

Frost at the Core

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ON DECEMBER 15th, in a small courtroom in central Moscow, Viktor Danilkin, a softly spoken judge, is due to start delivering a verdict. Its symbolism will go far beyond the fate of the two defendants, Mikhail Khodorkovsky and Platon Lebedev, former principal shareholders in the Yukos oil company. Both men have been in jail since 2003 on charges of tax evasion. Their sentences expire next year. In order to keep them in prison, the government has absurdly charged them with stealing all the company's oil.

Neither the first nor the second trial had much to do with the rule of law. But there the similarity ends. In 2003 Mr Khodorkovsky personified the injustice and inequality of the 1990s, when tycoons wielded enormous power over a state that could not even pay pensions and salaries on time. Seven years on, Mr Khodorkovsky is a symbol of the injustices perpetrated by corrupt bureaucrats and members of the security services, who epitomise the nexus between power and wealth. As Mr Khodorkovsky said in his final statement, "They turned, us, ordinary people, into symbols of a struggle against lawlessness. This is not our achievement. It is theirs."

The chances that Mr Khodorkovsky will be found not guilty are slim. If he were, it would be a sign that the system of Vladimir Putin, Russia's former president and current prime minister, was beginning to come apart. That system, which tolerates corruption and violence, has just received the endorsement of FIFA, which has awarded Russia the prize of hosting the 2018 football World Cup. But its evolution had much to do with Mr Khodorkovsky's story.

In the 1990s, when businessmen bribed the courts, both parties knew they were in the wrong. After Mr Khodorkovsky's case, a judge taking instructions from a bureaucrat felt he was in the right. The Russian state not only flagrantly flouted the law for its own interests, but also sent a powerful signal to its bureaucracy that this practice was now okay.

According to Alexander Oslon, a sociologist who heads the Public Opinion Foundation in Moscow, Mr Putin's rule ushered in a breed of "bureaucrat-entrepreneurs". They are not as sharp, competitive or successful as the oligarchs of the 1990s, but they are just as possessed by "the spirit of money" in Mr Olson's phrase, the ideology that has ruled Russia ever since communism collapsed. By the end of the 1990s the commanding heights of the economy had been largely privatised by the oligarchs, so the bureaucrat-entrepreneurs began to privatise an asset which was under-capitalised and weak: the Russian state.

Unlike businessmen of Mr Khodorkovsky's type, who made their first money in the market, the bureaucrat-entrepreneurs have prospered by dividing up budget revenues and by racketeering. "Entrepreneurs" who hire or work for the security services or the police

have done especially well, because they have the ultimate competitive advantage: a licence for violence.

No one worries about conflicts of interest; the notion does not exist. (Everyone remembers the special privileges given to party officials for serving the Soviet state.) As American diplomats are now revealed to have said, the line between most important businesses and government officials runs from blurry to non-existent. Putting Mr Khodorkovsky in jail, or awarding a large contract to one's own affiliated company, could be justified as a public good. Indeed, more people were in favour of locking up Mr Khodorkovsky, even though they knew it would benefit only a few Kremlin bureaucrats.

In 1999 the oil price started to climb and petrodollars gushed into Russia, changing the mindset of the political class. Mr Oslon points out that the most frequently used word in Mr Putin's state-of-the-nation address in 2002 was "reform" and its variants. A few years later the most frequently used word was "billion". Divvying up those billions has become the main business in Russia. Corruption no longer meant breaking the rules of the game; it was the game.

Shortly before his arrest Mr Khodorkovsky estimated state corruption at around \$30 billion, or 10% of the country's GDP. By 2005 the bribes market, according to INDEM, a think-tank, had risen to \$300 billion, or 20% of GDP. As Mr Khodorkovsky said in a recent interview, most of this was not the bribes paid to traffic police or doctors, but contracts awarded by bureaucrats to their affiliated companies.

Unlike private businessmen, who started to invest in their core businesses (Yukos among them) in the late 1990s, bureaucrat-entrepreneurs have little incentive to do so. Their wealth is dependent on their administrative power, rather than newfangled property rights. The profits are often stashed away in foreign bank accounts or quickly spent: on luxury property in European capitals, or on their children's education in British private schools. All this is inevitably accompanied by anti-Western rhetoric and claims of Russia's resurgence.

Unsurprisingly, surveys now show that the young would rather have a job in the government or a state firm than in a private business. Over the past ten years the number of bureaucrats has gone up by 66%, from 527,000 to 878,000, and the cost of maintaining such a state machine has risen from 15% to 20% of GDP. At the same time, Russia's standing in indices of corruption, property rights and business freedom has deteriorated. When its leaders talk up the state as the solution to all problems, the government's failure to satisfy people's basic needs, such as security and policing, becomes all the more striking.

The message of Krasnodar

On November 4th, National Unity Day, in the small town of Kushchevskaya in the Krasnodar region, eight adults and four children were killed in a house. They were the

family of a wealthy farmer and his guests. The youngest child, nine months old, suffocated when the killers set the house alight.

Terrible murders can happen in any country. This one stood out because it was the work not of a maniac but of a well-established criminal gang, which has terrorised the region for nearly 20 years. More than 200 trained thugs do its work, including dozens of murders and rapes. Its boss, Sergei Tsapok, was a deputy in the local council and had links with the chief law-enforcement agencies, the tax police and local government. The gang first emerged in the early 1990s, racketeering and carving up valuable plots of land. In 2002 it began to “legalise” and incorporate itself into local state power structures.

Mr Tsapok’s agricultural firm received massive state credits and grants. It employed the head of security of the local prosecution service as its in-house lawyer. In 2008 Mr Tsapok boasted that he was among the guests at the inauguration of Dmitry Medvedev as Russia’s president, according to *Novaya Gazeta*, an independent Russian newspaper. The gang ran the region not only under the gaze of government, but also in its stead.

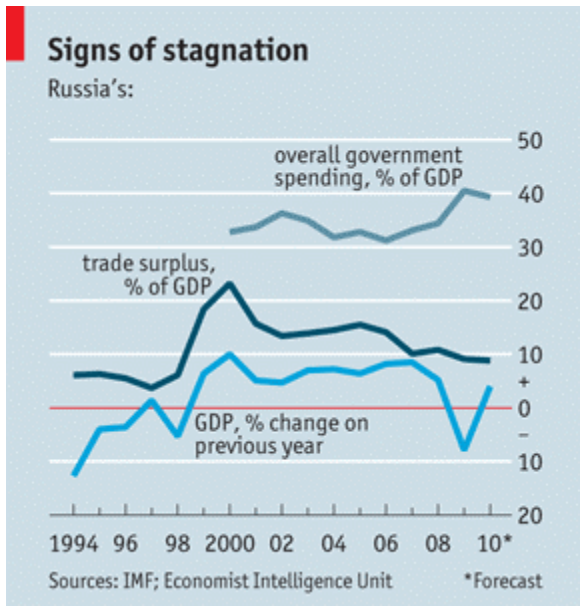
When the chief Russian investigator into the murders arrived a few days later from Moscow, he was besieged by complaints from all over the region. Alexander Tkachev, the governor, seemed dismayed by all the fuss: “Such a crime could have happened in any part of the region. Unfortunately, such gangs exist in every municipality.” Despite what happened, he remains in his job.

In the past such *bespredel* (extreme lawlessness) was mostly restricted to Chechnya and a few other parts of the north Caucasus. But violence has spread, and Kushchevskaya has caused horror not only because of the child victims, but because it presented a threatening model of a crumbling state. The government used to mask its problems with a thick layer of money. But as this layer gets thinner, the problems become more obvious.

A shrinking pie

Corruption was also excessive in the 2000s, but it was compensated for by strong economic growth and fast-rising incomes. This, and soothing television pictures, created a sense of stability. But the global financial crisis hit the Russian economy harder than that of any other large industrial country, exposing its structural weakness. As Vladislav Inozemtsev, an economist, argues in a recent article, the improvement in living standards was achieved at the cost of massive under-investment in the country’s industry and infrastructure. In the late Soviet era capital investment in Russia was 31% of GDP. In the past ten years Russia’s capital investment has been, on average, about 21.3% of GDP. (For comparison, the figure over the same period in China was 41%.)

Despite rising oil prices and a construction boom, Mr Inozemtsev says, in the post-Soviet period Russia has built only one cement factory and not a single oil refinery. The Soviet Union used to build 700km of railways a year. Last year, it built 60km. “We have lived by gobbling up our own future,” he argues. Peter Aven, the head of Alfa Bank, the largest private bank in the country, thinks today is like the late Soviet period: “Once again the



main source of wealth is oil and gas, which is being exchanged for imported goods. The state today is no better than Gosplan was in the Soviet Union.”

Russia’s trade surplus is shrinking. As imports grow, so does pressure on the rouble. The government is now running a budget deficit. Mr Aven says Russia’s budget balances at an oil price of \$123 a barrel. Three years ago it balanced at \$30. For all the talk of stability, only 6% of the population can imagine their future in more than five years’ time, which may explain why only 2% have private pension plans.

To keep up his approval rating, particularly among pensioners and state workers, Mr Putin has had to increase general government spending to nearly 40% of GDP (see chart). To pay for this he has raised taxes on businesses, which are already suffocating from corruption and racketeering. While Russia’s peers in the BRIC group of leading emerging economies are coping with an inflow of capital, \$21 billion fled out of Russia in the first ten months of the year. Unlike foreign firms such as Pepsi, Russia’s private firms are too nervous to invest in their own economy.

That economy is growing by less than 4% a year. This would be respectable in many Western countries, but as Kirill Rogov, an economic and political analyst, argues, it is not enough to sustain the political status quo. When the pie of prosperity was expanding, dissension within the elite made no sense. However, now that money is scarcer and the world is divided into “Mr Putin’s friends and everyone else”, as one businessman put it, conflicts are inevitable.

A sense of injustice is now growing in many different groups. Private businessmen and even oligarchs complain about the lack of rules and bureaucratic extortion. Middle-class Muscovites moan that officials in their black luxury cars, with their flashing blue lights, push them off the road and occasionally run them over. People in the north Caucasus feel they are treated like aliens rather than Russian citizens. Everyone is fed up with corruption.

The discontent does not register in Mr Putin and Mr Medvedev’s joint popularity ratings, which remain at 70%. But growing numbers of the elite feel that the present political and economic model has been exhausted and the country is fast approaching a dead end. “The problem is not that this regime is authoritarian, the problem is that it is unfair, corrupt and ineffective,” says one leading businessman. “Corruption will erode and bring down this system.” The paradox is that few Russian government officials disagree with this.

At a recent government-sponsored conference on Russia's competitiveness, everyone agreed that the system does not work. Russian politicians sometimes sound like opposition leaders, and Mr Medvedev makes pledges as if he were a presidential candidate. If Mr Putin has stopped lamenting the level of corruption in Russia, as he used to, it is only because he believes this is futile and that other countries are the same.

In a democracy, such confessions of impotence from top officials would probably prompt their resignations. In Russia it leads to a discussion of how best to preserve the system. Which tactics work better will be the subject of a conversation between Mr Putin and Mr Medvedev when they decide, probably next summer, which of them will become Russia's next president. As Mr Putin said, the decision will be made on the basis of what is best for Russia. ("Think of them as co-heads of a corporation," Mr Oslon suggests.) The aim is the same, but the styles vary.

Mr Medvedev calls for innovation and technical modernisation to revive growth. He is appealing through the internet to the most enterprising people in Russia, and is inviting Russian and foreign scientists to come and innovate in a specially created zone, called Skolkovo, which would be protected against the rest of the country by a high security wall and honest police.

The president, who is keen to keep his job after 2012, will try to persuade Mr Putin that it is in the interests of the corporation, and of Mr Putin as one of its main stakeholders, for his predecessor not to return to the Kremlin. He could cite the need for better relations with the West to legitimise the financial interests of the Russian elite, and the inefficiency of the security services as a support base. But even if Mr Putin would like to retire, can he afford to?

The two men may belong to the same system and want the same thing, but they are formed by different experiences. Mr Putin, despite his belligerence about the 1990s, is the very epitome of that period. He operates by informal rules and agreements rather than laws and institutions. He became president at the end of a revolutionary decade, when the job carried more risks than rewards. He is cautious, dislikes making decisions and rarely fires anyone, putting loyalty and stability above all else.

Mr Medvedev, on the other hand, was installed as president after nearly a decade of stability, when the political landscape was cleared of opposition and the coffers were full of money. He is a stickler for formality, though he is a lot less careful, and makes decisions that can destabilise the system—such as firing the previous mayor of Moscow, Yuri Luzhkov. But he is also weaker than Mr Putin, and may not be able to hang on to power.

The likeliest outcome is that the two will try to preserve their tandem one way or another. Kremlin officials dismiss talk of dead ends as pointless whining and alarmism from liberals. The prevailing view is that the system works and everything will carry on as usual. That may be wrong, however. "Mr Putin can return to the Kremlin technically, but he cannot do so historically," Mr Rogov argues. His popularity may be buoyant, but the

historic period of stabilisation and restoration which he initiated is coming to an end. Mr Putin always took great care over symbols, marking the beginning of his rule with the restoration of the Soviet anthem. At the time, it was a symbol of continuity and greatness. Today it sounds increasingly archaic.

As stability turns into stagnation, Mr Putin is becoming a symbol of the bygone 2000s. Mr Medvedev, on the other hand, with his tweets and his iPad, has absorbed hopes of change among the younger, more restless set. He has done nothing to justify this; as a recent editorial in *Vedomosti*, a Russian business daily, argued, “Medvedev is strong not because of his deeds, but because he rides an illusion.” Nonetheless, the wish for change is real.

Dissenting voices

This is reflected in the media. Glossy lifestyle magazines are becoming politicised; one has even put Lyudmila Alexeeva, an 83-year-old human-rights activist, on its cover. The beating-up of Oleg Kashin, a journalist from *Kommersant*, a mainstream newspaper, troubled the well-heeled more than the murder of Anna Politkovskaya did three years ago, precisely because Mr Kashin—unlike her—did not oppose the regime or write about Chechnya. And recently Leonid Parfenov, a stylish Russian TV presenter, caused a scandal when, at an awards ceremony attended by Russia’s most powerful media executives, he said that Russian television reporters have turned into servile bureaucrats. “Our television”, he said, “can hardly be called a civic or public political institution.”

It was not what Mr Parfenov said that was news, but the fact that he said it at all. He used to steer clear of words like “civic” or “duty”, and argue that Russian liberalism was not found in politics, but in fashion boutiques and Moscow coffee shops. Many young, successful Russians shared his view. Mr Parfenov’s speech reflects a change of mood among them, as well as a growing interest in politics. Although state television has enormous sway over older Russians, the young, urban and educated get their news and views from the internet, which remains largely free of Kremlin propaganda.



Khodorkovsky – both man and symbol

Stanislav Belkovsky, a political commentator, sees a similarity between Russia’s situation and the period of *Perestroika* reform under Mikhail Gorbachev in the mid-1980s. As then, a large part of the elite has realised that the system is ineffective and is no longer willing to defend it. When ordinary people come to share this view, the system is in grave danger.

That moment may be some time away: the Russian economy is more flexible than the Soviet one, the elite is more diverse, the borders are open and there are safety valves to release dissatisfaction. But as Mr Khodorkovsky said in a recent interview from jail, the tensions between the declining performance of the Russian economy, the expectations of the population and the corruption of the bureaucracy will erode the system, whoever is president.

With Mr Putin in power, Russia may suffer deep stagnation, but a collapse of the system would be all the more dramatic. With Mr Medvedev stagnation may be shorter, but his grip on power would be weaker. This may matter little in the long run, but it makes a big difference for Russians living now—not least for Mr Khodorkovsky himself.