The Effects of Ownership Structure and Exogenous Shocks on State Capacity and Institutions in Resource-Rich States: A Case Study of Russia

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Abstract

Despite what a growing amount of research confirming evidence of the "curse" in the resource-rich Commonwealth of Independent States (CIS) countries, authors Jones Luong and Erika Weinthal argue that Russia indeed has found a potential "path out of the "resource curse". The authors find the answer to be through the privatization and transfer of its vast oil reserves to domestic owners Unlike most of the "resource curse" literature, they find that the ownership structure of a country's resource sector matters – and can have a significant impact on a country's institutions. Despite evidence showing this shift towards better institutions - exemplified by Russia's new Tax Code, Russia has recently seen a growing amount of its resources fall back into the hands of the state. Given these recent events, this paper seeks to reexamine the experience of Russia and to test Jones Luong and Weinthal's claims using alternative state capacity indicators. I find that in fact, although Russia has exhibited better indicators than its resource-rich neighbors, it has non-the-less been plagued with low indicators relative to other post communist countries. I argue this is in part due to its legacy of poor property rights protection; the maintenance of a system "partial reforms" by the "early winners" of transition. Subsequently I show that while indeed institutions improved after the 1998 crisis, they once again changed after the rise is sustained rise in oil prices from 1999-present. These exogenous shocks caused a renewed fear of poor property rights protection and the continued observation of greater state participation and control of the Russia's oil industry.

Introduction

Central and Eastern Europe has been the focus of a vast amount of academic research since the collapse of communism occurred nearly twenty years ago. The majority of the literature thus far has been dominated by the "essential problem of the road towards capitalism 'without adjectives'" (Bohle and Greskovits 2007: 90). In other words, social scientists and politicians alike have been more interested in the process of transitioning towards *a* market economy, without focusing much on the *type* of capitalism they were trying to achieve. However, in the past few years, these post-communist societies "indeed seem to have settled on divergent models of capitalism" and "'transitology' has moved on to comparison" (Ibid.).

Improving on the approach of Hall and Soskice's "Varieties of Capitalism (VoC) framework, Greskovits and Bohle effectively differentiate between the varieties of capitalisms found in the postcommunist countries. Based on the interplay between a number of factors including foreign direct investment (FDI), world markets, international institutions, they identify four types of capitalist regimes: the "state-crafted neoliberalism of the Baltic States"; the "embedded neoliberalism of the Visegrad countries"; the neo-corporatism in Slovenia; and finally, the "more directly world-market driven neoliberalism" of the Commonwealth of Independent States (CIS) countries (Bohle and Greskovits). Among their many findings, perhaps most interesting is the large gap found between the state capacity indicators and weak institutions exhibited by the CIS countries (Russia, Azerbaijan and Kazakhstan) compared to those of the other three groups (Ibid: 95-96).

Give that these CIS countries, along with Turkmenistan and Uzbekistan, are characterized a natural resource-rich countries (see Table 1), it is not surprising that these findings are in line with the vast amount of research documenting the correlation between abundant mineral resources (for example, oil, gas, diamonds, copper and gold) and weak state institutions – not to mention other negative political and economic conditions (e.g. Gelb 1988; Sachs and Warner 1995; Auty 2001; Shafer 1994). Are all of the resource-wealthy CIS countries thus cursed with weak institutions and other negative characteristics associated natural resource profusion? Or, do some states exhibit stronger institutions and governance capabilities than others – thus allowing for further "comparison" amongst this group? A select number of social scientists, and politicians, including President Vladimir Putin, would respond in the affirmative; pointing to the many market reforms Putin has pushed through in the Russian Federation[1] since coming into office in 2000, including a heavily revised fiscal policy, as well as the relatively high levels of GDP growth experienced over the past few years. Has Russia then been able to distinguish itself from the rest of the mineral wealthy CIS countries – saving itself from the common belief that all resource-rich states are "cursed" with poor growth and weak institutions? If so, how has Russia achieved this goal?

Despite what a growing amount of research confirming evidence of the "curse" in all of these countries (e.g. Kronenberg 2004), authors Jones Luong and Erika Weinthal[2] argue that Russia indeed *has* found a potential "path out of the "resource curse". The authors find the answer to be through the privatization and transfer of its vast oil reserves to *domestic owners* (Weinthal and Jones Luong 2001: 216). Unlike most of the "resource curse" literature, they find that the ownership structure of a country's resource sector matters – and can have a significant impact on a country's institutions. Their central claim becomes that only domestic private

[1]Henceforth referred to simply as Russia.
[2] The two authors have shared equal responsibility for the content of their works in this long-term joint project, and have rotated authorship on the articles they have generated (Jones Luong 2001, 2004; Jones Luong 2004; Weinthal and Jones Luong 2001, 2006).

ownership fosters institutions that more effectively constrain state leaders, encourages them to invest in institution building, and enables them to respond more successfully to booms and busts (Weinthal and Jones Luong 2006: 36). Through an empirical comparison of Russia with four other resource-rich countries of the CIS, they argue that only Russia has indeed achieved the best institutional reforms - highlighting recent adoption of a new Tax Code which they argue to be “even better” than Western Standards.

If these findings are indeed valid, and this ownership structure really does promote stronger state institutions and therefore economic stability, what of the recent trend towards the increased state control over Russia’s vast oil reserves, as well as other industries (OECD 2006)? What of the recent attacks on privately owned companies, including once largest Russian oil company Yukos? Given this recent trend, and the general lack of empirical research on the effects of ownership structure on the institutions of resource-rich states (Ross 1999), this analysis seeks to make a contribution to the literature through a case study of the Russian experience. I seek to show that, although ownership structure does indeed lead to improvements in investment and quality institution-building – as exhibited by Russia’s new Tax Code, and Russia does exhibit better state capacity than it’s neighboring countries, reaching the levels of reform achieve in other post-communist countries has been limited by a number of factors, including legacy of poor property rights regime, the Hellman’s partial reform, and finally due to the susceptibility to exogenous changes to market conditions. I also suggest that that the “sustained” high oil prices over the past few years may prove to be too attractive for the Russian government to pass up, and it runs the risk of falling into the resource curse trap, after all.

This paper is organized in the following manner. Chapter One reexamines the claims made by Jones Luong and Weinthal, using alternative state capacity indicators to gauge state capacity. Subsequently, Chapter Two shows, thru an examination of the legacy of poor property rights protection, why and how the “early winners” had the incentive to maintain “partial reforms” throughout the 1990s and how this contributed to the continued low governance scores observed. Finally, in Chapter Three I examine the role two exogenous shifts in market conditions – the 1998 Financial Crisis, followed by the sustained rise in oil prices led to further changes in institutions, through an examination of the proposed changes to subsoil legislation.

Chapter 1: An Alternative Solution to Managing Mineral Wealth?

As mentioned above, research into what many have come to call the "resource curse" is by now almost superfluous.[3] From world famous economist Jeffrey Sachs to billionaire philanthropist George Soros, it appears everyone is interested in either researching and/or trying to solve this apparent "curse." The majority of literature on the "resource curse" has emphasized the negative economic and political consequences that countries blessed with natural resources incur, including: poor macroeconomic performance, unbalanced and erratic growth over the long term; susceptibility to changes in the commodity market and rise and fall of oil prices, and notably *weak institutions* (see, for example, Sachs and Warner 1995; Shafer 1994; Karl 1997). However, as Ross points out in his comprehensive evaluation of a number of the leading studies on the subject, surprisingly few have looked at the importance and role of *ownership* structure, be it by the state, or privately owned by locals or foreign transnationals (1999: 319). This approach, however, may prove to be quite effective in examining natural resource wealth's impact – particularly on state capacity and institutions.

The work of Pauline Jones Luong and Erika Weinthal[4] does just this. The authors develop a framework which analyzes the impact of different ownership structures on institution building in resource-rich states – calling into question whether it may be state ownership rather than a mere abundance of resources and the influx of external rents generated from these resources during boom periods that 'curses' resource-rich countries (Jones Luong 2004; Weinthal and Jones Luong 2006). Their argument develops through two parts: the first concerns the impact that

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[3] For comprehensive reviews of the 'resource-curse' literature, see Ross 1999; Stevens 2003; and Rosser 2006.

[4] Henceforth referred to as JLW.

domestic pressures have on mineral-rich states' choice of ownership structure, or the development strategy they adopt toward their mineral sector; the second concerns the effect that ownership structure has on the nature of the relationship between the state and the mineral sector, and consequently, institutional outcomes (Jones Luong and Weinthal 2001: 3). They find, interestingly, that the most conducive ownership structure for strong institution building is through the *privatization* to *domestic* actors (Jones Luong 2004: 2; Weinthal and Jones Luong 2006). The logic being that by dispersing the proceeds to these actors, and accordingly taking them out of the state's direct control – generating new economic interests outside the state apparatus – these actors will have both a vested interest in securing their property rights and the means to bring state actors to the bargaining table (Jones Luong 2004: 2). In this scenario, it is reasoned, business-relations are *clear* and *symmetrical*, and thus, their incentives for building institutions that act as formal guarantees are likely to converge such that *strong*, *broadly effective*, and *stable* institutions emerge (Ibid.: 11). Accordingly, privatization to domestic actors offers an alternative path out of the "resource curse" because it creates an incentive for both state and societal actors to bargain over and eventually establish the 'formal rules of the game' (Weinthal and Jones Luong 2006; 43).

1.1 Reasons for the Lack of Studies on Ownership Structure

Jones Luong and Weinthal give a number of reasons why previous work on the "resource curse", particularly those using economic explanations, have, for the most part, ignored the role of ownership structure and its potential impact on mineral-rich states' institution-building capacity. The authors suggest that a key reason behind why it has not been much addressed has been for the reason that the majority of the prevailing literature has made the assumption that mineral wealth is always and necessarily *state-owned* and *centrally* controlled (Jones Luong 2004: 10). They further present two reinforcing logics that have underlain this consensus. The first comes from the sectoral approach – according to which the very nature of the mineral sector is one which has *high* capital intensity, *high* economies of scale and whose firms are both inflexible and concentrated (Jones Luong 2004: 4).[5] These types of sectors require state ownership, as only states themselves are believe to be able to secure the significant FDI or loans from international banks often needed for expensive extraction and development. The second rationale stems from the assumption that leaders in resource-rich countries have a strong incentive to maintain state ownership and control over their resource sector given the enormous rents associated with such exports they may capture – assuming that these leaders face little to no domestic constraints in the process (Ibid.).

Yet another reason for why this assumption of state ownership has remained so dominant, has been due to fact that the majority of the literature on the "resource curse" thus far has focused on the *same* historical period (~ late 1960s to early 1990s) – popular as it represents the time of post-colonialism and widespread state building (Jones Luong 2004: 1). This was also a time during which most mineral-rich countries exercised state ownership over their resources. So, while the focus was on the negative effects of the "resource curse" on the states themselves, they may have overlooked the possible reverse correlation – that centralized, state ownership may have actually led to such negative outcomes.

[5] What Shafer refers to as 'high/high sectors' (Shafer 1994: 10-11).

Terry Lynn Karl's book, *The Paradox of Plenty: Oil Booms and Petro-States*, remains one of the more important works to date on the subject of oil's impact on state capacity. Her central claim is that

> dependence on petroleum revenues produces a distinctive type of institutional setting, the petro-state, which encourages the political distribution of rents. Such a state is characterized by fiscal reliance on petrodollars, which expands state jurisdiction and weakens authority as other extractive capabilities wither. As a result, when faced with competing pressures, state officials become habituated to relying on the progressive substitution of public spending for statecraft, thereby further weakening state capacity (16).[6]

One could make a case, then, that Karl also makes the assumption regarding state ownership of its natural resources as being inherent (as Jones Luong does throughout her 2004 work) – by citing statements such as "in developing countries, mineral rents accrue directly to the state" (Karl 1997: 48).[7] However, a more important deduction from her work might be that she finds the role of ownership may not much matter at all. Rather, the negative institutional outcomes which plague oil-rich countries will occur, no matter what the ownership structure. She argues oil-exporting states tend to bear a striking and broad resemblance to each other in state capacities and macroeconomic performance, *despite* differences in types of political regimes, cultures, geo-strategic locations, and the like (Ibid.: 49). "These characteristics have been able to *shape every oil state*," and "these commonalities eventually translate into similar packages of problems, similar ways of coping with these problems, and similar behaviors by officials in these countries" (Ibid.: 49, emphasis added). The cases analyzed below should show whether it may actually be *this* alternative hypothesis, that ownership does not indeed matter, that rings true.

[6] Ross effectively cites this passage as her central claim (1999: 317).
[7] While these rents could simply be understood as taxes, her use of the word "directly" suggests the lack of a middleman or non-state controlled owner.

Michael Shafer is best known for his book entitled *Winners and Losers: How Sectors Shape the Developmental Prospects of States* (1994). Interestingly, he finds, like Jones Luong and Weinthal, that *dispersion* of revenue sources promotes state capacity because it gives state leaders an incentive to building broadly effective institutions (1994). However, given his sectoral approach, he contends that this can only be possible in states where a low/low sector dominates.[8] This is because the nature of the mineral sectors (high/high) is inherently concentrated. Therefore, in this work, he does not sufficiently account for any alternative ownership structure in these high/high sectors.[9] However, he *does* address ownership structure of extractive sectors in one of his earlier, rather provocative articles entitled: "Capturing the Mineral Multinationals: Advantage or Disadvantage?" (1985). In this piece, he examines the problems Zaire and Zambia faced after nationalizing their copper industry – not so surprisingly in the time period mentioned above. He came to find that nationalization comes at the *cost* of losing "insulation" from a number of factors. At the international level, this means the demise of upstream oligopoly – making market risk harder to manage (at a disadvantage to vertically integrated multinationals) – and the loss of guaranteed market access and sufficient investment funds (1985: 28). Loss of insulation from exploitation for short-run economic and political gains and from union demands for excessive wages and benefits happens at the domestic level, he contends (1985: 28). TNCs, which owned, controlled, and operated the copper industry prior to nationalization, had previously insulated these nations from these negative effects. He posits, then, that most resource-rich nations don't possess the strength or autonomy to manage these costs – making the

[8] Low/Low sectors being those with low capital intensity as well as low economies of scale – thus being flexible and dispersed (Shafer 1994: 10-11).
[9] Jones Luong actually considers him to be 'agnostic' about ownership in this work – and rather interested only in sectoral characteristics (Jones Luong 2004: 10)

provocative claim that *foreign*, or TNC ownership, may actually serve to strengthen state capacity (1985: 49). This, therefore, is yet another alternative hypothesis.

1.2 Explaining the Variation in Ownership Structure

While Shafer's article addresses foreign vs. state ownership, he doesn't explore the alternative ownership structures that may exist. The work of Jones Luong and Weinthal is thus unique, as it has adequately distinguished and analyzed the complex and varying nature of ownership structures in the resource industry (Jones Luong and Weinthal 2001; Jones Luong 2004).[10] They establish four types of ownership structures – disaggregating ownership and control (Jones Luong 2004: 5):

1. **S1: state ownership (or nationalization) with low foreign investment:** the state owns the rights to develop all mineral deposits and the majority of shares in production, refining, and/or export facilities; foreign investors can participate either through contracts, such as carried-interest or joint ventures, that restrict their managerial and operational control or they can only operate as service subcontractors.
2. **S2: state ownership with high foreign involvement:** the state owns the rights to develop all mineral deposits and the majority of shares in production, refining, and/or export facilities; foreign investors can participate through more permissive contracts, such as productions sharing agreements (PSAs), which allow them significant managerial and operational control.
3. **P1: private ownership with low foreign involvement:** private (largely domestic) companies own the rights to develop all mineral deposits and the majority of shares in production, refining, and/or export facilities; foreign investors can either participate through contracts, such as carried-interest or joint ventures, that restrict their managerial and operational control or they can only operate as service subcontractors.
4. **P2: private ownership with high foreign involvement:** private (largely foreign) companies own the rights to develop all mineral deposits and the majority of shares in production, refining, and/or export facilities; foreign investors can either buy shares in existing facilities or participate through permissive contracts, such as

[10] Notably, the recent work by Ahrend (2005) examines the different owners *within* the Russian oil industry – identifying three types of owners: financial group-owned; oil-industry insider-owned; and state-controlled (2005: 591).

> productions sharing agreements (PSAs), which allow them significant managerial and operational control.

How, then, do states end up with these different structures? Rather than finding variation is a product of international factors, they argue that the interaction between two key *domestic factors* can help to predict which of these ownership structure strategies state leaders chose (Jones Luong 2004: 7):

1. The availability of alternative sources of export revenue
2. The level of political contestation

The first factor the authors identify is *the availability of alternative sources of export revenue.* Simply put, a state with access to alternative sources of export revenue "determines whether or not the leadership can maintain current levels of domestic spending without immediately exploiting their oil and gas reserves" (Ibid.). In other words, a state with alternative revenues can postpone the development of its oil and gas reserves, whereas a state without alternative sources of export revenue faces much greater time pressures to generate revenue from its oil and/or gas reserves (Ibid.). The extent of this alternative revenue in a state is determined by whether or not "(1) it can develop an existing export commodity independently, without the immediate need for inputs from beyond its borders, including foreign capital; (2) there already exists an export market for this particular commodity; and (3) the export of this commodity is capable of providing a disproportionate share of foreign revenue in the status quo" (Ibid.)

The second determining domestic factor, *level of domestic contestation*, refers to the contestation over the basis for dispersing political power and economic patronage. This "determines the amount of resources that current leaders need to maintain their hold on power" (Ibid). They measure this level according to whether or not "(1) there exists a cleavage structure that could function as a viable alternative to the current basis for dispensing patronage; (2) political parties and/or social movements based on such an alternative cleavage have emerged and gained popular support; and (3) these parties and/or movements have in fact made demands for greater resources" (Ibid). The more intense the challenge to maintaining the existing system for dispensing patronage, therefore, the greater the leaders' need to attain additional sources to maintain power.

Again, Jones Luong and Weinthal use the interaction of these two factors to explain the variation in ownership structure (summarized in Table 2) between the countries tested in their empirical study. Before reviewing their findings, I first review the corresponding impact these various ownership structures are predicted to have on institutions.

1.3 Corresponding Impact on Institutions

With this framework Jones Luong and Weinthal effectively link the structure of ownership to distinct *institutional* outcomes. In brief, "this is because each form of ownership fosters different incentives for institution-building by creating a different set of primary actors and form of business-state relations" (Jones Luong 2004: 11).

> It matters whether a state relies on taxes from extractive industries, agricultural production, foreign aid, remittances, or international borrowing because these different sources of revenues, whatever their relative economic merits or social import, have powerful (and quite different) impact on the state's institutional development and its abilities to employ personnel, subsidize social and economic programs, create new organizations, and direct the activities of private interests. Simply states, the revenues a state collects, how it collects them, and the uses to which it puts them define its nature (Karl 1997: 13).

To gauge variation in institutional outcomes, the authors use variation in *tax regimes*. Much like Karl, as cited above, the authors believe a country's tax system is key to understanding the "nature" of the country itself. For example, the lack of a viable tax regime has been consistently identified in the literature as impeding broad economic growth and the development of democracy (e.g. Chaudhry 1989; Karl 1997). A weak (or non-existent) tax regime is also viewed in the literature on the resource curse as perhaps the most prevalent negative outcome of resource wealth due to state leaders' myopic thinking and heavy reliance on external (rather than internal) sources of revenue (Ibid.). On the other hand, the development of a *viable* tax regime is often cited as 'facilitating transitions to democracy, economic development, and state capacity' (Weinthal and Jones Luong 2001: 216). In sum, the authors find that the "ability to extract revenue is the *best indicator of state capacity* because a reliable source of revenue is essential for leaders to build and maintain the modern state's coercive and administrative institutions" (Jones Luong 2004: 10, emphasis added).

Jones Luong and Weinthal depart from authors such as Shafer and Karl who both claim that mineral-rich states either don't build a tax system at all or rely only on revenues from resource sector taxes (Karl 1997: 61). Instead, the authors find that tax regimes vary depending on ownership structure: **S1:** leads to a *weak* tax regime (indirect tax); **P1:** leads to a *strong* tax regime (direct and indirect across sectors)*;* **S2&P2:** both lead to *hybrid* tax regimes - meaning based on both direct and indirect taxes, but only in the resource sector (summarized in Table 3). These findings support their claim that privatization to *domestic* actors appears to be the best path to strong institution building – as it, again, "creates an incentive for both state and non-state actors to bargain over and eventually establish the formal rules of the game" (Jones Luong 2004: 2). Fascinatingly, then, this contrasts to Shafer – who argues that *foreign,* TNC ownership proves best – and Karl, who maintains that resource-rich nations are doomed to have poor institutions, no matter the ownership structure. The empirical analysis in the following section helps to deduce which of these alternative hypotheses rings true.

1.4 Empirical Analysis

1.4.1 Cases

To test their hypotheses on the effects of various ownership structures on state capacity and institution building, the authors effectively compare the experience of Russia to four other CIS countries – Azerbaijan, Kazakhstan, Turkmenistan and Uzbekistan (2004: 2) – all of whose economies' dependence upon their rich natural resource endowments is unquestionable (Table 1). Their similar experiences under Soviet rule, their common social, political and economic legacies, and their vastly unexplored energy sectors make them especially great case studies for analyzing the reasons behind perhaps very different state capacities. Not to mention, upon independence, all of these countries were faced with the task of finding strategies to develop their *own*, rather than USSR controlled, energy sectors, while at the same time taking on the task of the state-building exercise (Jones Luong and Weinthal 2001: 2).

Upon independence, despite their many similarities, the resource-rich former Soviet states pursued notably distinct strategies toward developing their energy sectors (summarized by Table 4). Why was this the case, and – even more importantly for the purposes of this study – what impact have these varying strategies, and therefore ownership structures, had on their state capacities? Next, I examine the same cases using alternative state capacity indicators.

1.4.2 Defining State Capacity

As explained above, Jones Luong and Weinthal use the composition and stability of tax regimes across mineral-rich states as a gauge for institutional state capacity. Before presenting an alternate set of indicators for measuring state capacity, a better idea of what the term, 'state capacity' actually means is critical. Both Karl and Shafer present solid definitions. Karl defines the term as:

> State capacity has to be understood and judged in a larger sense as the sum total of a state's material ability to control, extract, and allocate resources as well as its symbolic or political ability to create, implement, and enforce collective decisions. Capacity is thus an aggregate, if imprecise, measure of the potential to raise revenues, provide services, exercise coercion, create consensus, and select and refine polices (Karl 1997: 45).

In his work, Shafer differentiates between *relative* and *absolute* state capacity. *Absolute capacity* is defined by the extent to which the state has the authority and means to extract and deploy resources; a technocratic, meritocratic, and internally cohesive bureaucracy; and effective monitoring and regulatory capabilities (Shafer 1994: 7). *Relative capacity* on the other hand, reflects the balance of a state's resources and institutional capacity, augmented by those of its allies, and the resources and capacity for collective action of actors it confronts (1994: 7).

This analysis borrows its definition of "state capacity," through the alternative indicators from the extremely well developed and thoroughly researched Worldwide Governance Indicators (Kaufmann *et al*. 2003 and 2006). In this World Bank study, beginning in 1996, Kaufmann *et al*. construct six aggregate governance indicators, motivated by their broad definition of governance *as the traditions and institutions by which authority in a country is exercised* – this includes (1) the process by which governments are selected, monitored and replaced, (2) the capacity of the government to effectively formulate and implement sound policies, and (3) the respect of citizens and the state for the institutions that govern economic and social interactions among them (Kaufmann *et al*. 2003: 2). The indicators are based on hundreds of variables and reflect the views of thousands of citizens and firm survey respondents and experts worldwide (Kaufman *et al*. 2006: 1). This analysis assesses the scores of the mineral-rich CIS countries in *three* of these indicators individually, as well as an aggregate of the three combined.[11] These three indicators are defined as[12]:

1. *Government effectiveness* (GE), the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.
2. *Regulatory quality* (RQ), the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.
3. *Control of corruption* (CC), the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests.

1.4.3 Empirical Findings and Analysis

Both Turkmenistan and Uzbekistan maintained both state ownership *and* state control (**S1**) over their energy sectors upon independence (Table 4). As Jones Luong points out, this was the case because *both* countries had and still have significant *alternative resources* – from cotton (Esanov *et al*. 2001: 9), in addition to their prominent energy sectors.[13] In Uzbekistan, cotton is their number one export, accounting for a staggering 42% of all exports in 2005. In Turkmenistan, cotton is its number two export, accounting for over 15% of its total exports.[14] Cotton rents, therefore, represented significant rents to satisfy and keep their leaders in power. In

[11] Bohle and Greskovits similarly utilize these indicators in their study (Bohle and Greskovits 2007: 95-97).
[12] For more information on, and definitions of all six variables (voice and accountability; political stability and absence of violence; government effectiveness; regulatory quality; rule of law; and control of corruption), see Kaufmann *et al*. 2003: 3-5; and 2006: 4.
[13] Turkmenistan has proven oil reserves of roughly 546 million barrels and natural gas reserves of approximately 71 trillion cubic feet (some reports give higher estimates), and Uzbekistan contains 594 million barrels of proven oil reserves with 66.2 Tcf of natural gas reserves (DoE/EIA, *Central Asia*).
[14] Figures for both countries taken from www.intracen.org

addition, neither Uzbekistan nor Turkmenistan was met with any significant contestation in the first several years after independence as ‘neither faced any direct or significant challenges to regionalism’ (Jones Luong and Weinthal 2001: 17). The combination of these two domestic factors has allowed both states to maintain their preferred ownership structures – opting for the most part not to privatize nor to seek much needed foreign direct investment. As reported in current EBRD reports, the two countries receive the least amount of FDI ($330M to Turkmenistan; $250M to Uzbekistan in 2005 in total), among all resource-rich CIS states. This lack of investment has prevented much needed development and upgrading of their underdeveloped extractive sector, as well as limited overall GDP growth for both countries, especially relative to the next three country cases (DoE/EIA, *Central Asia*).

What, then, of these two countries’ state capacities? Jones Luong and Weinthal’s framework maintains, “where the main actors are state elites and bureaucrats, business-state relations are blurred and symmetrical, their incentives for building discretionary institutions are likely to converge, and thus, institutions are likely to be *weak*…*ineffective* and *unstable*” (Jones Luong 2004: 11, emphasis added). Has this been the case? According to her research, Jones Luong finds that both countries developed and maintained unstable tax regimes which have continued to rely on indirect taxes across sectors – they also remain arbitrarily enforced in both countries because they are important side-payments for bureaucrats at all levels (Ibid: 18) (see Table 5). Are similar results observed when looking at both countries’ governance indicators? The scores of both show a resounding yes. Both score in the lowest 10th percentile consistently in all three indicators, scoring considerably worse than the other three resource-rich CIS countries. This is vividly reflected through Figures 2-6. These findings therefore support the hypothesis that state ownership and state control over their natural resource sector contributes to the establishment of *weak* institutions. This is further supported by the findings of Esanov *et al.*, who find that these two countries have adopted "much less reform-oriented policies than in the rest of the CIS" (Esanov *et al*. 2001: 9).

Azerbaijan and Kazakhstan's experiences differ greatly from that of the aforementioned two states. Unlike both of these states, neither Azerbaijan nor Kazakhstan inherited an agricultural crop or manufactured good that they could export to generate a sufficient amount of hard currency right after independence (Jones Luong and Weinthal 2001: 15). In terms of political contestation, Luong and Weinthal found that while Azerbaijan did not encounter any political contestation upon independence, Kazakhstan did – stemming from conflict between its two main ethnic groups – Kazakhs and Russians (Ibid: 18). Therefore, due to the deviation in this second domestic factor, Azerbaijan and Kazakhstan ended up with somewhat different ownership structures (Table 4) – with the former maintaining state ownership and the latter privatizing to mainly foreign investors[15], but *both* being taken over by foreign *control* in their extractive sectors. This difference, the massive inflow of foreign capital and control, compared to the two previously discussed countries, is quite drastic. Total FDI, in 2005 alone, to Kazakhstan was $2700 million and to Azerbaijan it was $1173 million – meaning Kazakhstan attracted over ten times the FDI as Uzbekistan (EBRD).[16] Figure 1 illustrates the dramatic increase in FDI in Azerbaijan's oil sector leading up to 2002. In contrast, therefore, both of these countries have seen rapid growth. For example, Azerbaijan's real GDP grew by an impressive 26 percent in 2005 - and with the completion of a largely foreign funded

[15] Jones Luong and Weinthal present a detailed account of the privatization process in Kazakhstan (2001: 20).
[16] Of these figures, approximately 70-80% of this money went to the countries' energy sector (Esanov *et al*. 2001).

pipeline, BTC, it is expected that oil revenues will contribute to a doubling of Azerbaijan's GDP by 2008 (DoE/EIA, *Azerbaijan*). Kazakhstan has shown similar growth patterns. What, however, of their state capacities and institutions?

As maintained by Jones Luong and Weinthal's framework, both of these ownership structures (**P2, S2**) should lead to 'hybrid' institutions – or institutions designed specifically for the mineral sector that are 'effective' but 'increasingly unstable' (Weinthal and Jones Luong 2001; Jones Luong 2004: 11-13). What does this mean? This outcome results because the power struggle between the two actors – state elites and foreign investors – is 'asymmetrical.' Although foreign investors initially have greater leverage over the design of institutions – such as tax regimes and regulatory policies – because these developing, (or transitioning) mineral-rich countries are in desperate need of their capital for development, "once these foreign investors have made their investments (i.e. their costs are 'sunk') state elites can exercise greater leverage over institutional design" (Jones Luong 2004: 13).[17] In sum, the end result should be a tax regime based on both direct and indirect taxes, but only in the mineral sector and increasingly unstable with arbitrary enforcement (Ibid: 15). See Tables 3 & 5. Empirically, Jones Luong and Weinthal effectively show how this hypothesis applied to these two cases. Azerbaijan, they find, has relied increasingly on VAT and excise taxes from the energy sector. For example, the State Oil Company of the Azerbaijani Republic – SOCAR – which collects the proceeds from foreign contracts, is the single largest taxpayer (Ibid: 18).

The experience of Kazakhstan is particularly revealing. Weinthal and Jones Luong find that Kazakhstan indeed did, *initially*, appear to have a viable tax regime due to the direct influence of foreign investors (Weinthal and Jones Luong 2001:

[17] This is not the first this concept has been explored. See Moran (1978, 1985).

216). In fact, a tax code adopted in 1995 is said to be "a direct outcome of international insistence that Kazakhstan develop a western-style tax system" and has been described as "comprehensive, modern, and investor friendly" (Ibid: 222). However, while in the short-term foreign investors were able to bargain with the central government and receive a favorable tax regime, in time – as their assets became fixed and their sunk costs have increased – their bargaining position has weakened over time. As a result, the tax regime has become "increasingly volatile" and the government has "consistently reneged on their tax agreements" and "has sought to extract additional revenue from the foreign investors" (Ibid. 222). Accordingly, Kazakhstan has increased its dependence on the foreign investors for revenues and has failed to expand its tax base.[18]

In terms of Kazakhstan and Azerbaijan's governance indicators, it is apparent that they both score significantly higher than the former two cases, particularly in the *government effectiveness* and *regulatory power* indicators (Figures 2 and 3). This suggests that the need for and presence of foreign investors/foreign control of these two countries' energy sectors has played a role in the reform and shaping of institutions in these countries.

Finally, we come to the country, which Jones Luong and Weinthal consider to have the most conducive ownership structure for implementing strong institutions (**P1**). According to Jones Luong and Weinthal, Russia was able to adopt such an ownership structure due to its unique domestic situation upon the dissolution of the USSR. Because Russia was the center of the USSR 'empire,' and because of its sheer size compared to the other states, it inherited a much more diversified and less

[18] For an in-depth analysis of this shift in Kazakhstan's tax regime, see Weinthal and Jones Luong's 2001 article, in which they also compare it to Russia's tax regime.

devastated economy (Jones Luong and Weinthal 2001: 30). Russia's large energy sector was also significantly more developed than any of the other CIS countries[19], and could immediately earn revenues from exporting through its existing pipeline networks. This factor accounted, therefore, for the low foreign involvement in Russia's oil industry post-USSR compared relatively to the amount of FDI flowing into both Kazakhstan and Azerbaijan. For example, according to the FDI performance index rankings of 140 countries, which takes the ratio of a country's share in Global FDI flows to its share in Global GDP, Azerbaijan was the 3rd highest from 1994 to 1996 and the 8th highest from 1998 to 2002; while Russia was 108th and 104th highest respectively (UNCTAD 2002 & 2003; as cited by Bayulgen 2005: 3). What's more, between 1994 and 2002, even though Azerbaijan had about 1/6th of Russia's oil resources, it received at least seven times more FDI per barrel of its proven oil reserves than Russia (Ibid.).

The *high* levels of political contestation (between regional cleavages based on the country's primary administrative-territorial divisions; and divisions based on nationality – i.e. Chechnya) created impetus for what came to be the widespread privatization of the country's energy sector to domestic actors – as a means of appeasing demands and maintaining the support of regional and nationalist leaders (Jones Luong and Weinthal 2001: 31). Consequently, Russia adopted the **P1** ownership structure – defying the mainstream assumption of state ownership and control discussed above. Why, then, should this structure theoretically lead to the creation of strong, and stable institutions? When the actors are state elites and domestic owners, the business-state relations fostered are both 'clear' and

[19] Russia's production peak of 12.5 million barrels per day in 1988, while part of the USSR, remains unmatched to this day (DoE/EIA, *Russia*).

'symmetrical' – by symmetrical meaning that each actor has some bargaining power over the other, with the state having the authority to revoke property rights and reducing revenue through higher taxation, and with domestic owners being a critical source of tax revenue for the state (Ibid: 12). This dynamic should, in the theory presented here, "promote mutual incentives for building stable, effective, and far-reaching institutions" (Ibid: 12). Table 3. Has this been the case in Russia? In terms of its tax regime, Jones Luong finds that Russia has established the most comprehensive and "stable" tax regime, increasing the budgetary contribution of personal income tax and corporate income tax *across* sectors, rather than just in its energy sector - also establishing a formal tax code that has remained relatively stable (Jones Luong 2004: 17).[20] Does this then lead to strong state capacity and high governance indicators?

Throughout Figures 2-6 we see that Russia *has* scored relatively consistently higher than all four other countries analyzed above in all three indicators, as well as the aggregate – the sharp dip in Figure 6 accounting for the vacuum of power in the interim between Yeltsin and when Putin came to power. It *appears*, then, that these findings support the hypothesis made by Jones Luong and Weinthal – that a resource rich country with **P1** ownership structure should promote the strongest institutions. However, upon closer inspection of the indicators, we see that in fact all five countries, including Russia, exhibit relatively poor governance scores across all categories. This finding calls back the findings of Bohle and Greskovits (2007) – who observe the average governance indicators of Russia, Kazakhstan and Azerbaijan (not even accounting for Turkmenistan and Uzbekistan) are much lower than those of

[20] Note, however, that this formal new Tax Code did not occur until after Russia's 1998 financial crisis – which, they argue, served as the impetus for institutional change and its subsequent adoption (Jones Luong and Weinthal 2004). This is discussed in Chapter Three.

other post-communist transitioning economies such as the Baltic and Visegrad countries (Bohle and Greskovits 2007). (See, for example, Figure 7) The subsequent chapter explores potential reasons for this phenomenon.

Chapter 2: Property Rights, Privatization and "Early Winners": Explaining Russia's Low Governance Indicators

This chapter presents two potential reasons for why Russia has been plagued by poor governance indicators and categorized as a "weak" state since the demise of communism. The first argument refers to Russia's legacy of poor private property rights protection – in clear opposition to the now commonly held belief that solid property rights protection is one of key and necessary institutions needed for a well-functioning market economy. The second reason, which is closely linked to the first, cites the argument advanced by Joel S. Hellman (1998). He theorizes that the "early winners" of the transition process – in our case the private local owners of Russia's oil reserves, who arguably attained these assets as a direct result of the lack of a legitimate property rights regime – have "sought to stall the [Russian] economy in a *partial reform equilibrium*," preventing Russia from ever forming legitimate institutions (Hellman 1998: 204). This chapter will present these two lines of reasoning in three sections. The first looks at the history and legacy of property rights protection in Russia (or the lack thereof). The subsequent section covers the privatization process – looking at the privatization of Russia's oil industry in particular. The last section covers the work of Hellman.

2.1 Legacy of Property Rights[21]

2.1.1 Russia's Historical and Soviet Tradition on Property Rights – or lack thereof

The Russian tradition of property has been marked by the "total merger of power and ownership" (Hedlund 2001: 221). The rulers of old Muscovy not only

[21] See Acemoglu (2003), Alchian and Demsetz (1973), Barzel (1989), Frye (2004, 2005), and North and Thomas (1973) for reviews on the importance and history of property rights. This subsection serves to contrast mainstream ideas of property rights to that of the Russian conception.

held autocratic power, but also laid claims to complete ownership of all productive assets (Pipes 1974). And, as land could be held only in "in return for lifelong service (*pomestie*), even the nobility was reduced to a state of *de facto* serfdom" (Hedlund 2001: 221). Whilst the West's feudalism went through "a process of gradual strengthening of the rights of vassals and subjects," which ultimately resulted in the end of feudalism, Russia went through a process of "retrogression," where "the power of the Tsar was gradually strengthened, to the point where the system as a whole degenerated into complete submission of the whole population" (Ibid.). "The overriding ambition by a series of Russian rulers to eradicate all sense of rights or contractual obligations was manifested above all in the process of removing private property in land, completed by the 16th century" (Ibid.).

Despite some changes throughout the years, and even attempts to adopt land reforms near the end of the 19th century, tsars never succeeded in completing them (Troyanov 2001). Shortly after coming into power, with the ironic Bolshevik slogan of "All Land to the Peasants," the Communist Party adopted a Land Decree on October 26, 1917 barring private ownership of land for decades to come (Ibid.). The "real core" of Lenin's program, thus, unfolded to be the resurrection of the patrimonial and basically rights-free system of old Muscovy (Hedlund 2001: 222). For nearly three-quarters of a century, the Soviet system would be marked by the absence of private property, market-based pricing and "the role of the state as a guarantor of generally accepted rules" – with the power and full control over *all* the country's productive assets. As a result, when the Russian reformers set out in 1992 to create a modern market economy through mass privatization, resting on 'secure' property rights and the 'inviolability' of contracts, "they were up against a historical legacy the full weight of which was probably poorly understood and the relevance of which was publicly denied" (Ibid.: 225). It should therefore come as no surprise that such a process – which aimed at fundamentally restructuring Russian society and Russian culture – has been plagued with problems, and that:

> …the roots of the Russian predicament lie, namely in the path dependent absence in Russian tradition of a state that is ready, willing and able to shoulder a role as legitimate guarantor of the rules of the game, and in the equally path dependent evolution of organizational responses and mental models that help economic actors in exploiting the opportunities for gain that are offered by such a *weak state* (Hedlund 2001: 227, emphasis added).

This section on property rights, as illustrated in the quote above, explains one potential reason for Russia's poor governance indicators and weak institutions – that being Russia's path dependent legacy, which has led to a persistently weak property rights regime. It is argued in the next section that this very lack of secure property rights was on of a few factors allowing for the capturing of a major proportion of Russia's oil reserves by a small group of domestic investors.

2.1.2 "Property without Rights"[22] - the Privatization of Russia's Oil[23]

> Based on the expectation that, other things equal, private ownership generates stronger incentives to produce than does state ownership, policymakers and international financial institutions have advised governments from Asia to Africa to transfer their state-owned assets to private hands. However, the potential gains from privatization may not be realized if the property rights are viewed as insecure (Frye 2005: 3-4).

2.1.2.1 Early Privatization – Maintaining State Control

The general laws for privatization of the oil complex were laid down in Presidential Decree no. 1403, issued on 17 November 1992. This decree called for the

[22] Taken from the title of Stefan Hedlund's "Property Without Rights: Dimensions of Russian Privatisation," which has effectively served as one of the key resources for this chapter.
[23] See also Blasi *et al*.; Aslund (1995); Braguinsky (1999); or Hedlund (2001). For an in-depth analysis of the privatization of Russia's energy sector, see Lane and Seifulmulukov (1999: 25-26) or Kim (2003: 73-104).

division of assets between subsidiaries and holding companies in the following way: For subsidiaries, the stock was divided into two parts: the smaller (25 percent) was composed of preference (non-voting) shares. These were to be distributed free of charge among the employees (management and workers) of the enterprises (Lane and Seifulmulukov 1999: 24). The remainder – the ordinary voting shares – were to be divided as follows:

- Thirty-eight percent was placed with an oil holding company, or in some cases transferred for temporary management to the state enterprise, Rosneft – the objective here being to give a controlling stake of 50.7 percent of voting shares to the hold company;
- Ten percent was to be offered for sale on advantageous terms to the enterprise's workers;
- Five percent was for sale on advantageous terms to the enterprise's management;
- 3.75 percent was for sale by "check auction" to small nationalities of the north and employees of joint stock companies (JSCs) of oil pipeline transport enterprises;
- Finally, 18.25 percent was for sale though check/and or cash auctions to other (local and foreign) buyers (Ibid.: 24-25).

The above regulations took place during the first stage of the Russian privatization procedure (1992-1994)[24] – when "vouchers" were the primary means of acquisition. In addition to the distribution of vouchers, initially the ownership of assets of the holding oil companies was also divided between government and financial institutions with the former having a major share (Ibid.: 25).[25] The scheme of privatization in the fuel and energy complex was slower and a bit more cautious than in other sectors of the economy – for three years, control of the stock of the

[24] For a more detailed and general accounts of this period, see any of the works cited in the immediately preceding footnote.

[25] There were differences, however, between the various companies. For Lukoil, Yukos and Surgutneftegaz, during the first three years, 45 percent of the stock was owned by the federal government; 40 percent was to be sold on investment tenders to financial institutions such as banks, and the remainder was to be tendered for privatization checks. For companies established in 1994 and 1995, the share retained for three years as federal property was increased to 51 percent, while 49 percent was to be sold. Overall, a limit of 15 percent of total assets was placed at this time on ownership by foreign investors (Lane and Seifulmulukov 1999: 24).

established companies belonged to the state, whose representatives became directors of oil companies. Initially, when the oil holding companies were created, "the government retained 100 percent of their shares, giving it the right to appoint all the directors, as well as top management" (Ibid.: 26). This soon changed under the second phase of Russian privatization.

2.1.2.2 Second Stage of Privatization - Capturing Russia's Black Gold

The year 1995 marked the beginning of a new phase, or second wave of privatization. The government at the time was having a hard time paying its bills thanks to low levels of tax collection, the war in Chechnya, and heavy subsidies to failing industries (Freeland 2000: 93). With a presidential election also coming up, the head of Uneximbank, Vladimir Potanin, proposed to the government that he and "some of his banker friends" loan funds to the cash-strapped government, with repayment secured by the government's majority state in key strategic industries that had been excluded from voucher privatization (Ibid.). In a now notorious program known as "loans for shares," the government auctioned control over its shares in lucrative metals, oil, and other companies in return for the loans, giving the shares as security "to whomever lent it the most money" (Ibid.). The program, which *barred foreigners* from participating, and which was clearly *inefficient* and *non-transparent* on multiple fronts, gave rise to the "oligarchs" – a term referring to the small group of bankers and industrialists who were able to gain control over billions worth of state assets, notably in exchange for helping in the reelection of President Yeltsin.[26] Consequently, some of Russia's most valuable oil companies, auctioned off at

[26] See Guriev and Rachinsky's "The Role of Oligarchs in Russian Capitalism" (2005).

astonishingly below-market prices, fell into the hands of these well-connected "oligarchs"[27]:

- 51% of Sidanko was auctioned off to an affiliate Unemimank, which organized the auction, for $130 million. The winner paid the equivalent of 2 cents per barrel for Sidanko's known reserves, when the going rate for international reserves was $4-5 per barrel. Two years later, BP paid 4 times that amount for a 10% state in the company
- 5% of Lukoil was sold to Lukoil affiliates for $250.01 million, $10,000 over the minimum bid. Weeks earlier, Arco had paid more than seven times that for a comparable Lukoil state.
- 40% of Surgutneftegaz, a company with annual oil output equal to France's Total at the time, was purchased by Surgut itself for $88 million.
- A consortium believed to represent Boris Berezovsky won 51% of Sibneft, Russia's then seventh largest oil company, for $100.3 million, $300,000 over the minimum bid.

Almost every auction held by the banks was rigged, and in almost every instance, competitors were prevented from bidding so that the winner was in fact a cover for the bank that conducted the auction (Freeland 2000). It was in this way that Mikhail Khodorkovsky was able to pay a mere $300 million for control of Yukos (through his Menatep banking group), a company that a few months later had a market value of between $3 billion and $5 billion, rending Khodorkovsky Russia's richest man almost overnight (Lane and Seifulmulukov 1999).

In sum, following the argumentation above – and in particular that of Freeland (2000) and Guriev and Rachinsky (2005) – the capture of the lion's share of Russia's oil reserves by these so-called "oligarchs" was due in-part to the fact that the state was strapped for cash and was forced into selling shares in oil companies for loans from the above-referenced banks. The owners of these same banks were then able to gain control – via illegitimate mechanisms, and because the state was unable to repay its debts – which may not have been possible had Russia had a proper property rights and

[27] Examples taken from Bivens and Bernstein 1998; Freeland 2000.

legal regime. It is inferred here that this was a difficult *compromise* that Yeltsin had to make during an *election year*. The state's reluctance to give up control is boosted by the fact that the private oil companies were only "allowed" to gain control and operate the "old fields," while the new ones were reserved for state oil companies (Aslund 2005: 612). The state also retained monopoly control of Russia's extensive oil and gas pipeline system,[28] and most notably, monopoly control of the state's vast gas fields (said to be the largest in the world) (Ahrend 2005: 596).[29]

The above narrative thus paints a somewhat alternative picture to the one advanced by Jones Luong and Weinthal of the reasons behind the factors causing Russia's unique ownership structure of its energy resources (2001; 2004).[30] While, indeed, it can be reasoned that the government's retaining of the gas industry served as an alternative revenue source[31], the authors do not account for additional factors such as: the lack of legitimate market and legal institutions to ensure fair and transparent transactions; the role played by the powerful, well-connected bankers; the fact that it was an election year; or even for the relatively low oil prices observed during that period.[32]

Nevertheless, the large majority of oil fields in Russia *did* fall into the hands of private owners. According to privatizers at the time, these private businessmen, even if they came into their wealth and ownership states in illegitimate ways, were

[28] Controlled by Transneft and Gazprom, respectively – both state-controlled companies.
[29] For more on privatization of Russia's gas companies (or lack thereof), see Kim (2003).
[30] Note, again, that the authors attributed private ownership to be the interaction between two domestic factors: alternative sources of export revenue and political contestation (Jones Luong and Weinthal 2001; Jones Luong 2004).
[31] Even this claim can be challenged, as the revenues from their retained oil pipelines as well as from their natural gas exports don't exactly fit Jones Luong and Weinthal's "alternative" export revenue terminology - as they are still both part of the same sector.
[32] It would be interesting to know whether the privatization of Russian oil assets would have even happened had the price of oil been higher. Recall that from 1992 to 1999 the world price for Brent crude averaged US$22.50 in 2005 dollars ($17.60 in nominal terms), compared to current prices of over $50 a barrel (Milov 2006).

expected to maximize profits, use resources more efficiently, and restructure their enterprises – more efficiently than politicians or bureaucrats could do. However, for many years following privatization, there was a greater tendency toward asset stripping and insider-dealing than restructuring and good corporate governance (Freeland 2000). It is suggested that the very absence of a clear property rights regime, an independent judicial system, and the Russian legacy of state control were contributing factors in prompting this behavior. Hellman's breakthrough research explores why these powerful businessmen had the incentive, and power, to "block specific advances in the reform process" – consequently contributing to Russia's continuously low governance indicators (Hellman 1998: 204). (SEE Figure 6). The next section summarizes his unique findings.

2.2 "Early Winners" and Partial Reform

2.2.1 "Winners Take All"

Joel S. Hellman's 1998 "Winners Take All: The Politics of Partial Reform in Postcommunist Transitions" provides groundbreaking conclusions for why, at least as of 1998, many postcommunist countries had failed to implement second, let alone third stage market economic reforms – maintaining instead a system characterized by "partial reform" (Ibid: 217).[33] He defines "partial reforms" as: *the selected introduction of market mechanisms into an economy in which substantial spheres of activity still operate according to alternative mechanisms of coordination* (Ibid.).[34] Hellman contends that, counter to the conventional views found in political economy theory, the pressure to adopt this suboptimal course of reform "does not derive from

[33] This section does not cover the more technical aspects of Hellman's arguments, for example, his analysis of the so-called "J-curve." Refer directly to his article for more on this.
[34] In other words, mechanisms that allowed for non-market activities such as rent-seeking.

the losers – unemployed workers, impoverish pensioners, superfluous state bureaucrats, and so on," but from the "winners" of the first round of reforms (Ibid.). These reforms include the two phases of privatization in Russia mentioned above, amongst others.

The early "winners" in many postcommunist countries are: "state managers turned private owners;" "rising financial-industrial conglomerates;" "new entrepreneurs-cum-mafiosi;" and of course Russia's oil *oligarchs* (Ibid: 233). They are all big winners as a result of: privatization; the newly emerging securities markets; the liberalization of domestic and foreign trade; and gaining control over valuable oil reserves for a *fraction* of their worth, respectively (Ibid.). These "highly concentrated" groups enjoy rent-seeking opportunities which have arisen from, among other things, "price differentials between the liberalized sectors of the economy and those still coordinated by nonmarket mechanisms," as well as profit earned from selling highly subsidized natural resource inputs (oil and gas) to foreign buyers at world market prices – allowed by incomplete price liberalization (Ibid.: 219). No matter what the scenario, these arbitrage opportunities "generated rents to those in a position to take advantage of these market distortions (Ibid.).[35] Rationally, these winners thus do not want to give up these generous inflows of income unless the efficiency gains of further market reforms exceed these large sums of rent.[36] This phenomenon is perhaps best explained in the words of Hellman, himself:

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[35] Vadim Volkov boldly studied one of the infamous groups amongst these "winners" of partial reform. He shows how competition to exploit the distinctive opportunities thrown up by the chaotic transition to the market and the failure of the state to provide adequate legal and practical security created a "violent entrepreneurial" sector in which rents were collected for the protection for one's property. He calls this group the "violent entrepreneurs"(Volkov 2002).

[36] Note that the present tense is used in this section. However, while the early winners characterized here still, for the most part, maintain their large assets (with notable exceptions like Yukos' Khodorkovsky), *some* of the rent-seeking activities detailed have been limited by more recent events such as higher quality market reforms. This is discussed in Chapter Three.

> If economic reforms continue to progress over time, then the market distortions that produce these concentrated rents should gradually be eliminated. Further price liberalization undermines arbitrage operations between the fixed-price state sector and the free-price export sector. The progressive hardening of enterprise constrains eliminates the misallocation of state subsidies. Privatization coupled with the creation of an effective corporate governance structure reduces asset stripping by enterprise insiders. While these measures produce efficiency gains for the economy, they also alter the flow of private gains to the initial winners of reform. The winners give up a concentrated stream of rents generated by the initial market distortions for a share of the overall efficiency gains associated with further market reforms. As a result, progress in the implementations of market reforms could reduce the private gains to the initial winners over time, while increasing efficiency gains for the economy as a whole (Hellman 1998: 219).

Again, as summarized above, the early winners of reform consequently have "an incentive to veto any reform proposals" that would move the economy toward more comprehensive reforms, since such measures would "begin to decrease the rents they gained at the earlier stage of the reform process" (Ibid: 222). How are they able to do this? Hellman argues that these winners have such powerful influence because, due to their very highly concentrated gains, they are able to play a more active role in policy formation due to their large resources[37], their smaller number, and "their selective incentives for collective action." These winners are also most successful in countries characterized by low executive turnover rates, and those in which reformers were less susceptible to the reaction of the losers of the reform process. Hellman reveals that the experience of Russia is clearly that of a country that fits these criteria. This is exemplified by the "remarkable 20-point increase in the income share of the top quintile" (Ibid.: 226) Russia has experienced. Following this logic, this "top quintile" of winners – personified by the likes of the multi-billionaire oil oligarchs such as Yukos' Mikhail Khodorkovsky – have the resources, therefore, to influence the implementation or rejection of certain policy reforms. An example of

[37] Used often for bribery.

a reform pushed through under Yeltsin was the implementation of a Civil Code in 1995, which represents a step towards better property rights protection than observed previously.[38] Next, the influential role played by Russia's biggest "winners" – the oil oligarchs – in sustaining this "partial reform" environment is addressed.

2.2.2 "Partial Reforms"[39]

2.2.2.1 Taxation

Prior to the end of 1998[40], the privately owned (not to mention state-owned) Russian oil companies enjoyed a period of large additional revenues by way of their influence and the maintaining of the partially reformed business environment. In response to both formal and informal taxation mechanisms implemented by the regional and local governments at the time – levied for social services and infrastructure investments – the oil companies responded by developing a series of "legal and semilegal schemes" to "hide their profits through which they effectively evaded heavy taxation" (Gustafson 199: 207; as cited by Jones Luong and Weinthal 2004: 141). This process of tax evasion, most commonly by way of transfer pricing.

[38] For example, while the 1993 Constitution already proclaimed the right to private ownership, there was not yet a set of laws in place to protect these rights. The Civil Code was meant to do that. However, there were still problems with this law, exemplified by the fact that despite undergoing numerous amendments (for example 1996, 1997, 1999), Chapter 17 of the Civil Code – which was intended to establish a framework for transactions in land – was not brought into effect until 29 October 2001, when the new Land Code of the Russian Federation came into force (as will be mentioned briefly again later). See, for example, Medushevsky (2002) for more information on Russia's Civil Code.

[39] Note that the change in tense in this subsection implies an historical recounting. It is therefore not specified here as to whether the partial reforms and benefits the oil oligarchs enjoyed in the 1990s are still applicable today. This is in part due to the limited scope of this paper, as well as the difficult nature of documenting the existence or magnitude of benefits captured.

[40] In other words, before the adoption of Part I of Russia's new Tax Code, which was adopted in July 1998. This Tax Code is discussed further in Chapter Three.

Through valuable personal communications with a number of industry insiders[41], Jones Luong and Weinthal effectively summarize this behavior:

> Because the corporate income tax (or profits tax) was based on trade rather than production, parent companies could reduce their official income by creating trading subsidiaries (often located in a low tax zone within Russia) from which they purchased oil at below market prices to offshore Russian intermediaries (often located in a free-trade zone). By some estimates the [oil companies] have been able to hide at least 25% of their export proceeds through transfer pricing…Actual (versus statutory) tax rates on oil not only were lower than they should be, but also differed markedly from company to company…Another form of tax evasion that detracted from profit-making activities included the development of intricate schemes to avoid payroll taxes. Here, parent companies would [also] create offshore subsidiaries to pay their employees, arrange for insurance companies to pay their employees under the guise of large monthly payouts from life insurance policies, or pay higher corporate banking fees so that employees would earn higher interest rates than the market rate on their checking accounts (Jones Luong and Weinthal 2004: 141).

Following in close line with Hellman's theory, therefore, the oil oligarchs were not only in large part "winners" of large amounts of legitimate and illegitimate revenues, but they were able to also exert influence over some of the tax reforms which allowed for these very loopholes used to secure extra revenue. This political influence was achieved through various forms of *lobbying*, such as: "simply bribing deputies;" supporting "insider" officials; and personal contacts within ministries such as the Ministry of Fuel and Energy (Ibid.). This power was exemplified in March 1997, when, the oil companies "persuaded both the Duma and the government to reverse a R15,000 increase in the excise tax" that the Ministry of Finance and State Tax service had pushed through several months before (*RPI*, March 1997; as cited by Jones Luong and Weinthal: 144).

[41] Including, amongst others, Vitaly Yermakov, Research Associate, Cambridge Energy Research Associates (CERA) (Jones Luong and Weinthal 2004).

Next, it is shown how, inferring these same lobbying mechanisms, the oil oligarch were also played a role in the adoption of “partial” (meaning, in this context, clear and secure) mineral rights legislation.

2.2.2.2 Subsoil Law[42]

An amendment of the “Law on Subsoil” was made in 1995.[43] It established the list of grounds to obtain the right to subsoil use that had previously reflected the Licensing Regulations only, as well as the list of grounds for the re-registration of said rights. Also in 1995, the RF Subsoil Committee approved the “Instruction On the Procedure for Re-Issuance of Licenses for Subsoil Use” (otherwise known as “Instruction 65”) (see Borodin *et al*. 2003).

The same year, another law relating to subsoil rights was enacted. This law was aimed at attracting foreign investment. The “Law on Production-Sharing Agreements” – eagerly awaited by foreigners, was signed by Russian President

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[42] To this day, under Russian legislation, natural resources, including oil, gas, precious metals and minerals, underground waters, and other commercial minerals situated within the territory of the Russian Federation are still the property of the state (Borodin *et al.* 2003: 39). The right to possess, use, and dispose of subsurface resources is under the joint authority of the Russian Federation and its constituent entities.[42] Subsurface resources cannot be bought, sold, gifted, inherited, pledged or alienated in any other way (Ibid.). However, simultaneously, the right to use subsurface resources may be alienated or transferred from one person to another in cases permitted by federal legislation. Such is the context in which individuals, domestic or foreign, may establish certain “rights” – in the form of licenses or product-sharing agreements – over these resources. At present, the oil- and gas-extraction companies in Russia may operate on the basis of the law On Subsoil (1992); the law “Concerning Production Sharing Agreements” (1995); and other normative acts governing relations associated with the use and protection of land, water and the environment which arise in connection with the use of subsurface resources (Borodin *et al.* 2003: 40).

[43] On February 21, 1992, the *original* Law No. 2395-1 “On Subsoil” was adopted for the first time. The law regulates relations arising in connection with the geological study, use, and protection of subsurface resources within the territory of the Russian Federation. Pursuant of the law, subsurface resources may be developed only on the basis of license. The license contains information on the site to be developed, the period of activity, financial conditions, etc. In addition to payments for the right to use subsurface resources, companies operating on the basis of a license must pay other generally established taxes, such as profits, VAT, etc. (Ibid.). On July 15, 1992, the Russian Federation passed the Regulations On the Procedure for Subsoil Use Licensing (the “Licensing Regulations”), which covered the basic issues, related to the license issuance mechanism (Bardin and Sapozhnikov 2003: 16).

Yeltsin on December 30, 1995. Product-sharing agreements (PSA) allow the investor to give the state a fixed portion of production (gas or oil) instead of taxes and other fees. An effective PSA law allows the investor to avoid payments for use of subsoil, land, and other natural resources, and mandatory payments for social and medical insurance (Yakren 1997). However, after its enactment, the law left many investors, particularly foreign, unimpressed, as difficulties – with the above referenced tax regime, complicated formalities for concluding production-sharing agreements, provisions of customs and export/import exemptions, and problems with the law "On Subsoil" – undermined the law's potential (Ibid.).

Not surprisingly, it is observed that both of these legislative reforms came during the time of second round privatizations highlighted above – when the government was trying to sell shares in many of its previously state-owned and controlled oil companies – not to mention the exact period when Yeltsin was unashamedly seeking support for his reelection. These "partial" legal reforms, implicitly, were in part efforts to reinforce investors,' (or rather lenders') confidence that the shares on offer would not be recaptured or renationalized following receipt of sales revenues, loans, or even campaign contributions. These fears were in part due to Russia's legacy of poor property rights protection which is illustrated above.

Following the logic of Hellman's argument, I infer that lobbying by the oil companies may have also had influence in the application of the PSA law – as the law was subordinate to that of the "Law on Subsoil" – in which participation of foreign involvement was severely limited, thus benefiting private local owners. Notably, then, despite the adoption of the PSA law, foreign participation in the acquiring of rights to, as well as the investment, and development into Russia's oil assets has remained, even today, at an extremely low percentage (see, for example, Bayulgen 2005).

Noticeably, the above narrative also supports the theory of Jones Luong and Weinthal outlines in Chapter One of the “symmetric” relationship between the oil oligarchs and the state. This is substantiated by investment activities of the oil oligarch, which again included asset-stripping and lack domestic capital investments – arguably due to the due to the constant (and as is shown later, warranted) fear of renationalization by the state.

In summary, the net winners of the initial reform process – in this case Russian oil oligarchs – did not oppose the initiation of the reform process, “nor have they sought a full-scale reversal of reform” (Ibid.: 204). In fact, they pushed for certain reforms such as the “Law on Product-Sharing Agreements,” and for better property rights protection not only to retain rent revenues – from, among other things, tax evasion – but, to protect themselves from the perceived threat of the recapturing of their illegitimately attained assets by the state.[44] Arguably, they were able to maintain this system until the end of the 1990s by way of lobbying and powerful political and personal influence. This was exacerbated in this case, as Russia was also characterized by a low degree of political inclusion and low executive turnover rates. Accordingly, in spite of some moderate increases, this maintenance of *partial reforms* – aided by these oil oligarchs – kept Russia’s governance indicators *low* – especially compared to the non-resource rich postcommunist countries (see Bohle and Greskovits 2007).

While these findings appear to accurately mirror reality until the late 1990s, in later works by Jones Luong and Weinthal argue that Hellman’s theory, and the maintenance of partial reform, effectively came to an end (Weinthal and Jones Luong

[44] I also posit that, loosely related to Hellman’s theory, the Law on PSAs also served as an effort to maintain some sort of semblance of a commitment to market reforms to portray to the rest of the free-market world.

2004). The next chapter explores the mechanisms and reasons behind this trend towards the implementation of quality institutions in Russia, and a “cooperation” between the oil companies and the Kremlin in the early years of the twentieth century.

Chapter 3: Exogenous Shocks, Oil Prices and Institutional Change

The seminal works of Acemoglu *et al.* (2001), Gleaser and Shleifer (2004) find that institutions are not necessarily exogenous[45], but that they are created or change as the result of different economic conditions – and thus *endogenous*. Following this logic, as well as that of the resource curse literature – which posits that countries whose economies rely predominantly on their abundant natural resources are particularly affected by sudden changes in the world's commodities market (see Shafer 1994) – this chapter explores the institutional changes that have occurred in Russia in response to two changes in the Russia's economic environment: the 1998 Financial Crisis and the subsequent "sustained" rise in oil prices starting just before the turn of the last century.

3.1 1998 Financial Crisis and Russia's Subsequent Reforms

In August 1998, following, among many other things, the Russian government's decision to devalue the ruble and place a moratorium on external debt payments triggered a financial crisis that "sent shockwaves throughout the Russian economy: real GDP plummeted, inflation and unemployment soared, and commercial banks went bankrupt (OECD 2000: 33-45, as cited by Jones Luong and Weinthal 2004). Among those hit unexpectedly hard by the crisis were the private oil companies who had been "winning" so much over the past few years. In fact, these companies (e.g. Yukos) faced bankruptcy and lacked cash flow to service their large, mainly foreign, debt – exacerbated by the devaluatation of the ruble (*RPI*, September 1998: 7). Futhermore, due to this reduction in revenue inflows, combined with the lack of domestic investment to boost productive capacity, mentioned above, "they

[45] See Banerjee and Ghatak (2005) for a review of this literature.

could not immediately reap the benefits of the ruble's devaluation by increasing production" (Jones Luong and Weinthal 2004: 146).

The crisis, which thus effected not only the government, but the oil oligarchs, reveals the extent to which these *symmetrically* powerful actors are "both vulnerable to global markets, and thus the costliness of their previous failure to cooperate" (Ibid: 145). Jones Luong and Weinthal suggest that it was this dynamic which led the two groups of actors to realize their mutual dependence on one another for both of their recoveries, "but also to insulate themselves from the effects of future crises" (Ibid.: 146). The aim of the Russian government would be to find revenue to regain budgetary stability. While the oil companies – who were plagued by underdeveloped or aging infrastructure of their oil fields – finally succumbed to the need to ask Western partners for the necessary capital and technological know-how (Ibid). This meant that the oil companies would need improved property rights protection, not only for successfully attracting this much needed foreign investment, but for their own protection against capture by the state. According to the logic developed by Jones Luong and Weinthal, the financial crisis of 1998 thus served as an "exogenous shock" and the "impetus" for the change in relationship between these "early winners" and the state (2004). It effectively served to help both groups realize the need for "stable rules" – and thus "mutual cooperation." This new dynamic should henceforth account for the increase in quality institutions.

Evidence of this shift came through a number of "incremental" reforms that came especially after the inauguration of President Vladimir Putin – who succeeded Yeltsin in March 2000. This is marked by the original failure on the part of the new

Tax Code (Part I).[46] In 2000, "the government only received approximately $30 billion in the windfall rent from natural resources sales in 2000, while 75% remained in the hands of oil and gas exporters" (Jones Luong and Weinthal 2004: 141). This failure might be attributed to the remains of corrupt officials in the government under Yeltsin – who has already proven to been open to bribery and corruption. Thus, Putin represented a fresh face. This was aided by the fact that he not only enjoyed a popular mandate, but also "faced a Duma that was less polarized, and therefore more pliable." after the 1999 elections Putin seemed poised to unilaterally redefine Russia's political climate and single-handedly push through his economic agenda (Jones Luong and Weinthal 2004: 142). Putin came into power with a clear objective: "Russia needs strong state power and must have it"[47] – as it had become clear to all by that point that Russia's statehood was significantly *weakened* by the unsuccessful "partial reforms" examined by Hellman of the 1990s – and thus the restoration of state strength was his goal.

In Putin's first term, he emphasized the need for free market institutional reforms to achieve this goal (see, for example, Aslund 2004) – and actually, a number of market oriented reforms *were* passed under Putin. Jones Luong and Weinthal effectively highlight the above-mentioned new Tax Code to support their claims (Jones Luong and Weinthal 2004). In 2001, Part II of the Code was enacted. It includes specifications on various taxes, including the VAT, corporate profits tax, personal incomes tax, and the social tax (see Weinthal and Jones Luong 2002). These reforms created a tax regime in Russia which has not only eliminated the earlier

[46] Part I of the Code, which was enacted first in 1999, did lay much of the groundwork for a legitimate tax regime – covering administrative and procedural matters, including the introduction of new taxes and protection of taxpayers' rights (Jones Luong and Weinthal 2004).
[47]Part of his "Russia on the Threshold of Millennium" address. Accessible at: www.pravitelstvo.gov.ru/english/statVP_engl_1.html

loopholes (outlined prior) in the era of Hellman's "partial reforms," but has increased collection rates, and, "by most accounts exceeds Western standards" (Ibid: 217).

Other market reforms advanced under Putin have included[48]: in 2001, a new capitalist Land Code was finally adopted; on July 24, 2002, the law "On The Turnover of Agricultural Land" – i.e. the privatization of agricultural land – was adopted; and in October 2002, a new bankruptcy law was adopted (Aslund 2004: 409-410).

There is also substantiating evidence of a shift from the illegitimate behavior of the "early winners" outlined above. It is suggested that a number of moves have been made on the part of the private oil companies to assure the Russian governments that the private oil companies were committed to reform (Jones Luong and Weinthal 2004: 144). These include committing to pay their taxes by December 1999 in a now famous meeting with President Putin, as well as committing themselves to implementing international accounting methods and corporate governance codes (Ibid.; see also Frye 2005). Perhaps most notably (and now, perhaps most ironically) they illustrate how Yukos "[had] been one of the leaders in demonstrating to the Russian government how the [private oil companies] have changes their beliefs following the 1998 financial crisis" (Ibid: 146). Yukos pursued: corporate governance; hiring international management (25% of top-level management); increasing investments in Russia; and building strategic partnerships with Western companies (see Goldman 2004).

These changes have had a profound impact on Russia's economy. The above reforms created "the perception that property rights had become sufficiently secure

[48] For an in depth discussion of reforms during Putin's first term, see Aslund (2004).

(even though from hindsight this perception turned out to be misguided in some cases) was one of the factors contributing to the recovery of investment in 2000 and especially 2001" (Ahrend 2005: 590). This is substantiated by the incredible increases in investment – particularly in the oil-sector, by private owners – as he finds that by 2000, their investment was already 70 percent above 1998 levels (Ibid.). This increase in investments rationally led to increases in oil production and exports over the next few years.[49] This also means that "private oil producers directly accounted for somewhere between one fifth and one quarter of GDP growth" – which reached high levels of just under 10% (Ibid.).

As referenced to earlier, of particular support to the claims made throughout the work of Jones Luong and Weinthal – that private, local ownership is preferential – are the findings of Ahrend (2005). He uncovers that Russia's private oil companies accounted for almost all of the growth recorded in the period following the financial crisis.[50] What's more, these are the very firms – those controlled by major financial groups (the so-called *finansisty*), rather than those under the control of the oil-industry that drove this growth (~70%) – which once epitomized the rent-seeking, "early winner" behavior prior to the crisis (see Aslund 2005). Ahrend goes as far as to suggest that Russia "would not have achieved the growth performance of the last few years if they had remained under state control" (Ibid.: 592).

Even more support for this line of thought is found in the experience of Russia's gas industry. Interestingly, the gas industry "is arguably Russia's least-reformed sector and undoubtedly one of its least efficient" (Ahrend 2005: 597; see also Ahrend *et al*. 2007; Kim 2003). Production has grown "by around 1.5 percent per

[49] Clearly, high oil prices "were another major factor" (Ahrend 2005: 590).
[50] Again, he differentiates between owners *within* the Russian oil industry – identifying three types of owners: financial group-owned; oil-industry insider-owned; and state-controlled (2005: 591).

annum over the last five years, as against an all-industry average of over 6.7 percent" - not to mention the incredible growth rates cited for the privately controlled oil industry during the same period. This comes as a surprise given the world's (particularly Europe's) insatiable demand for natural gas. Thus, it is inferred that this can be attributed to the ownership structure. As mentioned elsewhere in this paper, Russia's gas industry has remained in the control of the Russian state, by way of state-controlled gas monopolist Gazprom.

In short, besides confirming the role of exogenous shocks in inducing institutional change and a new relationship between previously at-odds actors, a number of implications can be made from the arguments and findings presented in this section. First, the new Russian Tax Code suggests not only that the ability of economic elites to derail the economic reform process is more limited than Hellman's pessimistic account suggests, but also that, under certain conditions, these "early winners" can in fact serve as the engine of further economic reform and institutional change (Jones Luong and Weinthal 2004). It also supports their earlier findings that privatization to *domestic* owners offers a potential way for resource-rich countries to escape the so-called "resource-curse," because it forces governments to negotiate with domestic actors for revenues (Jones Luong and Weinthal 2001 & 2004). If Russia's oil sector had been state-owned rather than privatized in August 1998, the crisis may not have had the same effect (Ibid. 2004: 150). Jones Luong and Weinthal reason that the Russian state would not have felt the same degree of vulnerability to oil price fluctuations that induced its desire to formalize revenue extraction "because it would have the option to either arbitrarily confiscate profits, increase exports, and/or borrow abroad against future revenue from their resource wealth (Jones Luong and Weinthal 2004: 150).[51] The experience of the gas industry supports this claim.

Therefore, given these marked improvements, exemplified by the sharp increase in "government effectiveness" indicators between 2000-2004 (See Figure 8), high GDP growth rates, and improved investment environment, why then has there been a noticeable increased stake in Russia's oil reserves by state-owned and controlled companies, when the above so clearly presents reasons not to pursue such a strategy? The next section explores this phenomenon and seeks to illustrate the potential impact the rising price of oil may have had on institutional changes.

3.2 Rise in Oil Prices and the Changes in Subsoil Legislation

> The task that I have set before the government is to make the reforms irreversible.
>
> Boris Yeltsin, October 1991.

> Russian President Vladimir Putin has told leading Russian businessmen he does not want a reversal of privatization.
>
> BBC July 28, 2000

> Putin against reversal of privatization.
>
> Headline Interfax New Agency, September 26, 2003

> I am a categorical opponent of a review of the results of privatization.
>
> Vladimir Putin, Italian News Agency, November 5, 2003

> Any allegations that Russia is preparing to revise the privatization results are groundless.
>
> Vladimir Putin, RFE/RL, April 11, 2005.[52]

Between January 2002 and January 2003, the price of oil increased 76% from about $17 per barrel to $30 per barrel (OECD 2006). Prices have only increased

[51] These are the most common responses to "busts" among resource-rich countries in which the resources are state-owned (Karl 1997).

[52] All of these are cited in the introduction to Timothy Frye's 2005 article "Original Sin, Good Works, and Property Rights in Russia: Evidence from a Survey Experiment," p. 3.

further, at prices above $70 per barrel in the past few years (Ibid.). Following the same institutional economics theory (e.g. Acemoglu *et al.* 2001; Gleaser and Shleifer 2004; Reynolds and Kolodziej 2007) that institutions are endogenous, and that states with abundant natural resources are particularly susceptible to changes in market conditions (see Shafer 1994) – it is argued that this economic condition of "sustained" high oil prices has led to institutional change and events such as the legal attack on Yukos and the proposed changes to Russia's mineral rights legislation. I address the Yukos Affair first.

3.2.1 The Yukos Affair

The legal and political onslaught against the oil company Yukos has, of course, been the most visible and controversial sign of the shift towards greater state control of Russia's oil sector (OECD 2006: 37).[53] In late 2003, Yukos – then Russia's largest oil company, which, through active participation in the privatization process during the 1990s, accumulated 20 percent of the country's oil production (Goldman 2004: 319) – came under investigation. Its majority shareholder Mikhail Khodorkovsky was arrested on a variety of charges, including violations of the Law on Privatization. This came after Mr. Khodorkovsky, the (now former) head of Yukos, publicly criticized the Russian government and "stated his belief that the government should not own and control all of the oil pipelines within Russia" (Reynolds and Kolodziej 2007: 946). He was finally charged for tax evasion (Frye 2005: 11). After, the government demanded that the company pay back these taxes and fined it for not having paid. Once it became apparent that Yukos would be unable to pay $28 billion in back taxes and fines, the government auctioned off

[53] See Goldman (2004) or Tompson (2005) for a detailed analysis of the Yukos affair.

Yuganskneftegaz (Yukos' main oil-producing unit). Ironically (or not), Yuganskneftegaz was bought by state-owned Rosneft – which effectively means the re-nationalization of 11% of Russia's current output (Reynolds and Kolodziej 2007: 946).[54]

The question then becomes whether the arrest of Khodorkovsky was merely for his illegal activities[55] - and thus serving as an example for the rest of the country's major private oil companies who think twice about evading taxes, or whether the government saw him as a convenient target for covering the government's real motive of benefiting from the high revenues associated with the hike in oil prices (Reynolds and Kolodziej 2007). Of near certainty, however, is that the private oil companies' persistent weariness regarding the protection of their property rights has proven justifiable. Moreover, the extent that at least *one* apparent aim of the campaign against Yukos was to engineer a change in ownership, the attack on the company increased uncertainty about the security of property rights and thus created further disincentives to long-term investment (OECD 2006: 37).

According to Dr. Evgeny Yasin - one of Russia's leading liberal economists, and "one of the earliest and most influential theorists of the Russian economic revolution and mentor to those who led it," minister of economy from 1994 until 1997, and advisor to Soviet and Russian governments from Gorbachev to Putin (Aron 2006: 1) – the Yukos affair and the arrest of Khodorkovsky evinced the "revanche of

[54] This number likely grown since the time of writing, as the rest of the Yukos assets are fought over.
[55] Some senior officials continue to insist that the affair was simply a tax case. However, it is difficult to make sense of the authorities' handling of the case in such terms. Often, the state took steps that reduced the budget's potential gains from the case, and other aggressive tax "optimisers" in the sector were treated relatively well by the authorities. The recent discount of the tax liabilities of former Yukos subsidiary Yuganskneftegaz is a telling example in this context. Not to mention, if the government were that concerned with tax evasion, they would have to prosecute nearly every major company in the country. (OECD 2006: 47).

a bureaucracy" (Yasin 2005: 176-177). A new era of "state capitalism," in which the state in attempting to gain back power and property has emerged (Aron 2006: 4).

While this represents perhaps a more extreme view, a number of other signs have pointed to a shift in institutions in Russia – institutions which on the surface appear to promote free market reforms, but at the same time have the potential to aid the government's efforts to recapture "strategic" assets. Among these are the proposed changes to Russia's subsoil legislation. These changes are explored here.

3.2.2 Changes in Subsoil Legislation

A number of changes have occurred to the subsoil law under Putin's administration. First, following the 1995 amendment of the 1992 "On Subsoil" law, two additional amendments were made in 2000 and 2001. The amendments added more specifics to the provisions of the 1995 Law related to: holding of tenders and auctions; issuance and re-issuance of licenses; and *termination of the rights to use subsoil* (Bardin and Sapozhnikov 2003: 15) – with the last being of most obvious relevance to Putin's cause. More radically, over the past few years, Russia has been in the process of redrafting a *new* mineral rights law – in what appears to be a quite different institutional thrust compared to that of the private property thrust in the 1990s. In early 2003, the Russian Ministry of Natural Resources (MNR), were the first to attempt a replacing of the Subsoil Law (that of 1992, with revisions made in 1995) with a draft they had prepared. This first draft was actually not too far from the status quo, as it allowed the administrative licensing system to continue instead of replacing it with a market-based contract mechanism, as it was initially proposed (IEP 2005: 1). As a result, not long after, the government called for an alternative draft, this time developed by the Ministry of Economic Development and Trade (MEDT), by the summer of 2003. The MEDT put the Moscow-based Center for Strategic Research (CSR) in charge of this new law – with the key actors being Anton Ivanov and Vladimir Milov, President of the Institute of Energy Policy. This draft was more market-based – as it suggested a transfer from licensing system to the civil (contract-based) relationships in subsoil.[56] This change suggested that the government only wanted contracts as the sole form of agreements and that the existing licenses would fade out.

The next year, however, saw yet another change. No sooner had the CSR draft been completed, than the MNR was put back in charge over the new law. According to the IEP, this was due to the significant reorganization of the Russian Government connected with the re-election of Vladimir Putin (IEP 2005: 2). The head of MNR at the time, Yuri Trutnev, was put in charge of the project. It turned out, that the initial support he had for the CSR version faded quickly, and the MNR proceeded with a third, significantly different new draft. Why the change of heart this time? Well, it should be noted that throughout this short period, the price of oil substantially increased from a low of $23 a barrel in May 2003, to a high of $48 per barrel in March of 2005 – a significant hike (Reynolds and Kolodziej 2007: 940). So what is most beguiling is that during this price increase, the new draft created decidedly did not look to establish a contractual rule of law, but rather "looks to push control of the oil and gas sector back toward the government (Ibid.). This new draft proceeded on to be approved by the Russian Government on March 17, 2005 and was submitted to the State Duma on June 17, 2005.[57]

[56] The Russian language version of this draft can be found at: http://www.csr.ru/material/original_134.stm. The IEP 2005 article also clearly outlines its core principles (IEP 2005: 2).
[57] The draft was accepted by the Russian government with only slight changes (IEP 2005: 2). While the State Duma has decided to not yet adopt the New Subsoil Law, for now (Tompson 2006: 16), and it

Upon first reviewing the New Subsoil Law ("NSL"), it seems to encourage private ownership of oil leases and free markets as it allows current license holders (controlling 92% of Russian oil and 83% of natural gas) to continue operating under the license system until their licenses expire (IEP 2005: 2; Reynolds and Kolodziej 2007: 944). Article 91, Part 2 even requires companies to register their permits as "property rights," granted by licenses, in a state property rights register in order for their rights to be confirmed (IEP 2005: 3). However, as those at the IEP have effectively acknowledged, it appears many aspects of the new law "may lead to a total reconsideration of the detailed license conditions for each and every current investor." Other items of the draft show signs of the government's move towards reestablishing control of the oil industry.

For example, the weakness of the NSL for old license holders is that, instead of the CSR law, the already issued licenses are not simply left alone under the old conditions and the regulations of the old legislation, but are given a completely new regulation framework, specified in Chapter Six of the new law (IEP 2005: 3). It calls for the *detailed amendments of the existing licenses and license agreements to ensure their compliance to the new law.* While the process does not implicitly mean that the fundamental rights of the investors will be reconsidered, however, "this will put an additional bureaucratic pressure on investors with uncertain perspectives" (Ibid.).

A further example is the NSL's not-so-subtle indirect discouragement of foreign investment and participation. Article 122, Part 4 of the NSL seems to protect current foreign license holders, saying "foreign individuals, individuals without citizenship, or foreign legal entities which were granted rights for subsoil operations

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may very well undergo further changes before enactment, the approval by the government, as well as the recent accumulation of oil reserves by Russian state-owned companies suggest an analysis of this new draft is of notable importance.

before the current law became effective, have a right to exercise their rights in accordance with the terms of licenses or product sharing agreements during the terms set therein" (quoted in IEP 2005: 5). However, according to Article 60, part 5, the government may simply *ban* the involvement of foreign companies in any future bidding in an ad hoc manner (Reynolds and Kolodziej 2007: 944).[58] This also means that "any Russian investor, participating jointly with any foreign companies elsewhere, may be prohibited from participation in the auction, even if his company is more than 50% owned by Russian residents, and the participant of the auction is a Russia-registered company 100% owned by this investor. And companies with even 1% foreign participation most definitely will not have access to the auction" (IEP 2005: 6).

Therefore, while the new Subsoil Law can in one light be seen and promoted as a progressive move towards a market-based contract system – it appears fairly clear now that the plan targets the reduction of foreign participation in Russia's oil and gas sector. In addition, while under the new law existing licenses should be unaffected, we see that even they can be revoked if it is found that past taxes were not paid – as in the case of Yukos (Reynolds and Kolodziej 2007: 945). These highlight the increasing *risks* associated with investment into Russia's energy sector, calling the security of property rights once again into question. They also reflect, as Reynolds and Kolodziej effectively point out, a "clearly parallel" move to that of the initial steps that OPEC

[58] Article 60, Part 5 allows the government to prohibit bidding on future auctions for the following bidders: "Foreign individuals without citizenship or foreign legal entities" with: "right to appoint single executive body of a legal entity [bidder] or appoint more than 50% of executive board, board of directors or another executive body of a legal entity [bidder]"; "total share in capital of a legal entity [bidder] exceeds 50%"; "direct or indirect control over more than 50% of the voting shares of a legal entity [bidder]"; and "direct or indirect control over more than 50% of the equity capital of a legal entity [bidder]" (quoted in IEP 2005, 6).

countries took on their way to the nationalization of their oil industries in the 1970s (Ibid.).

In sum, while the above events, such as the attack on Yukos and proposed changes in legislation do not confirm a complete “revanche of bureaucracy,” or the total renationalization of Russia’s oil (at least not yet), these findings supports the arguments that institutions are endogenous and subject to change – particularly in resource-rich states. This susceptibility to external factors is thus implied to have kept Russia’s govenernance indicators low – in spite of the reforms made in few years following the 1998 financial crisis, and the preferable ownership structure Russia has (thus far) maintained of its oil sector. The implications of this are considered next.

Conclusions

Through an empirical review of Jones Luong and Weinthal's hypotheses in Chapter One of this paper, I argue that their line of argumentation holds in terms of Russia exhibiting better institutions – in this case measured by governance indicators – than those found in the other CIS countries. These findings answers the question posed in the introduction of whether it is possible further differentiate between the experiences of the CIS resource-rich states. However, it appears, rather than a comparison between good and bad, this is like comparing between different shades of grey. Like Bohle and Greskovits, the empirical analysis in this paper shows that all of these resource-rich states, including Russia, have exhibited, to date, *low* (albeit occasionally fluctuating) governance indicators *relative to* the other post-Communist countries, not to mention the developed world.

In Chapter Two, I present a combined theory as to why Russia, despite its desirable ownership structure, demonstrates continuously low state capacity indicators. I reveal that this has, at least in part, to do with two factors: the path dependent absence in the Russian tradition of clear property rights protection; and the maintenance of "partial reforms" by the early winners of the reform process, which kept institutions from ever reaching the quality of those found in non-resource rich countries.

By way of a reassertion of some of Jones Luong and Weinthal's later findings as well as providing additional empirical support, this paper's last chapter shows how Russia's 1998 financial crisis served as the impetus not only for positive market economy oriented institutional change – evidenced by the new Tax Code, but for a change in the relationship between the oil oligarchs and the state. It is inferred that this would not have been possible had the ownership of Russia's oil industry not been in the hands of domestic actors. I also find support of the claim that this form of private ownership fosters increased investment corresponding to improved macroeconomic performance. However this will only occur when and if institutions, such as property rights, perceived to be sufficiently secure. The lack of reform and poor growth rates of Russia's gas sector provide further evidence of this. Nevertheless, this provides amble support for why Russia should make steps to privatize its gas sector to local investors, and the rest of the resource-rich CIS countries should follow suit with their resource industries, as well – in particular Turkmenistan and Uzbekistan. The current chances of this seem slim, however, especially in light of the recent shift back towards state ownership in Russia, as well as other countries – notably Venezuela.

Given Russia's proven shift towards quality western-style market economy institutions, by way of Russia's improves fiscal policy, what then to explain this observable shift in ownership of Russian oil, and a renewed threat to Russia's property rights regime? Why, despite Putin's rhetoric have actions appeared different? In the final sections of analysis, I posit that - in line with previous resource curse literature, and with the historic experiences of institutional change and nationalization of mineral rights and taxation that occurred in OPEC countries in the 1970s serving as precedent – that has once again caused a shift in institutions. This suggests Russia is not only particularly sensitive to exogenous shocks – like suggested in much of the resource-curse literature on countries which rely on commodities as their primary export sector (see Shafer 1994) – but that, sadly this may represent a confirmation of the Karl's somber conclusions – that resource-rich states are prone to state-control and are characterized by persistently weak institutional capabilities.

Perhaps the case of Russia will not be as grim as the experiences of many OPEC countries after the rise in oil prices in the 1970s. Perhaps they will learn from these mistakes. Already, according to the newest OECD report, despite some slippage in 2005-06, the authorities have largely resisted the temptation to use commodity windfalls to finance a spending spree (OECD 2006: 37). They have also established a Stabilization Fund meant to properly manage the windfall resource revenues. However, much needs to be done yet, in the way of legal reforms to finally change the legacy of poor property rights protection and economic diversification.

No matter how one looks at it, though, Russia will remain a resource-based economy for some time. This is simply due to the fact that Russia's current industrial and export structure is heavily resource based - and changes in the economic structure of a country take time (Ahrend 2005: 598). Therefore, the issue of "managing" a resource-based economy well is a highly important topic for Russia, whatever one's view of the desirability of further developing Russia's resource sectors or trying to pursue economic diversification (Ibid.). Thus, focusing on how and who manages the resource sector, and what institutions are in place remains critical.

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Appendix

Table 1: *Indicators of Resource Dependence****

In percent unless otherwise indicated

	Azerbaijan	Kazakhstan	Russia	Turkmenistan	Uzbekistan
Oil and gas export in per cent of total exports	85.2 (78.2)	46.8 (34.1)	50.4 (60.2)	81 (62.6)	12.3 (13.3)
Oil and gas export in per cent of GDP	30.5 (17.6)	24.7 (12.1)	21.5 (16.3)	68.7 (31.6)	4.3 (3.6)
Oil and gas revenues in per cent of total government revenues	36.2 (22.1)	27.5 (5.0)	30.1 (24.2)	42.0	14.8 (15.4)
FDI in oil and gas sector in per cent of total FDI	80.5 (71.0)	69.7 (83.3)	10.7	Na	na
Oil production (mt, 2000)	14.02	35.00	312.7	7.25	7.6
Gas Production (bcm) 2000	6.00	11.50	551.00	46	54.88

Source: A. Esanov, M. Raiser and W. Buiter (2001).

*Figures are for 2000, in brackets are for 1999.

Table 2: *Domestic Determinants of Resource Development Strategies*

Level of Contestation

Degree of Access to Alternative Sources of Rents		***LOW***	**HIGH**
	High	$\mathbf{S_1}$	$\mathbf{P_1}$
	Low	$\mathbf{S_2}$	$\mathbf{P_2}$

Table 3: *Ownership Structure and Institutional Outcomes*

Ownership Structure	Primary Actors	Business-State Relationship	Incentives for Institution Building	Mode of Institution-Building	Institutional Outcome
S_1	STATE ELITES + BUREAUCRATS	**BLURRED** + SYMMETRICAL	CONVERGE	(IMPLICIT) BARGAINING	**WEAK**
S_2	STATE ELITES + FOREIGN INVESTORS	CLEAR + *ASYMMETRICAL*	*DIVERGE*	*COERCION*	*HYBRID*
P_1	STATE ELITES + DOMESTIC OWNERS	**CLEAR** + SYMMETRICAL	CONVERGE	(EXPLICIT) BARGAINING	**STRONG**
P_2	STATE ELITES + FOREIGN INVESTORS	CLEAR + *ASYMMETRICAL*	*DIVERGE*	*COERCION*	*HYBRID*

Source: Jones Luong 2004: 24

Table 4: *Divergent Energy Development Strategies in the CIS*

	Foreign Involvement	
	High	**Low**
Private Ownership	Kazakhstan (P2)	Russian Federation (P1)
State Ownership	Azerbaijan (S2)	Uzbekistan and Turkmenistan (S1)

Source: Jones Luong 2004: 27

Table 5: *Ownership Structures and Tax Regimes in the Soviet Successor States*

COUNTRY	OWNERSHIP STRUCTURE	ACTUAL OUTCOME and CAUSAL MECHANISM
Uzbekistan and Turkmenistan	S_1	**Weak Tax Regime** ⇒ Relies exclusively on indirect taxes in all sectors; ⇒ Highly unstable and arbitrarily enforced **Implicit Bargaining** ⇒ Product of informal bargaining among elites
Azerbaijan	S_2	**Hybrid Tax Regime** ⇒ Relies on a combination of direct and indirect taxes but only in energy sector ⇒ Foreign investors increasingly subjected to arbitrary taxation **Coercion** ⇒ Initially dictated by foreign investors; Increasingly dictated by the President and SOCAR since 1998
Russian Federation	P_1	**Strong Tax Regime** ⇒ Increasing reliance on direct versus indirect taxes across sectors ⇒ Increasingly stable and consistently enforced since 1998 **Explicit Bargaining** ⇒ Product of series of formal negotiations among governing elites and Russian oil companies
Kazakhstan	P_2	**Hybrid Tax Regime** ⇒ Relies on direct and indirect taxes but only in the energy sector ⇒ Foreign investors increasingly subjected to arbitrary taxation since 1998 **Coercion** ⇒ Initially dictated by foreign investors; Increasingly dictated by the President and KazakhOil since 1998

Source: Jones Luong 2004: 28

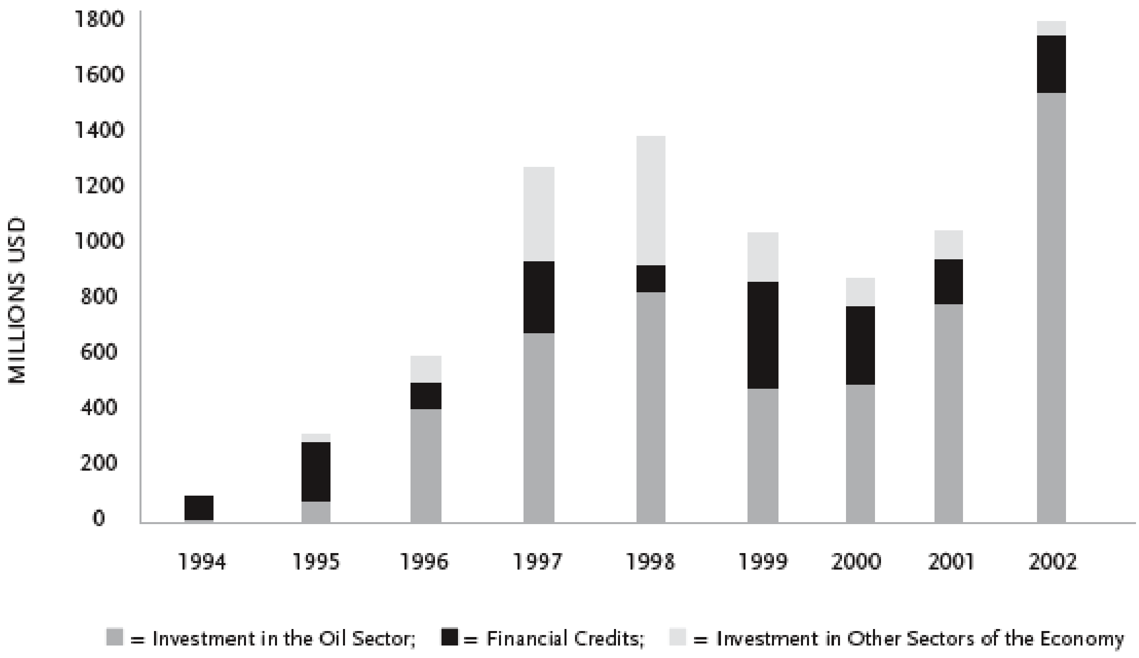
Table 6: *Major State Acquisitions in the Oil & Gas Sector, 2004-2006.*

Company	Sector	Date	Mechanism
Tuapse oil refinery	Oil refining	December 2004	Rosneft purchases 40% from minority shareholders to take full control of the refinery.
Yuganskneftegaz	Oil and gas	December 2004	Rosneft purchases 76.8% stake from the firm OOO “Baikalfinansgrupp”, the winner of a state-organised auction of Yuganskneftegaz shares to settle tax debts.
Tambeyneftegaz	Oil and gas	May 2005	Gazprombank purchases a 25% stake from Novatek.
Northgas	Oil and gas	June 2005	Gazprom regains control of independent gas producer Northgas, taking over a 51% stake following litigation.
Gazprom	Oil and gas	July 2005	State-owned Rosneftegaz purchases 10.7% of Gazprom to raise state’s direct stake in Gazprom above 50%.
Selkupneftegaz	Oil and gas	July 2005	Rosneft purchases 34% stake from independent gas producer Novatek.
Sibneft	Oil and gas	October 2005	State-owned gas monopoly OAO Gazprom buys 69.66% stake for $13.1 bn.
Verkhnechonskneftegaz	Oil and gas	October 2005	Rosneft purchases 25.9% stake from Interros Holding.
Udmurtneft	Oil	June 2006	Rosneft acquires a 51% stake from Sinopec after the latter buys 96.7% from TNK-BP for an estimated $3.5 bn.
Sibneftegaz	Gas	June 2006	Gazprombank purchases a 51% stake from Itera.
Novatek	Gas	June-July 2006	Gazprom purchases a 19.9% stake for a sum reportedly exceeding $2 bn.

Note: The table excludes acquisition of foreign assets by state-owned companies.

Source: OECD (2006)

Figure 1: *Foreign Investment in the Oil Sector of Azerbaijan, 1994–2002*



Source: Tsalik 2003: 9

Figure 2:

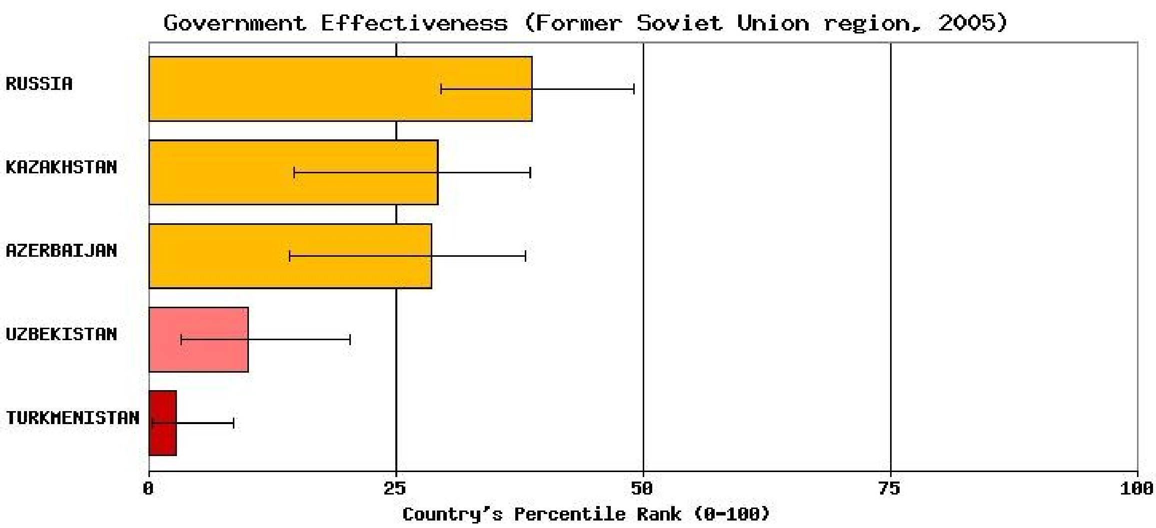


Figure 3:

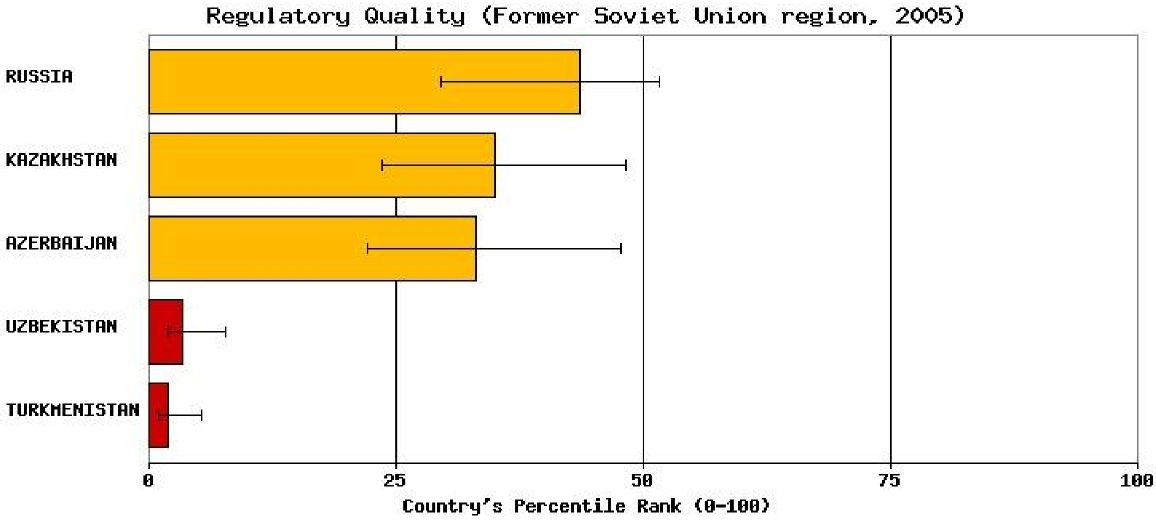


Figure 4:

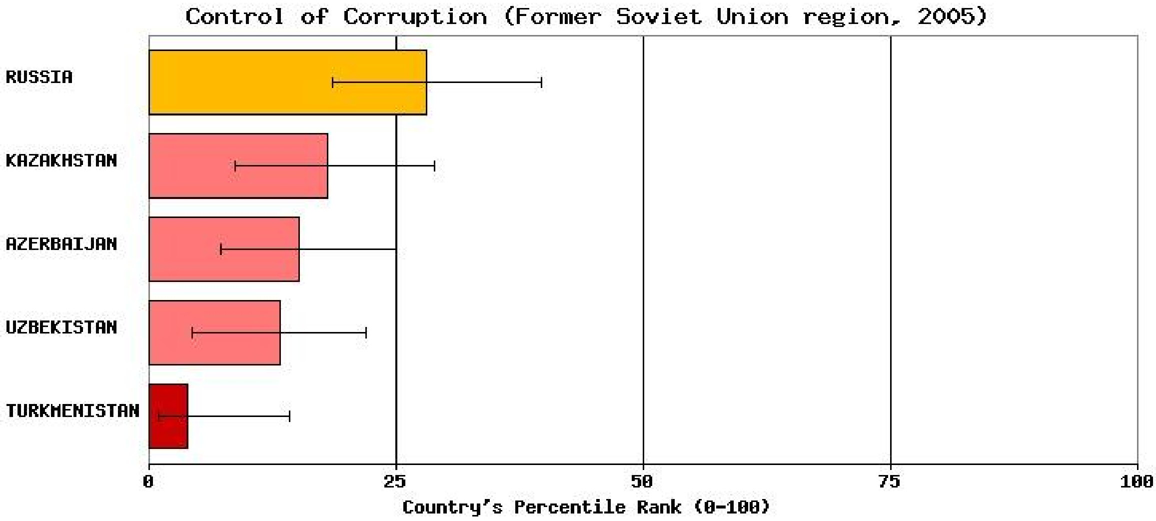
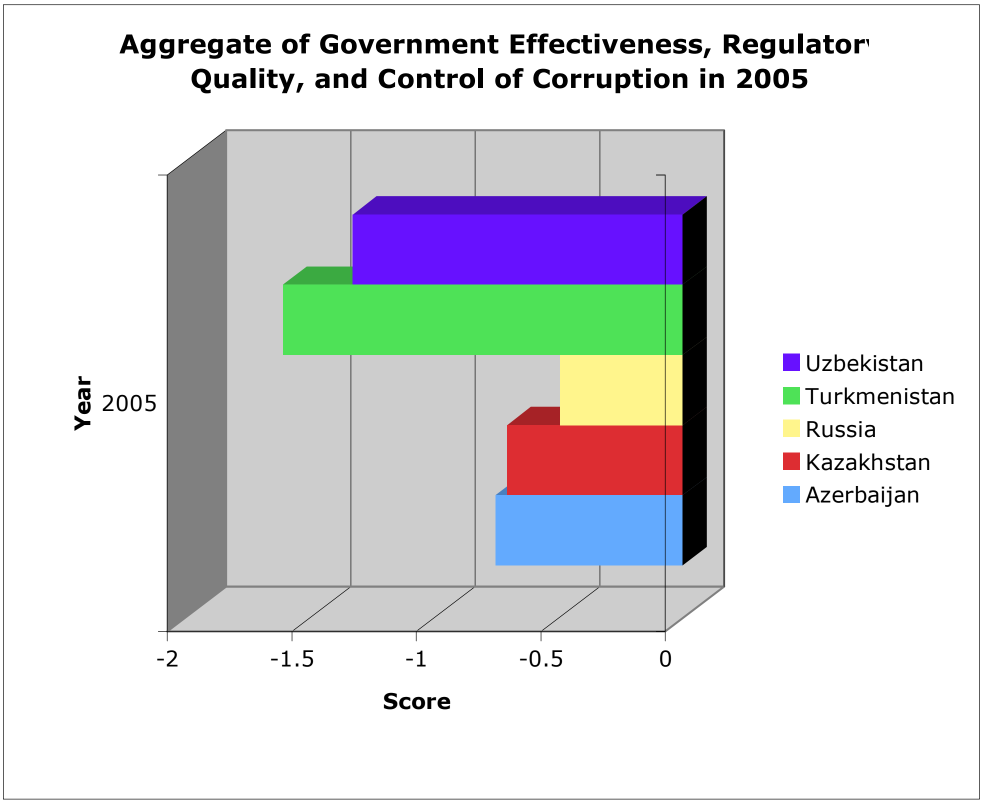


Figure 5:



Aggregate of Government Effectiveness, Regulatory Quality, and Control of Corruption in 2005
Year
2005
-2
-1.5
-1
-0.5
0
Score
Uzbekistan
Turkmenistan
Russia
Kazakhstan
Azerbaijan

Figure 6:

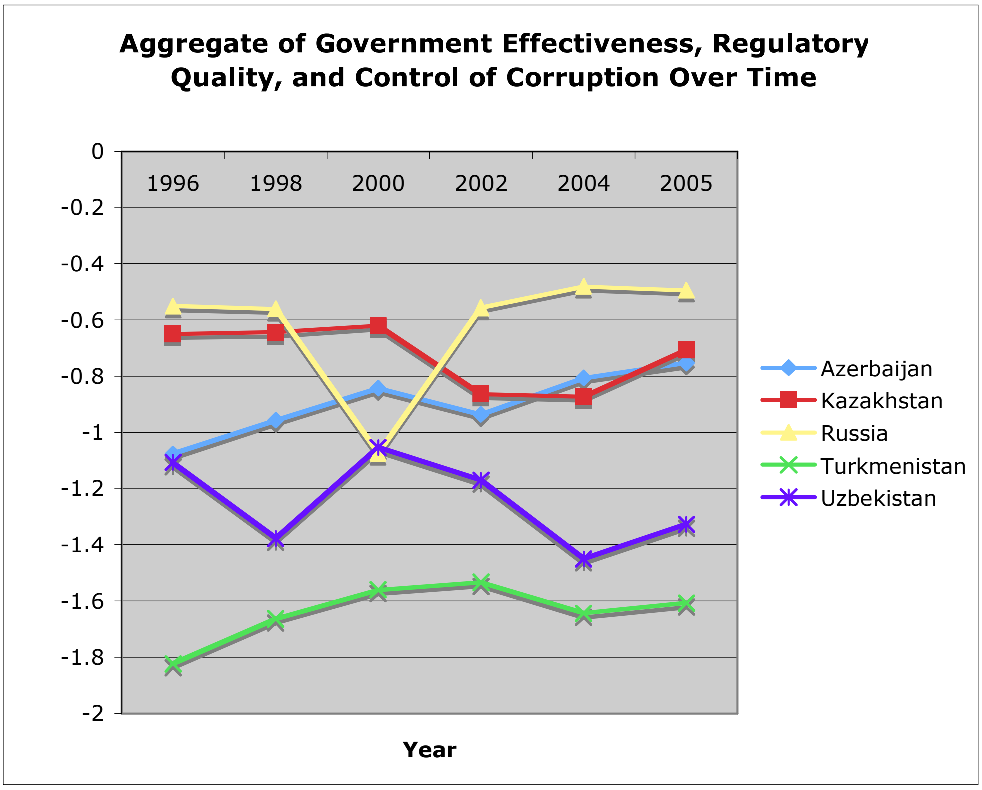
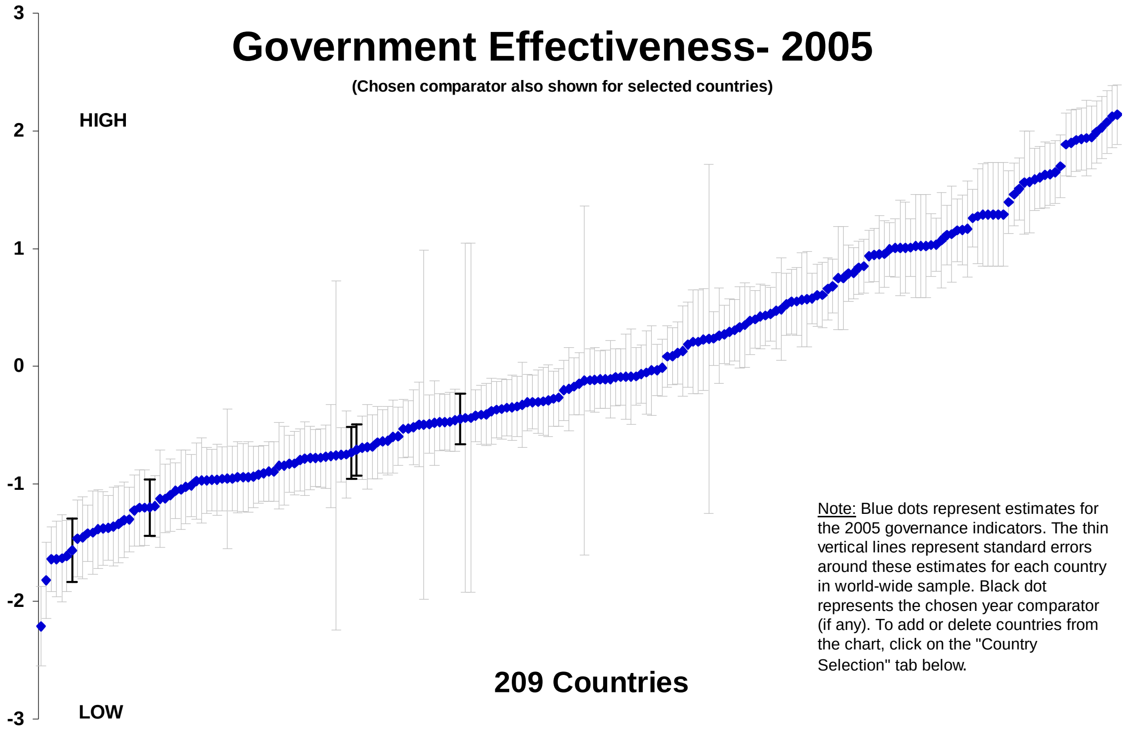

Aggregate of Government Effectiveness, Regulatory Quality, and Control of Corruption Over Time
0
-0.2
-0.4
-0.6
-0.8
-1
-1.2
-1.4
-1.6
-1.8
-2
1996
1998
2000
2002
2004
2005
Year
Azerbaijan
Kazakhstan
Russia
Turkmenistan
Uzbekistan

Figure 7: *CIS Indicators Compared to the Rest of the World*



Source: "Governance Matters V: Governance Indicators for 1996-2005 " by Daniel Kaufmann, Aart Kraay and Massimo Mastruzzi.
Disclaimer: The governance indicators presented here reflect the statistical compilation of responses on the quality of governance given by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries, as reported by a number of survey institutes, think tanks, non-governmental organizations, and international organizations. The aggregate indicators in no way reflect the official position of the World Bank, its Executive Directors, or the countries they represent. As discussed in detail in the accompanying papers, countries' relative positions on these indicators are subject to margins of error that are clearly indicated. Consequently, precise country rankings should not be inferred from this data.

Figure 8

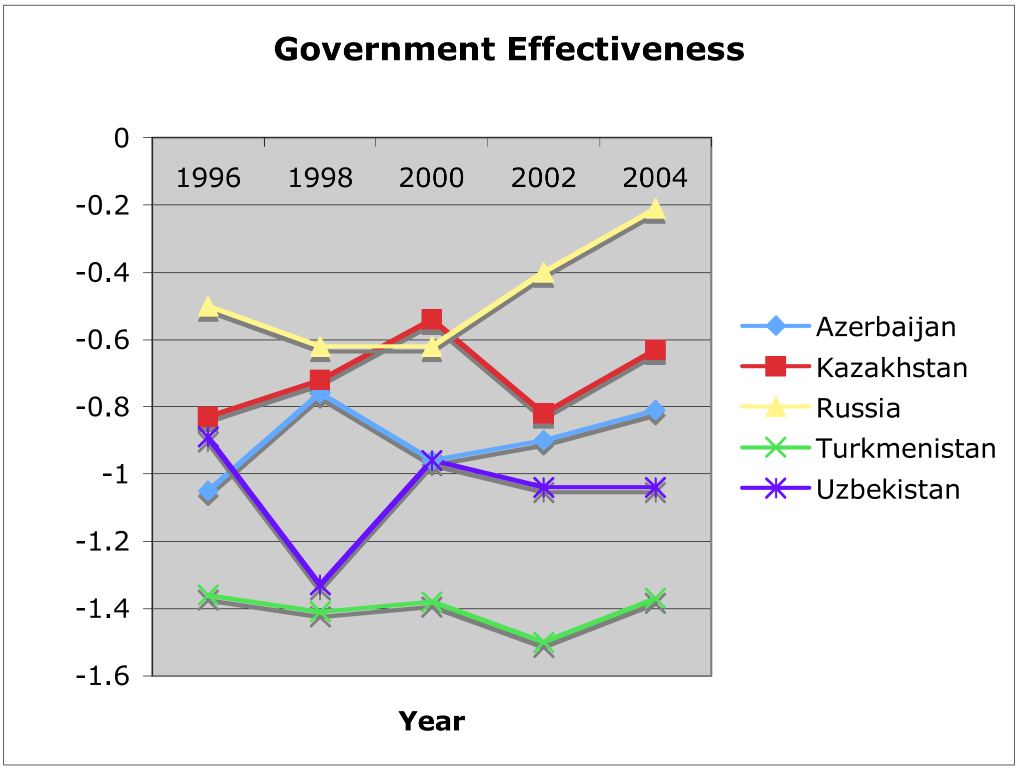


Figure 8: Crude oil output and exports, 2003-06
Growth, year-on-year

QuickTime™ and a
TIFF (LZW) decompressor
are needed to see this picture.

Source: OECD (2006).