

Putin, Coase, and Khodorkovsky

Based on Gaddy and Ickes, *Russia's Addiction: The Political Economy of Resource Dependence*, Brookings Press, forthcoming, 2008.

Barry W. Ickes

The Pennsylvania State University

October 2007

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- To understand Russia we must examine the importance of oil and the distribution of the rents from its production

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- To understand Russia we must examine the importance of oil and the distribution of the rents from its production
- It is productive to think of Russia as a grand protection racket

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- To understand Russia we must examine the importance of oil and the distribution of the rents from its production
- It is productive to think of Russia as a grand protection racket
 - misses a central element

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- To understand Russia we must examine the importance of oil and the distribution of the rents from its production
- It is productive to think of Russia as a grand protection racket
 - misses a central element
- How to centralize and control the distribution of massive rents is the central political problem

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- To understand Russia we must examine the importance of oil and the distribution of the rents from its production
- It is productive to think of Russia as a grand protection racket
 - misses a central element
- How to centralize and control the distribution of massive rents is the central political problem
- Follows in the wake of the second Russian oil boom

Defining Resource Rents

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- The value of current production less costs of production and transport

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- The value of current production less costs of production and transport
- What is *potentially* available for distribution

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- The value of current production less costs of production and transport
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- Definition

$$R_t \equiv P_t Q_t - C_t \quad (1)$$

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$$R_t \equiv P_t Q_t - C_t \quad (1)$$

- Actual costs differ from reported costs, so reported rent is

$$\begin{aligned} \hat{R} &= P_t Q_t - \hat{C}_t \\ &= P_t Q_t - C_t - \varepsilon_t. \end{aligned} \quad (2)$$

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- Rents are *much* bigger than after-tax profits:

$$P_t Q_t - C_t = \frac{\pi'_t}{1 - \tau - \tau'} + \rho Q_t + \varepsilon_t \quad (3)$$

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- Key item → fluctuations in price of oil

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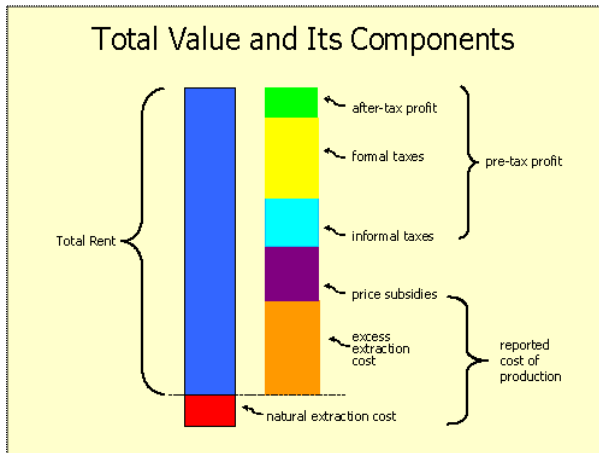
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- Price subsidies, excess costs, formal taxes, informal taxes

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- Informal taxes are of two main types:

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- Formal taxes are those prescribed by legislation.
- Informal taxes are of two main types:
 - (1) bribes paid to government officials; and
 - (2) payments made for the support of public sector needs that are nominally voluntary but in fact mandatory for businesses, for example, payments made by enterprises to support the social sector of towns and regions, cultural programs, philanthropic giving, and so on.

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- weak property rights increase informal taxation

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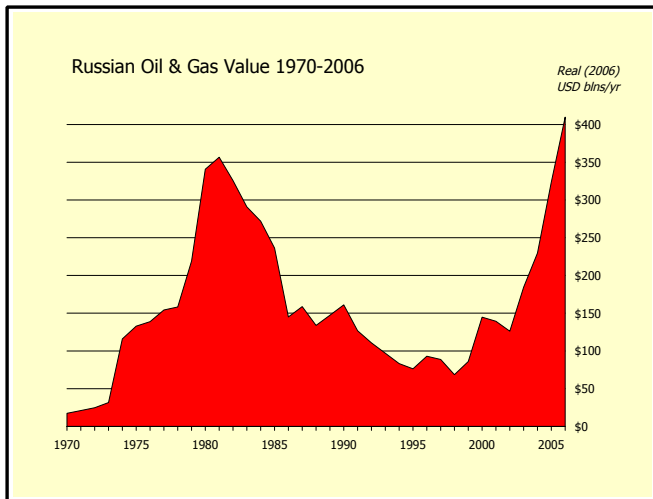
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- weak property rights increase informal taxation
- informal categories of rent are the part of the iceberg below the surface

Oil and Gas Rents 1970-2006

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- Resource rents are huge



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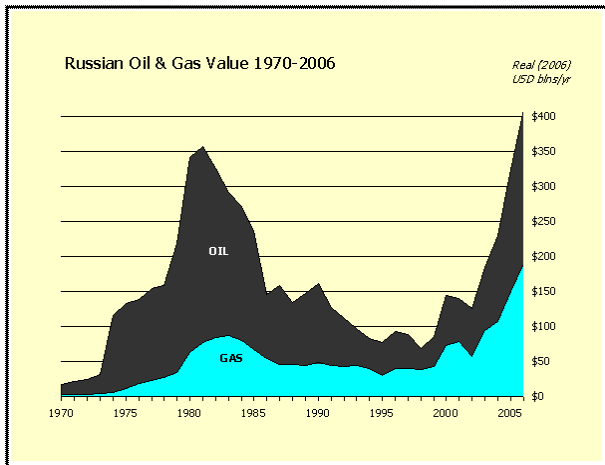
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Oil and Gas Rents 1970-2006

- Oil rents larger, gas rents more stable



Iceberg

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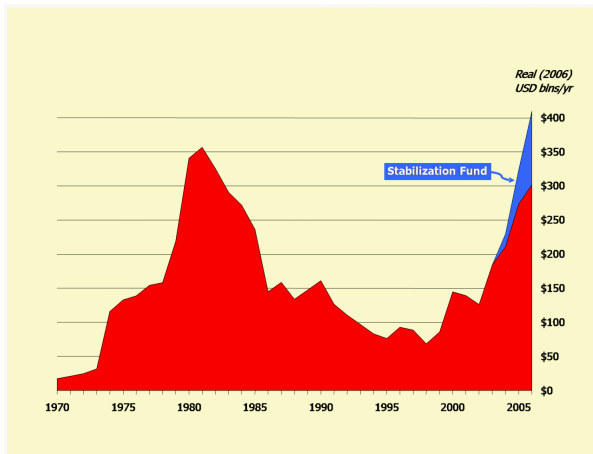
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- Stabilization fund protects formal expenditures of budget, but is only a small share of rents.

Iceberg

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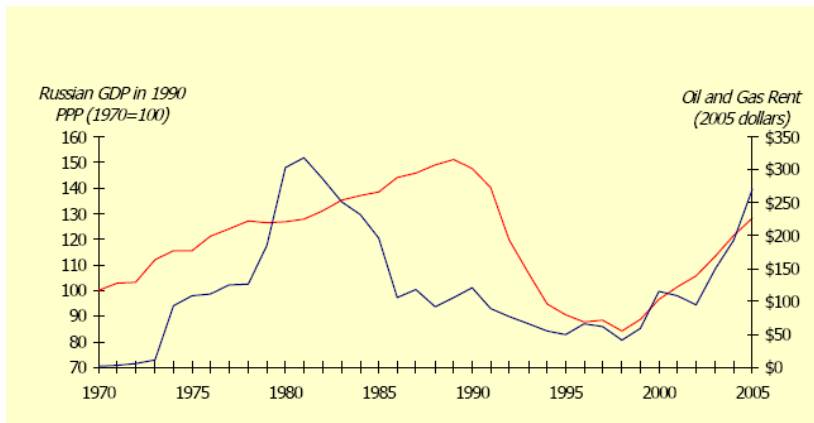


Rents and Russian GDP

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■ Rent Fluctuations Crucial for GDP movements



Growing Importance of Rents

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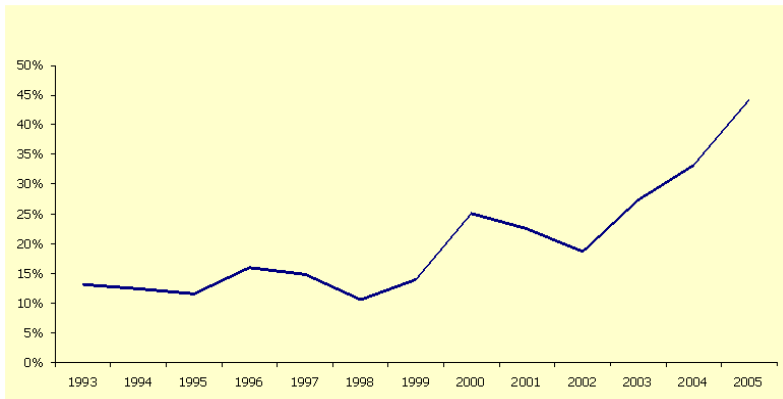
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■ Share of Rents in Russian GDP



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- Resource Sector dominates economy

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- Resource Sector dominates economy
 - Private wealth could dominate the state

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- To create strong state essential to control the distribution of rents

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- To create strong state essential to control the distribution of rents
 - control formal rent distribution via tax reform → primarily and administrative reform (Zubkov)

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- How to control informal rent distribution?

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- How to control informal rent distribution?
 - take control from regions, stop oligarchs from buying governors

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 - take control from regions, stop oligarchs from buying governors
 - appointed governors become “regional rent allocation managers.”

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 - voluntary funds

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 - control excess costs of production

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- How to control informal rent distribution?
 - take control from regions, stop oligarchs from buying governors
 - appointed governors become “regional rent allocation managers.”
 - voluntary funds
 - control excess costs of production
 - new bargain with oligarchs – stay out of politics

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- The point of a protection racket is that the guy offering you the protection is the one who represents the threat that you need to protect against.

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- The point of a protection racket is that the guy offering you the protection is the one who represents the threat that you need to protect against.
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- The point of a protection racket is that the guy offering you the protection is the one who represents the threat that you need to protect against.
 - “property rights protection rackets.”
 - The property rights are what are under threat, and the one who threatens them is the one who is asking for the payoff.

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- local and regional, government-sanctioned protection rackets

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- Why not just formal taxes?

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- Why not just formal taxes?
 - much more control over how it is spent

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- More important is the central government's protection racket
- Why not just formal taxes?
 - much more control over how it is spent
 - also creates addiction

Missing element

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 - can't let money rule the system
- System is designed to extract rents and control the economy

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Missing element

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 - the behavior of companies to insure rent-sharing through production and serve the interests of the state as defined by Kremlin
 - expropriation risk weakens property rights, creates viability insurance

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 - cannot let money determine decisions

Inverted Funnel Economy

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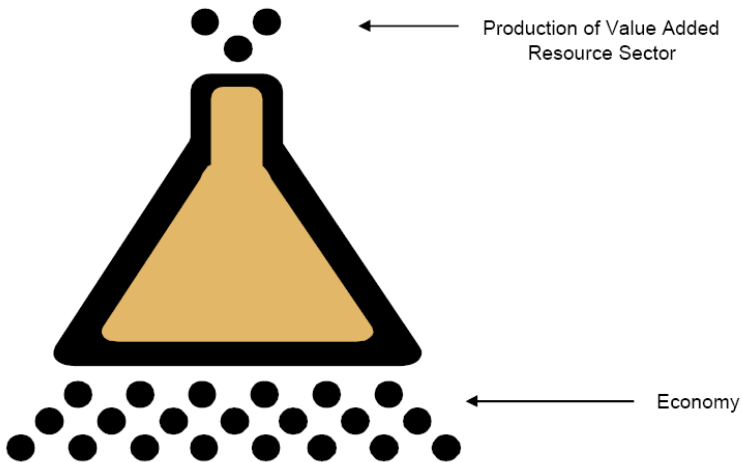
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- Three characteristics of addiction

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- Three characteristics of addiction
 - 1 tolerance - the need for an increasing amount of the substance to obtain the same effect

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- Three characteristics of addiction

- 1 tolerance - the need for an increasing amount of the substance to obtain the same effect

- Investment in the energy sector exploded during 1975 and 1985, "energy as a whole increased its share of the industrial investment budget from 28 percent to 39 percent" (Allen 2003: 204)

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■ Three characteristics of addiction

1 tolerance - the need for an increasing amount of the substance to obtain the same effect

- Investment in the energy sector exploded during 1975 and 1985, "energy as a whole increased its share of the industrial investment budget from 28 percent to 39 percent" (Allen 2003: 204)
- Meanwhile, productivity in the oil sector was plummeting: during this period, the capital stock increased by a factor of 2.45, employment by 25%, while output fell by 21%

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 - Investment in the energy sector exploded during 1975 and 1985, "energy as a whole increased its share of the industrial investment budget from 28 percent to 39 percent" (Allen 2003: 204)
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- 2** withdrawal - severe unpleasant effects when the addict ceases to use the substance

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- 2** withdrawal - severe unpleasant effects when the addict ceases to use the substance
- 3** craving - "willingness to sacrifice all (to the point of self-destructiveness)" in order to obtain and use the substance

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2 withdrawal - severe unpleasant effects when the addict ceases to use the substance

3 craving - "willingness to sacrifice all (to the point of self-destructiveness)" in order to obtain and use the substance

- Claim: addiction to oil rents transformed the economy "physiologically"

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- Khodorkovsky's" (fatal) mistake was that he believed he actually owned YUKOS."

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- Khodorkovsky's" (fatal) mistake was that he believed he actually owned YUKOS."
- More accurately, he believed he owned YUKOS' rents.

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- Khodorkovsky's" (fatal) mistake was that he believed he actually owned YUKOS."
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- In fact, he had only legal (formal) property rights to the company's rents, not economic (de facto) rights.

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- Khodorkovsky's" (fatal) mistake was that he believed he actually owned YUKOS."
- More accurately, he believed he owned YUKOS' rents.
- In fact, he had only legal (formal) property rights to the company's rents, not economic (de facto) rights.
- The actual owners of the economic property rights were the millions of workers, families, regional residents, geologists, politicians, etc. who had been enjoying those rents since the Soviet period

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 - Khodorkovsky believed the virtual economy ended in 1998

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 - The actual owners of the economic property rights were the millions of workers, families, regional residents, geologists, politicians, etc. who had been enjoying those rents since the Soviet period
 - Khodorkovsky believed the virtual economy ended in 1998
 - In other words, the de facto property rights to the rents which the virtual economy system conveyed to the population and others no longer applied.

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 - In other words, the de facto property rights to the rents which the virtual economy system conveyed to the population and others no longer applied.
 - It seems natural to assume that an owner of an asset has property rights over the income the asset produces.

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 - The actual owners of the economic property rights were the millions of workers, families, regional residents, geologists, politicians, etc. who had been enjoying those rents since the Soviet period
 - Khodorkovsky believed the virtual economy ended in 1998
 - In other words, the de facto property rights to the rents which the virtual economy system conveyed to the population and others no longer applied.
 - It seems natural to assume that an owner of an asset has property rights over the income the asset produces.
 - It is this assumption of Khodorkovsky that got him into trouble – key to understanding the game

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- Shift rents to the formal sector by reducing excess costs and informal rent distribution

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- Shift rents to the formal sector by reducing excess costs and informal rent distribution
- Yukos cuts out excess costs and pays no informal taxes

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- Shift rents to the formal sector by reducing excess costs and informal rent distribution
- Yukos cuts out excess costs and pays no informal taxes
- Introduces better monitoring so that less can be stolen locally

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- Shift rents to the formal sector by reducing excess costs and informal rent distribution
- Yukos cuts out excess costs and pays no informal taxes
- Introduces better monitoring so that less can be stolen locally
- This makes it solely a contest for rents between “Putin” and “Khodorkovsky.”

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- Shift rents to the formal sector by reducing excess costs and informal rent distribution
- Yukos cuts out excess costs and pays no informal taxes
- Introduces better monitoring so that less can be stolen locally
- This makes it solely a contest for rents between “Putin” and “Khodorkovsky.”
 - But the previous claimants are not neutral.

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- Shift rents to the formal sector by reducing excess costs and informal rent distribution
- Yukos cuts out excess costs and pays no informal taxes
- Introduces better monitoring so that less can be stolen locally
- This makes it solely a contest for rents between “Putin” and “Khodorkovsky.”
 - But the previous claimants are not neutral.
 - They are at this point — when the fight begins — against Khodorkovsky, not Putin. It was Khodorkovsky, not Putin, who dispossessed them.

Khodorkovsky in Tomsk

- Roundtable in Tomsk with deputies

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 - “Next slide, please.”

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- Roundtable in Tomsk with deputies
 - Khodorkovsky is on the attack. He has Power Point
 - “Next slide, please.”
 - slide shows clearly how many high-paying jobs YUKOS created in T oblast in the past fiscal year. Yukos pays taxes delivers oil at cost, but the deputies are not happy

Khodorkovsky in Tomsk

- Roundtable in Tomsk with deputies

- Khodorkovsky is on the attack. He has Power Point
- "Next slide, please."

- slide shows clearly how many high-paying jobs YUKOS created in T oblast in the past fiscal year. Yukos pays taxes delivers oil at cost, but the deputies are not happy
- "It's as if he demonstratively does not want to understand that money from the oblast budget is allocated by the bureaucrats, while fuel oil delivered by YUKOS at cost to heat the northern towns goes to heat the northern cities no matter what. There's no way you can reallocate fuel oil from the northern towns into the pockets of the officials."

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 - "It's as if he demonstratively does not want to understand that money from the oblast budget is allocated by the bureaucrats, while fuel oil delivered by YUKOS at cost to heat the northern towns goes to heat the northern cities no matter what. There's no way you can reallocate fuel oil from the northern towns into the pockets of the officials."
 - "That's nice," blurts out one of the deputies

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 - “That’s nice,” blurts out one of the deputies
 - “But why aren't you investing in the local economy?”

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 - “That’s nice,” blurts out one of the deputies
 - “But why aren't you investing in the local economy?”
 - Why aren't you placing orders with our local companies? Why aren't you buying T cable, for instance?”

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 - “That’s nice,” blurts out one of the deputies
 - “But why aren't you investing in the local economy?”
 - Why aren't you placing orders with our local companies? Why aren't you buying T cable, for instance?”
 - “Could I have the next slide, please,” says Khodorkovsky with a smile.

Khodorkovsky in Tomsk

- “We tested samples from all the companies that produce cable in T oblast and the neighboring oblasts.”

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- “We tested samples from all the companies that produce cable in T oblast and the neighboring oblasts.”
 - Holy shit! He's prepared for everything!

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- “We tested samples from all the companies that produce cable in T oblast and the neighboring oblasts.”
 - Holy shit! He’s prepared for everything!
 - The next chart makes clear that not a single cable produced in T oblast meets YUKOS’ standards on a single one of its criteria.

Khodorkovsky in Tomsk

- “We tested samples from all the companies that produce cable in T oblast and the neighboring oblasts.”
 - Holy shit! He’s prepared for everything!
 - The next chart makes clear that not a single cable produced in T oblast meets YUKOS’ standards on a single one of its criteria.
 - Not strong enough or flexible enough in freezing temperatures – plus it’s too expensive.

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- “We tested samples from all the companies that produce cable in T oblast and the neighboring oblasts.”
 - Holy shit! He’s prepared for everything!
 - The next chart makes clear that not a single cable produced in T oblast meets YUKOS’ standards on a single one of its criteria.
 - Not strong enough or flexible enough in freezing temperatures – plus it’s too expensive.
 - Maybe because the price of the cable includes some generous kickbacks for the government officials who do the lobbying to persuade the big companies operating in the region to buy the cable?

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 - Not strong enough or flexible enough in freezing temperatures – plus it’s too expensive.
 - Maybe because the price of the cable includes some generous kickbacks for the government officials who do the lobbying to persuade the big companies operating in the region to buy the cable?
 - “Why don’t you advise your producers to raise the quality of their cable. Do that and we’ll gladly buy it. You know, that would be easier than shipping it halfway across the country.”

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 - (from "Uznik tishiny" ["Prisoner of Silence"] by Valeriy Panyushkin, 2005)

Khodorkovsky's Problem

- After shifting rents to the formal sector he needed to control taxation

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- After shifting rents to the formal sector he needed to control taxation
- Put him in direct competition with Putin

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- After shifting rents to the formal sector he needed to control taxation
- Put him in direct competition with Putin
 - Putin absolutely could not allow Khodorkovsky to buy the Duma, or escape paying the taxes, or defy the protection racket scheme.

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Conclusion

- After shifting rents to the formal sector he needed to control taxation
- Put him in direct competition with Putin
 - Putin absolutely could not allow Khodorkovsky to buy the Duma, or escape paying the taxes, or defy the protection racket scheme.
 - Any one of those three outcomes would mean utter defeat for Putin and be tantamount to turning the country over to the oligarchs.

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 - Any one of those three outcomes would mean utter defeat for Putin and be tantamount to turning the country over to the oligarchs.
- Successful oligarch versus Khodorkovsky

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- After shifting rents to the formal sector he needed to control taxation
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 - It is a lot easier to bribe an umpire to call strikes balls than to change the rules so that it takes five strikes before the batter is called out

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- How do pick a new head of the "protection racket"?

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- How do pick a new head of the "protection racket"?
 - or to preserve the current boss in a new form?

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- How do pick a new head of the "protection racket"?
 - or to preserve the current boss in a new form?
- "Protection racket" is a fundamental organizing principle. Constitution only limits the formal position of boss.

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Conclusion

- How do pick a new head of the "protection racket"?
 - or to preserve the current boss in a new form?
- "Protection racket" is a fundamental organizing principle. Constitution only limits the formal position of boss.
 - no desire to change the policy or course of the "protection racket"

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 - or to preserve the current boss in a new form?
- "Protection racket" is a fundamental organizing principle. Constitution only limits the formal position of boss.
 - no desire to change the policy or course of the "protection racket"
 - How can you maintain in it in the face of an election?