

# Russia's Addiction

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## 1 Introduction

Long-term growth in Russia. Could talk about the conventional factors. Investment rates, deterioration of human capital, development of market institutions. But there is a more fundamental issue that concerns Russia's long-term growth, that constrains it, and shapes it. That is, Russia's addiction.

- Resource Dependence is the fundamental determinant of Russia's political economy. Resource Abundance can become addictive. Russia's addiction leads to peculiar behaviors
- Key notion is addiction through production. This makes it costly to adjust to declines in rents, and it frames Russia's response to current oil prices

## 2 Resource Rents

### 2.1 Importance of Resource Rents

To understand Russia's political economy it is useful to focus on resource rents. Comprehensive view of the impact of resources on the economy. The focus is on oil and gas because of size and because they are easier to estimate.

- Resource rents are huge in Russia

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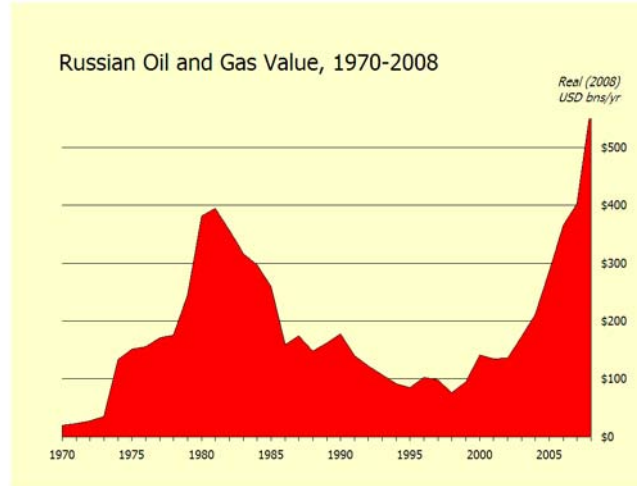


Figure 1:

### 2.1.1 Defining Resource Rents

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

Definition

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

Actual costs differ from reported costs, so reported rent is

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

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

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

Key item → fluctuations in price of oil – estimate of rents is relatively invariant to cost estimates

Resource Rents are huge. And they are volatile. Oil is the more volatile part of course.

Resource Rents play a crucial role in how leaders are evaluated:

Resource Rents and Political Economy

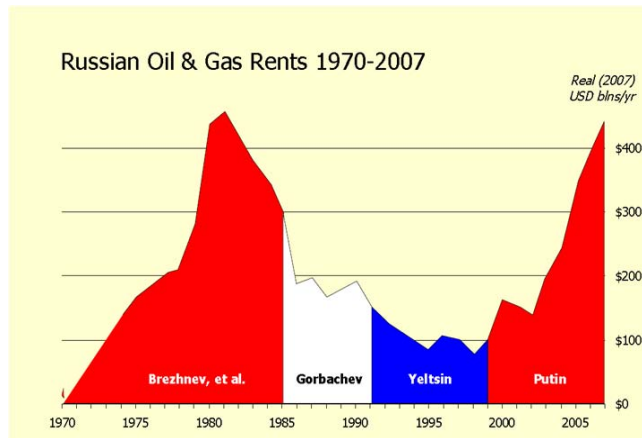


Figure 2:

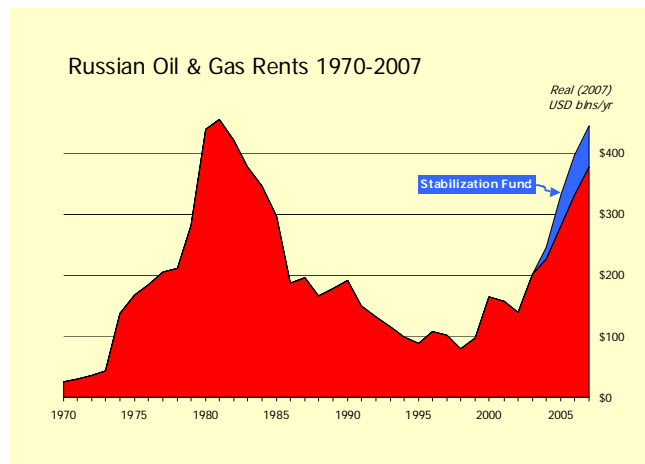


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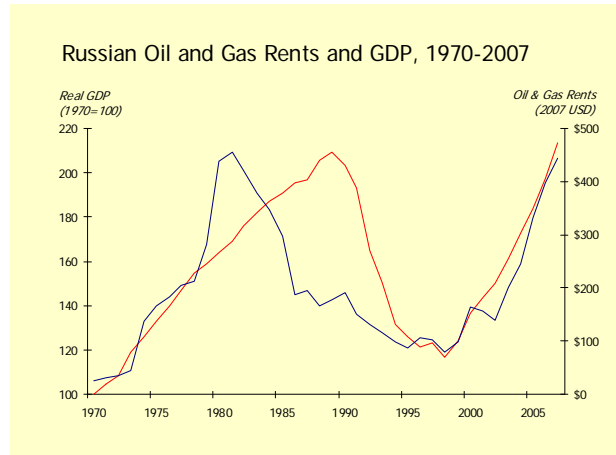


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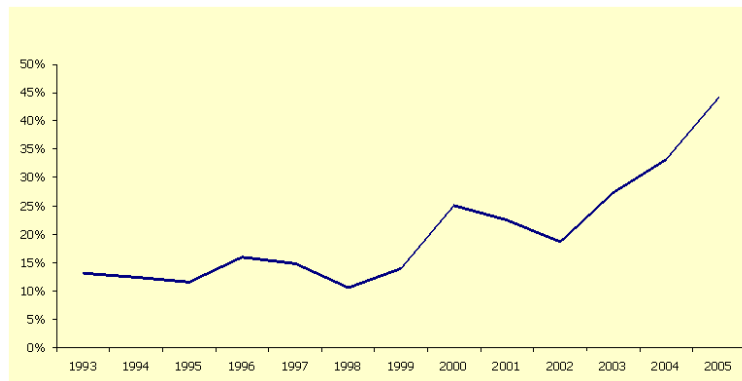


Figure 5:

Rents and Russian GDP

Rent Fluctuations Crucial for GDP movements

Growing Importance of Rents

Share of Oil and Gas Rents in Russian GDP

Much larger than value added share of this sector in GDP

## 2.2 Distribution of Rents

The political economy of addiction is determined by the distribution of rent, and who controls it. To understand this we start with the components of rents

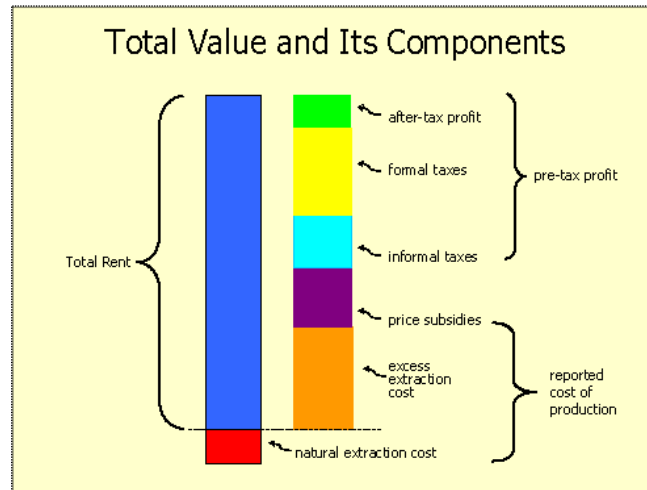


Figure 6:

### Categories

- Profits, formal and informal
- Formal taxes are those prescribed by legislation.
- Informal taxes are of three main types:
  - bribes paid to government officials; and
  - payments made for the support of public sector needs that are nominally voluntary but in fact mandatory for businesses
  - public-private partnerships
- Price subsidies,
- excess costs

informal categories of rent are the part of the iceberg below the surface

Components of rents

Some Implications

Excess costs and informal payments raise costs and redistribute value

Oil and Gas appears to be 10% of GDP when it is much more

Relative price of investment (PPP) is exceptionally high because of excess costs

Share of investment in GDP measured at PPP is exceptionally low

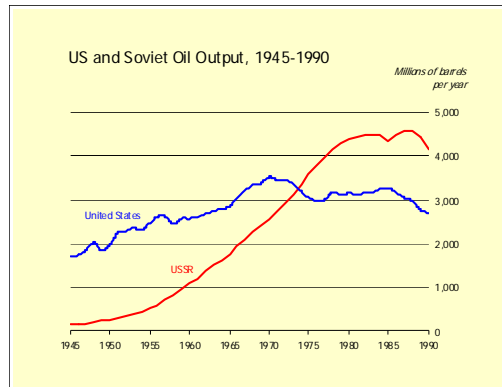


Figure 7:

### 3 Background

#### Historical Dependence

Russian growth has always been extensive

"In sum, the Soviet economic system became what it is in part thanks to the country's rich resource base, which permitted the planners largely to ignore the day-to-day discipline of the balance of payments and therefore also the imperatives of the market place and the pains of real economic cost. On this basis an elaborate and rigid institutional edifice sprang up. This economic system thrived for two human generations and achieved marked successes by its own criteria. But inevitably it hardened and came to be supported and protected by powerful vested interests [Grossman, 1983: 202].

abundance of resources and non-functioning price system leads to waste  
addiction to rents postponed fundamental reforms, made the system more fragile  
First Addiction

### 4 Addiction

#### Addiction through Production

explosion of rents leads to the creation of new (value destroying) activities. Defense, expansion of heavy industry, Siberia, CMEA subsidies are prime examples.

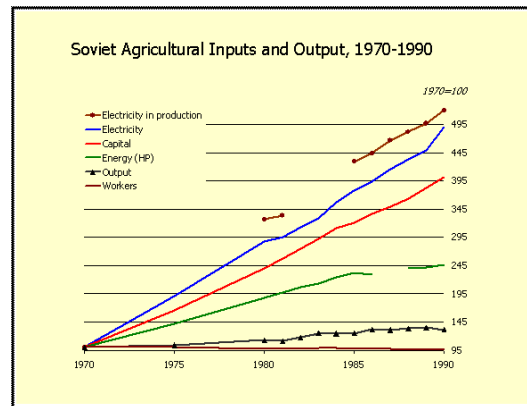


Figure 8:

The key point is that to gain access to the rents, agents engage in a thick layer of activity based on production. Production creates claims on future rents. Downstream claims through the production chain that seem legitimate but are dependent on the rents. The opacity of price system means that most beneficiaries do not realize they are addicted. In economy without price system you cannot know which production is really rent distribution

- this is the difference between addiction and rent-seeking

**Soviet Agriculture Example** Inputs dumped in, means of distributing rents

**Energy Sector Example** The resource sector itself was an example of addiction.

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

This may be seen as an appropriate response to the increase in the value of energy, but at the same time, 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 percent.

Partly the desperation to maintain rents

**Defense Addiction** Marshal Akhromeev on addiction

Why it was necessary to produce so many weapons? Akhromeev answered: "Because at a great cost of many sacrifices we created first-class factories, no worse than the American ones. Would you order them to stop work and begin producing cooking pots?"

Shakhnazarov described the "military-industrial mentality" as a "cancerous growth" that had metastasized to every sphere of Soviet life

This is an example of addiction. The investment in factories created interests that were very costly to reverse.

Opacity enhances durability. Think about ethanol versus direct subsidies in US. Subsidy-via-production, on the other hand, is opaque and psychologically satisfying

White Elephants

solve the intertemporal commitment problem, cash subsidies do not

Addiction through production requires continual infusions to continue activities

## 5 Addiction and Withdrawal

When rents exploded the Soviet economy became addicted in a manner that made coping with their absence costly.

increase in oil rents altered the system *physiologically*. This creates a serious problem: Difficulty in unwinding the activities created when rents decline.

There is a big difference between virtual economy and classic corruption. The former leads to resuscitation of dinosaur industries.

We argue that the explosion of resource rents had just such an impact on the Soviet economy.

When rents expanded they led to system-altering activities that heightened the need for these rents. Structural changes made withdrawal of the rents more costly to cope with and led to actions that made the economy even more fragile. This fragility then helps explain how the system could unravel so quickly when oil prices declined.

### 5.0.1 Addiction and Withdrawal

Addiction leads to short-time horizon – inability to think long-term. This leads to an inability to implement reforms.

Three characteristics of addiction:



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

In Soviet case tolerance arose because windfall was used for many new activities – defense, East European subsidies and other international adventures – interests created that depend on rents, makes withdrawal painful where is the methadone for an addicted Soviet economy?

## 6 Resource Curse versus Addiction

Resource curse typically involves three possible maladies: Dutch Disease, consumption boom, and corruption. Real exchange rate depreciation as a result of the export boom – leads to contraction of manufacturing. This is not really a disease, and it is not the issue here.

In the Soviet economy the resource boom takes on special features. Lack of transparency in the Soviet economy due to the price system.

resource boom filters into the Soviet economy – *through production*.

In the Soviet economy the price system hides the identity of the addicted enterprises. When rents decline it is not apparent which claimants should be cut. Withdrawal is thus much more painful than in market economies with similar resource booms.

### 6.1 Deindustrialization versus misindustrialization

Dutch disease leads to deindustrialization; resource are shifted away from manufacturing. In the Soviet economy the explosion of rents led to the creation of new enterprises and to increased subsidies. misindustrialization; creates addicts.

- In market economy the pain of losing the rents is deindustrialized manufacturing. → Rentier state

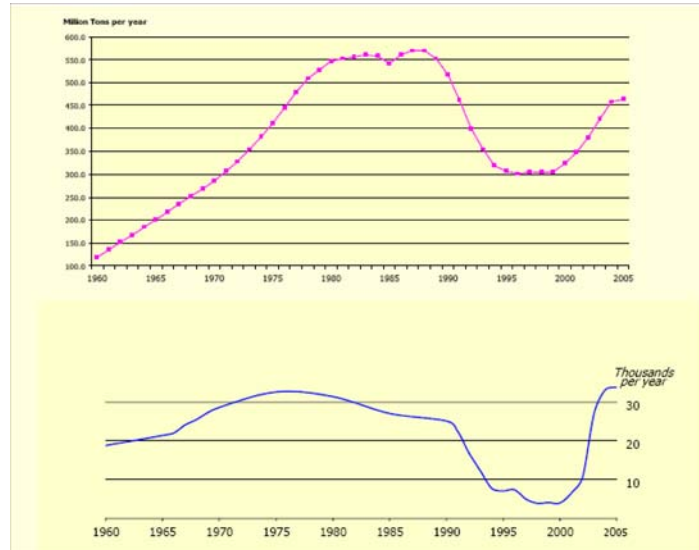


Figure 9:

- In STE the problem is that you created addicts who need recurrent infusions of value.

you have to produce to get value but then you become a claimant  $\implies$  loss of rents much more serious. The organism itself has been transformed by the consumption of the rents  $\approx$  physiological adaptation of an addict. The addict's body craves the substance, so that even the strongest will power cannot cope.

- Russian Disease

## 7 Russia versus Soviet

### Collapse and Addiction

collapse of the Soviet economic system did not end the addiction. the Soviet mechanism of allocating resources and rents changed. The system's dependence on rents continued, because dinosaur enterprises were not shut down. The mechanism of allocation changed  $\rightarrow$  virtual economy. Control of rents still critical to control of the economy

Russia still inverted funnel economy

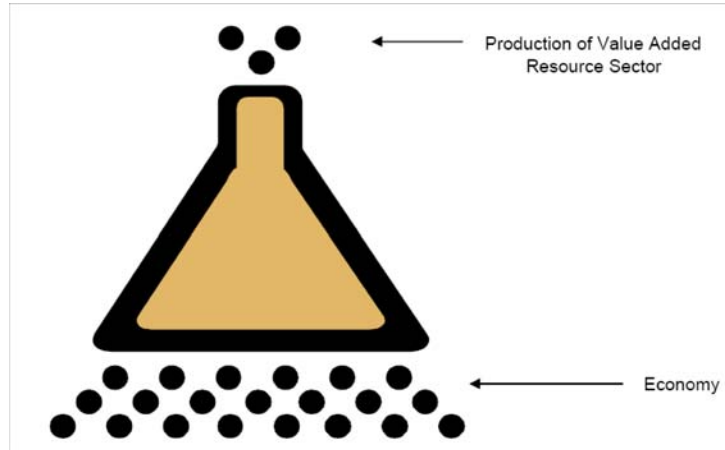


Figure 10:

## 8 Putin's System

### Putin's Problem

Resource Sector dominates economy

Private wealth could dominate the state

To create strong state essential to control the distribution of rents. Control formal rent distribution via tax reform → primarily and administrative reform (Zubkov). Primary goal of tax reform was to centralize rent collection. Notice that Putin accomplishes this before oil prices explode

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

### 8.0.1 Protection Racket

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. There were local and regional, government-sanctioned protection rackets. Much more important is the central government's protection racket

Why not just formal taxes?

Informal taxes leads to much more control over how it is spent. But it also creates addiction.

The Missing element

Protection racket is a way to get money, but not necessarily most efficient. why not just taxes?. The answer is Political Coase Theorem. It is imperative not to let money rule the system. Concentration of wealth is the key factor. In Soviet economy too much wealth concentrated in too few hands. Allows wealth to buy Duma.

Putin's System

Putin's achievement was to centralize rent control from the bottom up system that survived Soviet collapse. System is designed to extract rents and control the economy

They want a market economy, but with their own rules. 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

Surkov on the Protection Racket

“I personally believe that the stratum of our leading industrialists ... is very thin and very valuable. ....they are the bearers of capital, of intellect, of technologies. ... That is a very delicate sphere, and it is not a place for people who do not have a sense of the delicate nature of the moment. . .”

‘the oil men are no less important than the oil,’ [neftyaniki ne menee vazhny, chem neft'] and therefore the state should make good use of them both.”

## 9 Khodorkovsky

Khodorkovsky

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. 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

Khodorkovsky's Gambit

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.

### 9.0.2 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."

"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. "We tested samples from all the companies that produce cable in T oblast and the neighboring

oblasts.” 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? “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.” (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. 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.

- Successful oligarch versus Khodorkovsky

Successful oligarch understands the rules of the game, tries to use relational capital to alter the decisions of the umpires in his favor. Khodorkovsky tried to change the rules of the game itself. 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. Surviving oligarchs — the successful ones are those that survive — realized it’s much better to be good at the prevailing system

## 10 Low Oil Prices

Withdrawal II

Oil prices are now back to where they were in 2004

### 10.1 Putin’s Former Problem

Manage addiction

Avoid creating new claimants when rents rise

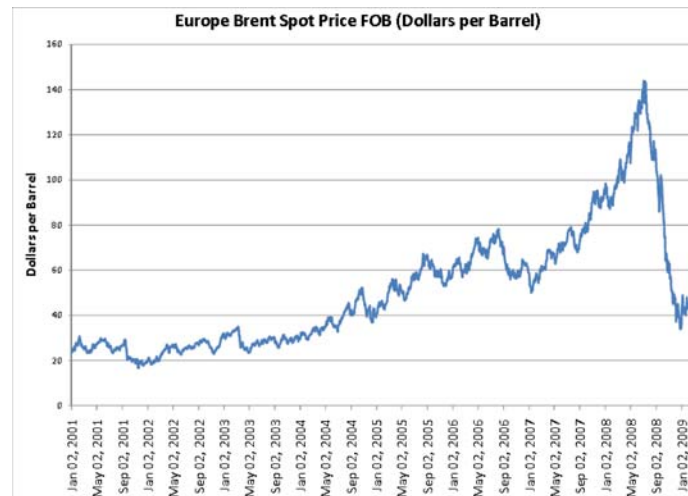


Figure 11:

Genetic predisposition to addiction means that incremental flows cannot be "sterilized"

Better not to earn them if price increase is transitory

Informal rents makes it hard to prevent new addiction if rents are produced

Will current fall in prices lead to new withdrawal problems?

## 10.2 Putin's Current Problem

How to manage addiction in period of rent decline. Current situation shows Putin was correct to limit new addicts, but even he succumbed to bubble mentality in 2008.

Dealing with withdrawal was unsuccessful in Soviet period. How Putin can manage remains to be seen.

Putin's Current Problem

Managing addiction is not the same thing as creating rents

## 10.3 Longer-term problem is how to keep the rent flow going

Remember the two fundamentals: structural legacy and oil dependency. For a sustainable future Russia has to address each of these.

- Can the structure be changed, and how? Can dependency not lead to addiction?  
Notice that addiction cannot be removed if structural legacies are not fixed.

Deep structural rigidities are source of addiction. Even without addiction – if structure can be changed – there are still issues concerning oil dependency. Can risk be managed?

- Specificities of Russia's future oil magnify the risk The real problem is how to continue to produce rents in the future given location of future reserves. Eastern Siberia problem vs. old oil, discrete investments. Hayekian solutions work for Western Siberia, but East requires big infrastructure investments
- But how does this fit with protection racket – how can you protect small guys? Too costly. Marginal benefits are not worth the shock to protection racket system
- Exposure to risk, price risk. In principle, there is a solution with risk sharing.
- The problem here is the possible tension between the optimal solution and Putin's system. Once again tension between control and economic efficiency. Political efficiency and economic efficiency. Can he implement the efficient solution and keep his system intact? Are there hybrid systems that solve the problem and are consistent with Putin's system?
- Can he deal with oil and gas separately from the rest of the economy? Phase out dinosaurs but retain control over oil
- Putin knows Lena Goldfields. Then why wouldn't Putin allow many western firms to share risk in Eastern Siberia? Because he does not extend protection he has less control. But what does he fear? Without control he can plunder but he cannot extort. He could only extract via pipelines, but that would be too transparent, too formal. Plus, it ignores the difference in magnitude between tax revenues and rent distribution.
- Only way it could work is the Conoco-Lukoil model or TNK-BP. Retain control but access to capital. Could this be extended to Rosneft and Surgutneftegaz. But Lukoil is very special. Looks like a modern company. Has some elements of western type corporate governance without leaving protection racket. Could the former evolve sufficiently towards the Lukoil model so that it could work? But the TNK-BP model is too costly to develop. It would involve too much



redistribution of wealth. The Lukoil solution is distasteful for purists, but it is one that would work with the Putin system. Risk is diversified sufficiently so that they would be able to commit to invest for the new oil.

- What if Putin cannot solve the problem? Russia gets its diversification wish!! Then Putin's system will not survive. If Putin can solve problem 12, then we can ask:
  - Can he pass this system on? Can he find someone who can take his role?  
He understand the real nature of this system
  - Will addiction ever end?
- Does the rent process intensify or do we get withdrawal from addiction? Will addiction, the rent-system ever end? Withdrawal. Obviously if rents stopped, no more oil.
- Can Russia ever get rid of this?
- Russia will certainly diversify. The question is whether it will diversify as a rich country or a poor country. That means maintaining the flow of rents. And limiting the adverse impact of addiction.