his second term,

Russia's policy toward the CIS was dominated by the so-called colored revolutions in Georgia, Ukraine, and Kyrgyzstan, and by gas trade.

Gorbachev's old Soviet Minister for Foreign Affairs Eduard Shevardnadze had returned to Georgia in 1993 and was elected president. Although Shevardnadze had muted Georgia's antagonistic relations with Russia, the Russian foreign policy elite disliked both him and Georgia. The Georgians had originally welcomed Shevardnadze, but they increasingly reacted against the corruption of his close relatives. In November 2003, Georgia held parliamentary elections, which Shevardnadze's party won through falsification, prompting mass protests. When a crowd attempted to overthrow Shevardnadze, his US-trained presidential guard refused to defend him, and he was forced to resign. The charismatic revolutionary leader Mikheil Saakashvili won a landslide electoral victory in a hastily scheduled presidential vote in January 2004. Russia did not mind Shevardnadze's demise and Minister for Foreign Affairs Igor Ivanov even mediated his resignation, but the popular Georgian Rose Revolution was the antithesis of Putin's managed democracy.

Ukraine was facing a similar situation to Georgia's in the fall of 2004. President Leonid Kuchma had reached his term limit, and his once-solid popularity had evaporated after sordid scandals. His regime was reminiscent of Yeltsin's—oligarchic and semidemocratic. A mixed opposition had almost won parliamentary elections in March 2002. Under the leadership of Viktor Yushchenko, the opposition was strong and well organized, and it enjoyed substantial support from the business community, while the oligarchs supported Kuchma.

Putin was intensely engaged in stopping a victory of the West-oriented and democratic opposition in Ukraine. One attempt was the Common Economic Space with Russia, Ukraine, Kazakhstan, and Belarus that Putin launched in February 2003. It was designed to keep Ukraine in Russia's orbit. Putin plunged deeply into Ukrainian politics, which he handled himself. He met President Kuchma once a month in 2004, and granted Ukraine substantial trade benefits.

Kuchma proposed Prime Minister Viktor Yanukovich from the largest Ukrainian oligarchic group as his successor. Putin agreed to support him and promised Russian enterprise financing of no less than \$300 million for his campaign.¹⁹ Russian TV, widely viewed in Ukraine, praised Yanukovich and slandered Yushchenko. Dozens of Russian political advisors, well paid by the Kremlin, descended on Ukraine to promote Yanukovich. Early in the campaign, Yushchenko was severely poisoned by an uncommon substance that probably originated in Russia. In the last month before the elections, Putin went to Ukraine twice to campaign for Yanukovich.

19. Personal information from the Yushchenko campaign in September 2004.

After the Yanukovych camp blatantly falsified the results of the second round of the elections, up to one million Yushchenko supporters poured into the streets of Kiev and the Orange Revolution was a reality. After mainly European mediation between Yanukovych and Yushchenko, they peacefully agreed to hold a third, fair round, which Yushchenko won (Åslund and McFaul 2006, Wilson 2006).

Putin's intrusive actions in Ukraine made him appear poorly informed, antidemocratic, anti-Western, and ineffective. In one stroke, he managed to unite the United States and the European Union, badly split over the war in Iraq, against himself. Putin seemed primarily worried about Ukraine as a democratic model for Russia. However intrusive Putin's policy was in Ukraine, its aim was domestic policy and it did not qualify as neoimperialist. When Yanukovych became prime minister in 2006, Putin lost interest in Ukraine.

The situation in Kyrgyzstan was reminiscent of Georgia and Ukraine. President Askar Akaev was approaching his term limit in October 2005, and his great popularity was slipping because of his family's conspicuous corruption. Like Georgia and Ukraine, Kyrgyzstan was semidemocratic and quite an open society. It had a strong, organized opposition with prominent leaders and some free opposition media. In March 2005, after a botched parliamentary election, the regime was overthrown. The unrest started in the south and moved to the capital Bishkek in the north. The presidential administration was stormed by a limited crowd and the Akaev family fled to Moscow. The Kremlin did not seem to mind and established somewhat closer relations with the newly-elected President Kurmanbek Bakiev than it had with Akaev.

In May 2006, a sudden armed uprising broke out in the Uzbek city of Andijan in the fertile but overpopulated Fergana Valley. Uzbekistan's President Islam Karimov sent in troops that killed a few hundred people, which stopped the uprising. Putin showed his appreciation of Karimov's resolute massacre, condemning the Andijan uprising as a terrorist act. The colored revolutions were over.

McFaul (2006, 166) has summarized the crucial conditions for the three colored revolutions: (1) a semiautocratic regime; (2) an unpopular leader of the *ancien régime*; (3) a strong and well-organized opposition; (4) an ability to create the perception quickly that election results were falsified; (5) enough independent media to inform citizens about the falsified vote; (6) a political opposition capable of setting in motion tens of thousands of demonstrators to protest electoral fraud; and (7) a division between intelligence forces, military, and the police. In addition, external actors can facilitate the development of many of these domestic factors.

The Kremlin appears to have drawn the conclusion that all these factors had to be dismantled in Russia, and Putin transformed Russia from a semiautocratic into a regular authoritarian regime.

Apart from the colored revolutions, Gazprom's interests dominated Russia's policy in the former Soviet space. Gazprom had two ambitions: to secure its monopoly over transportation and sales and to boost its export prices. It expanded its ownership and control over gas pipelines and sales of Central Asian gas to Europe, averting Western ideas of a new trans-caspian gas pipeline to Europe. Often it extracted ownership in debt-equity swaps from countries, such as Moldova and Belarus, which had run up large arrears for gas deliveries.

The biggest strife concerned Gazprom's new ambition to extract full market prices also from CIS countries. Because of corrupt trading schemes and neoimperialist sentiments, Gazprom had charged as little as one-quarter to one-fifth of the European price, and Ukraine and Moldova refused to accept stark price hikes. In early January 2006, Gazprom's Chairman and Russia's First Deputy Prime Minister Dmitri Medvedev was shown on Russian television turning off the gas tap to both countries in a macho display. But 80 percent of Gazprom's exports to the European Union passed through Ukraine. Not only the Orange Ukrainian government but also the European Union and the United States protested. A reasonable deal for Ukraine was settled within days, and the disruption lasted only two days. Moldova, however, was no transit country, and it received no gas for 16 days, after which it was forced to accept Gazprom's ultimatum.

In January 2007, Belarus, the Kremlin's closest ally, suffered the same treatment as Ukraine one year earlier. With 20 percent of Russia's gas deliveries to the EU going through Belarus, EU leaders protested loudly against delivery disruptions, and Belarus got away with a mere doubling of the gas price. Yet, by 2007, Gazprom had largely achieved its aim of market-oriented prices, which greatly boosted its profitability and stock price.

An untidy, unfinished business from the collapse of the Soviet Union was the so-called frozen conflicts: unregulated, separatist territories outside the control of the national government. The Moldovan province of Transnistria refuses to recognize the Moldovan government, and the Georgian territories of Abkhazia and South Ossetia demand independence from the Georgian government. The leaderships in these three territories are pro-Russian, and the Kremlin supports them with troops, but it has stopped short of recognizing their independence.

The Moldovan and Georgian governments want to restore their national integrity, whereas Moscow seems to enjoy the complication. In 2006, these conflicts escalated, and Russia suddenly embargoed Georgia's and Moldova's large exports of wine and fruits to Russia. It also blocked most transportation to and from Georgia and even bank transactions. Georgia played hardball, revoking its bilateral protocol on Russia's accession to the WTO, thus blocking Russia's entry into that organization, of which Georgia was already a member.

As Putin's second term is nearing its end, Russia's policy in the former Soviet space is strikingly ineffective. Russia has cut lingering subsidies to its poorer neighbors, which are trying to reach out to reduce their dependence on Russia because it no longer offers any benefits and has proven highly unreliable through many sudden disruptions of Russian gas deliveries and embargoes on successful exports. No Russian free trade initiative can work without a mechanism for conflict resolution.

In sum, Russia has failed to develop good relations with its neighbors, but the Kremlin does not seem to care. If you visit a Russian embassy in a CIS country, you find no Russian diplomat who speaks the local language. The problem with Russia's policy in the former Soviet space is less neoimperialism than disinterest and disrespect.

A New Distance from the West

Like Gorbachev and Yeltsin, Putin has been anxious to be accepted by the leaders of the big, wealthy Western countries. His interest has been primarily ceremonial. The two most important international events during his tenure have been the celebration of St. Petersburg's tercentenary in 2003 and the G-8 meeting in St. Petersburg in July 2006. On neither occasion was any significant decision made. Putin wanted to demonstrate Russia's return as a great power and his own international standing.

Gradually, Russia has drifted away from the United States and the European Union, and Western influence over Russia has waned. In 2004, Putin turned outright hostile to the West. After the Beslan massacre, Putin made a vague but ominous statement about hostile forces, implicitly referring to the United States as wanting "to tear from us a 'juicy piece of pie'" (Putin 2004c).

The Orange Revolution provided the tipping point. Russia's policy united the United States and the European Union against Russia, which accused the West of subversion in Ukraine. It was followed by Western protests over the restrictive Russian draft law on nongovernmental organizations in the fall of 2005, and Gazprom's disruption of gas deliveries to Europe through Ukraine in January 2006. Official Russian spokesmen blame the enlargement of NATO to the Baltic states and the US failure to eliminate the Jackson-Vanik amendment's potential (but implausible) threat of trade sanctions. In 2007, Putin escalated his rhetoric after the US revealed plans to establish antimissile bases in Poland and the Czech Republic. Putin threatened to target European capitals with nuclear missiles and to withdraw from two arms control treaties, CFE and INF.

Putin's underlying worry was that the West would instigate an Orange Revolution in Russia. The *siloviki* around Putin dislike the West, and increasingly Putin has let them take over. Their idea is that Russia is strong enough on its own. Judging from his public statements, Putin is caught in

“growth Darwinism,” contemptuous of the slowly growing West, while enchanted with the dynamic (and authoritarian) China. Meeting with prominent international journalists before the G-8 meeting in Heiligendamm in Germany in June 2007, Putin clarified his international outlook:

DER SPIEGEL: Mr. President, former Federal Chancellor Gerhard Schroeder called you a “pure democrat.” Do you consider yourself such?

VLADIMIR PUTIN: (laughs) Am I a “pure democrat”? Of course I am, absolutely. . . . The problem is that I’m all alone, the only one of my kind in the whole wide world. Just look at what’s happening in North America, it’s simply awful: torture, homeless people, Guantanamo, people detained without trial and investigation. Just look at what’s happening in Europe: harsh treatment of demonstrators, rubber bullets and tear gas used first in one capital then in another, demonstrators killed on the streets. That’s not even to mention the post-Soviet area. Only the guys in Ukraine still gave hope, but they’ve completely discredited themselves now and things are moving towards total tyranny there; complete violation of the Constitution and the law and so on. There is no one to talk to since Mahatma Gandhi died. (Putin 2007d)

No doubt this sarcastic tirade went down well with the Russian populist electorate, but it begs the question: About what does it make sense to talk to Putin?

US President George W. Bush, however, has not wavered in his confidence in Putin. On July 1–2, 2007, Bush honored Putin by inviting him to his father’s summer house in Kennebunkport, Maine. At the ensuing press conference, Bush revealed: “But one thing I’ve found about Vladimir Putin is that he is consistent, transparent, honest and is an easy man to discuss our opportunities and problems with . . . I know he’s always telling me the truth.”²⁰ As this book hopefully has shown, this statement was not quite true.

Putin has successfully divided the European Union for years. In 2004, when Poland and the three Baltic states became members of the EU, Moscow scolded them as “the new aggressive minority.” Russia undertook sanctions against them, invoking alleged sanitary or environmental concerns. It prohibited meat imports from Poland and fish imports from Latvia, while refusing to deliver oil by pipeline to Lithuania. In early May 2007, Estonia was subject to a cyber war attack, which took out its e-banking and e-government, for moving a Soviet war memorial.

Meanwhile, Putin has nurtured his friendship with Schröder, Chirac, and Berlusconi, and the southern wing of the European Union—France, Italy, Spain, and Greece—has supported Russia against Poland and the Balts. As a result, the EU has neither a Russia policy nor an energy policy, although it accounts for over half of Russia’s foreign trade and most of its gas and oil exports.

20. “President Bush Meets with President Putin of Russian Federation,” White House press release, July 2, 2007, available at www.whitehouse.gov (accessed on July 13, 2007).

Controversially, Schröder obtained the lucrative post as chairman of a Russian-German consortium for North Stream, a gas pipeline from Russia to Germany through the Baltic Sea immediately after he was voted out as German Chancellor in the fall of 2005. In his last days as Chancellor, he gave German approval to that pipeline.

Poland forced a harder EU position in November 2006, by vetoing an EU negotiation mandate on a broad agreement with Russia because of Russia's refusal to allow meat imports from Poland. In May 2007, at the EU-Russia summit in the Russian city of Samara, Estonia and Lithuania added their support, and President of the European Commission José Manuel Barroso stated a newly found EU unity:

The question of Polish meat is a difficult one for us. We had the opportunity to tell our Russian partners that difficulties for an EU member amount to difficulties for the entire EU. The European Union is based on the principle of solidarity. We now have 27 members. And Poland's problem is a pan-European problem. Just as Lithuanian or Estonian problems are problems for all of Europe.²¹

Under Putin, Russia's attitude toward the United States, the European Union, and the CIS countries has become tougher. However, the main goal of his foreign policy appears to be domestic image making: to show Russia's new strength and Putin's standing as an international leader. Russia's foremost international interest is that of Gazprom, and protectionist agricultural lobbies have been given a free rein. Senior Russian politicians habitually make unsubstantiated threats against other countries, but they are fortunately more aggressive than their follow-up. Sometimes vicious embargoes are suddenly being imposed, yet Russia is not reforming its military and only minor military provocations are attempted. Russian politicians can afford these jokes, because their country does not face any evident external threat and its exports enjoy ample market access.

Does Russia Suffer from an Energy Curse?

Russia's energy curse is evident, but in politics and structural policies rather than macroeconomic policy. In the 1970s, Brezhnev did not undertake any reforms because they did not appear necessary due to the USSR's abundant fortunes during the energy crisis. Although Russia today has a market economy, a similar vicious circle is apparent. The more the resource wealth is worth, the more latitude the president is afforded. Mistakes pass without correction, and ever worse malpractices are permitted.

Energy plays an enormous role in the Russian economy. According to Russia's official statistics, its contribution to GDP was only 9 percent even in 2006 (Goskomstat 2006, Deutsche Bank 2007). The national accounts, however, understate the importance of energy in Russia's GDP because of

21. Samara, May 18, 2007, www.kremlin.ru (accessed on July 13, 2007).

low domestic energy prices, especially for gas. Assuming normal market prices of energy in Russia, energy would have contributed almost 20 percent of GDP in 2006 (World Bank 2004). In 2006, energy accounted for 63 percent of Russia's exports and about 50 percent of its tax revenues. Gaddy and Ickes (2005, 562) found a strong positive correlation between oil and gas rents and GDP. The energy rents peaked at over 40 percent of GDP in 1981, while they were very low throughout the 1990s, when Russia reformed. They took off again from 2003, and Russia stopped reforming.

Is oil good or bad for Russia's economic development? In an important paper with multicountry regressions, Sachs and Warner (1996) found that countries that enjoyed an abundance of natural resources (measured as a share of their exports) had less long-term economic growth than countries with less natural resources. The question is why? Three categories of possible effects are: macroeconomic, structural economic, and political.

Macroeconomically, large resource exports influence the exchange rate and thus the wage level in dollars. Oomes and Kalcheva (2007) found that an increase in the Urals oil price of 1 percent led to a 0.5 percent appreciation of the real effective exchange rate. Russia's dollar wage increased an average of 30 percent a year from 1999 to 2006, boosted by large energy exports. Yet, given Russia's splendid economic performance, these effects do not appear to have had major negative repercussions.

Considering that Russia's GDP is increasing by almost 7 percent a year, while energy production has increased by 1 to 2 percent a year since 2005, the country's economy is swiftly diversifying. The service sector is expanding at the cost of industry, as it should. With Russia's comparative advantage in energy and metals production, manufacturing is inevitably impeded out. Why produce machinery in Russia rather than in Ukraine, when similar production facilities are available in both countries and Ukrainian wages are half as high?

Resources easily tempt governments to undermine their macroeconomic policies, but so far the crash of 1998 has kept the Russian government immune to this temptation as is evident from large budget surpluses, substantial international reserves, and a sizable stabilization fund (figures 6.2 and 6.6). Even if the Ministry of Finance is under pressure to spend more money, its resistance has been effective.

Still, Russia suffers from an energy curse in its structural policies. First, the renationalization wave began in 2003, when the international oil price was taking off (figure 6.4). State officials were overwhelmed by the temptation to seize oil companies because the high oil prices rendered production and cost control—that is, management skills—pretty irrelevant. It has been argued that the energy curse is a curse of state ownership, but Russia under Putin shows how the energy curse leads to state ownership (Tompson 2005, 355).

Second, Putin ended his economic reforms when Russia could achieve an annual growth of 7 percent without bothering with additional reforms.

If the oil price were to fall, by contrast, the government would probably pursue reforms again to maintain the 7 percent annual growth target.

Third, corruption, which declined during Putin's first years of structural reforms, started rising with the renationalization drive after 2004 (figure 7.6). State officials could not resist the temptation to transfer oil and gas wealth to themselves.

Fourth, Russia has become overly dependent on the taxation of oil. The marginal tax rate on oil production is no less than 88 percent (Gaddy and Ickes 2005, 564). A fall in oil prices would hurt Russia's state finances; the high oil taxes deter oil companies from investment in production and development; and the government pays little attention to other sectors of the economy, since it is financed by oil taxes.

The most important energy curse, however, is political. The resource wealth has greatly facilitated Putin's efforts to make Russia authoritarian. He does not need to ask the population for financing but can scare up two scores of immensely wealthy oligarchs. That is a reason for him to allow such a concentration of wealth. Acemoglu (2003) pointed out that oligarchies block entry but keep taxation down, which is Russia's current situation.

The question is how far economic policy can deteriorate. It can be halted by bottlenecks, falling output, and eventually by falling energy prices. It was not by chance that Russia undertook all its heroic reforms in the 1990s when the world oil price was so low (Gaddy and Ickes 2005, Gaidar 2006).

Putin's Model: Back to Nicholas I

The fundamental question is: What kind of Russia has Putin created? In his annual address in 2007, Putin (2007b) attempted an answer. First, he claimed to "achieve real democratisation of the electoral system . . . the proportional system gives the opposition greater opportunities to expand its representation in the legislative assemblies. . . . I am certain that the new election rules will not only strengthen the role of political parties in forming the democratic system of power, but will also encourage greater competition between the different parties." Yet, Putin has systematically eliminated democratic electoral competition.

Second, he said: "Decentralisation of state power in Russia is now at a higher point today than at any other time in our country's history." Yet, Russia is far more centralized under Putin than it was under Yeltsin.

Third, Putin stated that the "rapid expansion of our national information and media space is also having a beneficial effect on the development of democratic institutions and procedures." But he has suppressed the freedom of all major media.

Fourth, "it is impossible to imagine the democratic political process without the participation of non-governmental organisations, without tak-

ing into account their views and opinions. . . . This exchange of views, this dialogue with the NGO's, is developing consistently today" (Putin 2007b). Yet, Putin has stifled independent organizations with arbitrary regulations.

For eight years, Putin has talked about the reinforcement of democracy, and even after having abolished every bit of it, he cannot stop talking about his democratic ambitions. Apparently, Putin uses public statements as disinformation. He has restored the Soviet tradition of "newspeak," calling everything its opposite, as George Orwell (1949) described in his novel 1984.

To understand what is happening in Putin's Russia, we must not believe Putin's public or private statements, but examine his actual policy. After eight years of Putin, it is evident that his main endeavor has been to dismantle all democratic institutions and build an authoritarian system. His vindictiveness has been extraordinary, which is untypical of Russians. If somebody crosses him once, Putin seems determined to annihilate him. Few politicians show fury and contempt so often and so publicly.

First, Putin strangled major media. Putin can still manipulate the population through television, although the political reporting of the two central state channels, ORT and Rossia, is perfectly Soviet. The strength of the Putin regime lies in its skill to manipulate the elite, the media, and civil society, but if this propaganda deviates too much from reality for too long, it will eventually lose credibility.

Putin's second step was to rein in the regional governors. He appointed presidential representatives to supervise them and enforce federal legislation. He deprived the governors of their seats in the Federation Council. As its members were appointed, the upper chamber lost significance. Next, Putin abolished gubernatorial elections, appointing all governors himself. Russia's traditional centralization of power has been restored.

Third, he stifled the political influence of the oligarchs through the long and tortuous Yukos affair. If not even the property rights of Russia's richest man were safe, all property rights were unsafe. Not only individual oligarchs but also their organizations, such as the Russian Union of Industrialists and Entrepreneurs, lost out.

Fourth, while Putin appeared to improve Russia's courts through judicial reform, he subordinated the judges to the presidential administration rather than to regional governors.

Fifth, the Duma elections have lost all democratic content. A wide range of means have been used—refusal to register parties, the disqualification of candidates, illegal harassment, temporary arrests, and prohibition against public meetings. Each measure in itself might not appear too arduous, but taken together they are overwhelming (Fedorov 2004, Fish 2005). As a consequence, both liberals and communists have been marginalized.

A sixth step was to transfer power from the Council of Ministers to the presidential administration. The two most important measures came in

early 2004: the appointment of the weak Fradkov as prime minister, and the government restructuring that minimized its policymaking capacity.

All these profound institutional changes have gone in one direction. Putin has centralized power to the presidential administration and relied on FSB veterans to control the country. These secret policemen control much of the economy through the big state-owned corporations. Checks and balances have been minimized. Putin has deprived the formal institutions—the Federal Assembly, the Council of Ministers, and the regional governors—of any real power. As camouflage, he has set up informal advisory institutions, such as the State Council and the Public Chamber, which are of little or no consequence. As a result, Russia has suffered a far-reaching deinstitutionalization. Putin has concentrated power in his own hands, trying to micromanage everything. He and a handful of his closest aides in the Kremlin make far too many decisions about things that they know far too little about.

Paradoxically, Russia's economy is doing very well with a steady growth of 7 percent a year, and the standard of living is rising considerably faster. Thanks to the extensive market reforms in the 1990s and during Putin's first term, dominant private enterprises have driven growth, and the high oil prices have added impetus. No new reforms are in the offing, but the petrification of decision making has also safeguarded the survival of most reforms already adopted. Russia's market economy, solid macroeconomic stability, and focus on economic growth appear secure.

Putin is the master of good feelings. One of his outstanding political strengths is to reflect in himself everything that people want to see (Tregubova 2003). His main political achievement is that he has made Russians feel good about their country again. Gorbachev dug up all the tragedies in Soviet history and society. Yeltsin was perceived as drunk, corrupt, and just embarrassing. Putin is controlled and so is his media environment. Russia exudes strength and dynamism. In this scheme, foreign policy is not very important. Russia wants to be truly sovereign, and Putin plays with foreign policy as theater for the masses, providing amusement and projecting Russia's rising power, because Russia has no dangerous enemies. But nor does it have any real friends.

As Russia's political system and rulers change, so do its interests. Putin's KGB friends dominate the state administration and the big state enterprises, which badly need reform, but few reforms can occur contrary to the ruling interests. These hungry secret policemen accept few limits, least of all the private property of others. They take over one big enterprise after another. Sooner or later, the squeezing out of good enterprises by bad ones will be reflected in the growth rate. The threat is that inefficient state giants will gobble up efficient private corporations and promote old-style over-regulation and corruption.

In his excellent book on Russian conservatism, Richard Pipes (2005, 1) concluded: "The dominant strain in Russian political thought throughout

history has been a conservatism that insisted on strong, centralized authority, unrestrained either by law or parliament." Along these lines, current First Deputy Prime Minister Sergei Ivanov (2006) published an article in *Izvestiya* in 2006. In a Soviet manner, Ivanov presented the world as a competition between different value systems. He drew on Count Sergei Uvarov's famous triad of "Orthodoxy, Autocracy, Nationality," which became the ideological foundation of Tsar Nicholas I (Pipes 2005, 100). He argued that the "new triad of Russian national values is sovereign democracy, strong economy, and military power."

Putin's new concept of "sovereign democracy" is no democracy but the autocracy in Uvarov's triad. Russia's new strong economy is for real, but state monopolies are on the offensive. The military, however, is weak, not least because Ivanov failed to reform it during his five years as minister of defense. Today's real triad is: "autocracy, secret police, and state monopolies," and it is difficult to see any spiritual value embedded in either that or Sergei Ivanov's triad.

This is a time of cynicism. No ideology or values are apparent. Putin pampers the Orthodox Church, but it remains a symbol and a privileged cast rather than a force. At one moment, Putin appeals to populism and nationalism, but in the next he criticizes nationalism and demonstrates ethnic tolerance.

The late Soviet comedian Arkady Raikin once said: "If it is better than in 1913 it is already good."²² The Russian public agreed. One of the first private restaurants in St. Petersburg was named "1913." The period just before World War I is embellished in nostalgic Russian television advertisements. Putin seems to be returning Russia to this presumed ideal state. Fortunately, this is neither Soviet restoration nor fascism. Russia might need to return to the point where its development was so violently aborted. Yet, non-Russians would hardly regard the political system of the Russian Empire of 1913 as ideal or even viable. This reactionary project has been possible because Russians are tired of politics in their postrevolutionary stabilization. With its deinstitutionalization and dominant secret police, Putin's regime is more reminiscent of Tsar Nicholas I (1825–55) than Tsar Nicholas II (1894–1917). Neither regime ended well, and ill-fated wars were only one cause of their downfall.²³

Russia has entered the 21st century professing the creed of long-gone tsars. Putin's Russia is marked by a profound contradiction between an obsolete, overcentralized, authoritarian state and a swiftly modernizing market economy. Politically, Putin has deprived Russia of all relevant institutions, which will leave him alone before the people in a severe crisis. This revival of the long-dead tsarism is a monstrosity of nostalgia.

22. Quoted in *Izvestiya*, October 12, 1986.

23. The Crimean War and World War I, respectively.

