

# SOVIET COMMUNISM TO RUSSIAN GANGSTER COMMUNISM

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Let's go back to August 19 of 1991 in Moscow. - Mingling with the rush hour traffic, Red Army armored personnel carriers on the streets of Moscow this morning, heading to the Kremlin. They first moved in at four a.m., the first sign of the coup d'etat that removed Mikhail Gorbachev from power. With tanks in Red Square, the official word from the new government calling itself the National Emergency Committee, was that the architect of glasnost and perestroika was too ill to continue in office. A short statement reminiscent of the Soviet Union's past was broadcast by state television. - By mid-morning APCs were ringing the Defense Ministry and most government buildings. For many people on the streets, the reaction was one of sheer surprise and resignation. - So that was a pretty dramatic moment in August of 1991. And the coup of course was being prosecuted against Mikhail Gorbachev, who had come to power as the head of the Soviet Union in 1985. Leonid Brezhnev had been General Secretary of the Communist Party for a number of decades after Khrushchev, but he died in 1982 and it was an aging Politburo, and he was replaced in quick succession by two transitional figures, one of whom died after 14 months, and the other who died after 11 months. And so when Gorbachev came to power in February of 1985 there was a lot of head-scratching going on in the West as to what would become of the Soviet Union. And he rapidly transfixed people both at home in Russia, as the Soviet Union as it then was, and abroad. He seemed to be a different kind of politician, he was extremely charismatic. He was much younger. He could talk and behave like a Western politician and he quickly went on a kind of charm offensive around the world. He developed a strong rapport with Ronald Reagan which led to arms reduction talks in Reykjavik and he began the processes of what he called perestroika and glasnost.

Perestroika is Russian for restructuring, and he planned fundamental restructuring of the Soviet economy. He had become convinced that the old command system didn't work and had to be reformed. Glasnost was basically free speech, that they began opening up the state controlled media, they started creating much less, much more access to different media outlets. They allowed criticism of the regime that had been unthinkable until that time. And it seemed like, it seemed like the Soviet Union was really beginning to change,

and then of course in 1989, when the revolutions happened across Eastern Europe that I talked about last time, the Soviet Union did nothing. They didn't intervene as they had previously intervened in Hungary, they did not do anything to stop the departure of the East European countries from the Soviet Bloc, and the transitions that were by then would soon be getting underway. And Gorbachev was seen as this radical reformer. He was a reformer, he was not a revolutionary, and he thought that he could adjust the Soviet system in a gradual way to some new order. But as he did that, of course he ran into a lot of push-back from vested interests, from communist ideologues who didn't want change. And he was fighting a battle, both against them, and as we'll see in a moment, against reformers who thought that he was going too slowly. In any event, in the summer of 1990, 1991, the hardliners clearly had the upper hand and they locked him up in his dacha on the evening of August 18th, and that was the coup that appeared to be well underway by the next day. But things were not so simple, and history was gonna play out a little differently. So this is what happened a few minutes later. - Tanks were also positioned outside the Russian parliament building, Boris Yeltsin's headquarters. - Yeltsin, Yeltsin, Yeltsin. - The democratically elected President of Russia was soon striding out of the building to address a crowd of supporters.

His own radio and television stations by now occupied and forced off the air, he climbed aboard one of the Red Army's own tanks, and said the coup leaders had disgraced the Soviet Union. - And he went further, calling for civic resistance to the hard-line grab of power. - Yeltsin's supporters reacted with their bare hands, building makeshift barricades with whatever piece of disused machinery or brickwork was available. And one crane driver joined the effort, shifting concrete blocks to the delight of the crowd, helping build the obstacles designed to prevent any army attempt to seize the parliament building. No attempt was made. One army commander loyal to Boris Yeltsin, Colonel Konstantin Kobets, tried to reassure the crowd. - And that of course was a decisive moment because it indicated that the military was not supporting the coup. And that instead they were gonna be loyal to Boris Yeltsin. Now Yeltsin had himself been a traditional Soviet politician in the 1970s and 1980s and had initially been a supporter of Gorbachev's reforms. But he actually was on the more radical side of the Communist Party, at least at that time, in thinking that the reforms had to go faster and had to go, be more extensive. And he in fact got so frustrated that he did something that at that time in 1987 was unprecedented in the history of the Soviet Union, he resigned from the Politburo of the Communist Party. And nobody had ever done that before, there was consternation and it was sort of covered up in that in the end Gorbachev fired him and there was then some pretty significant conflict between them. It is said that in the midst of all of this Yeltsin actually tried to commit suicide at one point. And in any event he left the Communist Party and started to reconstitute himself as a Russian politician and eventually would run for the, to be a member of the Russian parliament. He had done that and in fact in June, in June of 1991, so we're talking about three months before the coup attempt he had been elected President of the Russian parliament.

And where they were in this video outside the White House, that was the building of the Russian parliament, as distinct from the Soviet government buildings, which we all know about, the Kremlin opposite Red Square. And so it was Yeltsin who stood up and faced down

the coup plotters while Gorbachev was in his dacha locked up on the Black Sea. And then the military decided to get behind him, and the next day you can see Gorbachev returning. - A president returns to power. Mikhail Gorbachev, flying into Moscow after being detained for three days on the orders of some of the men he appointed to senior positions within his own government. Their attempted coup d'etat crushed, he said tonight it was business as usual at the Kremlin, and despite the treachery of many of its senior figures, he wouldn't be leaving the Communist Party. - Gorbachev said tonight he'd made mistakes by putting his trust in men who would try to topple him. Many here now believe he's making another mistake by staying within a Communist Party that's so widely discredited after the events of this week. For World Monitor, I'm Simon Marks in Moscow. - So this was in fact the moment when the real power passed from Gorbachev to Yeltsin, as you'll see in a minute because Gorbachev couldn't detach himself from the idea that there had to be a gradual guided transition under the auspices of the Communist Party of the Soviet Union. And Yeltsin seized the moment and this is how it played out. - A president gets the cheers. He used the occasion to call for increased power for the Russian government and thanked his people for staying loyal. - Present at the rally, many of the men who once served with Mikhail Gorbachev. Economic advisor Stanislav Shatalin, and former Foreign Minister Eduard Shevardnadze. The men who helped mold glasnost now siding with the man of the hour. The Mayor of Moscow, Gavriil Popov, said to regain the support of the democrats, Gorbachev had to break with the Communist Party and recognize its seven decades in power were at an end.

Joining the celebrations, Gorbachev's former press spokesman Sergei Grigoriev and his wife. After three nights on the barricades, he says his old boss faces a fight to take the political high ground. - But I think that he will have to define his attitude and to elaborate his position very quickly, otherwise, his days in power might be counted. You can see judging by the rally and by the attitude of the people, that the democratic movement is actually gaining strength. - At the end of the rally, the Russian flag was hoisted above the parliament building in place of the hammer and sickle. Ships on the River Moskva blew an audible salute. Within an hour the crowd was heading to the seat of Soviet power, Red Square and the Kremlin. A tide of people bringing with them the banner of independence, a huge Russian flag, and shots of down with the Communist Party. The young guards on duty at Lenin's mausoleum looked as if they were about to be mobbed. When the time came to change the guard the normally solemn ceremony was derided by the crowd, a Communist shrine now openly mocked. From Red Square they moved on. Next stop, KGB headquarters and the statue in front of it of Felix Dzerzhinsky, the man who founded the secret police here in the 1920s. Yeltsin's spokesman promised them a crane would be brought in to bring the monument to the ground. Former Gorbachev supporters say the Russian president now has a better feel for the popular sentiment than the leader in the Kremlin. - I think that with his democratic instincts and his feel what the people want, and what the people need, he is really turning himself into man number one in the Soviet Union in terms of popularity and in terms of appeal to the mass. - So that was the dramatic four days that were really the denouement of the old Soviet order. Today, our agenda is gonna be five-fold.

We're gonna talk about why the Soviet Union collapsed, but only somewhat briefly. We're then gonna talk about the more interesting puzzle which is why it collapsed so peacefully. Why basically one of the two superpowers in the world folded up and just died. We're then gonna focus on the rise of gangster capitalism, the title of today's lecture. We're going to turn to the transition from Yeltsin, who governed throughout the 1990s, he gave up power to his hand-picked deputy Putin on the first day of the new millennium. He resigned effectively December 31st, 1999 and Vladimir Putin has been in control of Russia in one role or another ever since. And then lastly we're gonna focus on the question why is Russia so corrupt, and what lessons can we draw from the fact of its corruption. So that's what we'll do. Just to review the events that led up to those four days in August. In May 12th, the Baltic states, echoing an old agreement from 1934, having watched six months earlier the wall come down in Germany, signed an entente that indicated they were planning to secede from the Soviet Union. In June of that year the Congress of People's Deputies in Russia, that is where Yeltsin was run initially as a deputy and then become president, declared that it was sovereign over Russia's territory. In March of 1991 a referendum was held on whether or not to keep the Soviet Union together, and there was high turnout and a strong majority saying yes, although there were boycotts from the Baltics and four or five other Soviet republics that didn't participate in the referendum. June of that year, exactly a year after the Russian parliament, Congress of People's Deputies had declared itself sovereign, Boris Yeltsin had been elected as its president. We then had the four day attempted coup in August as we've just witnessed. In the midst of that coup I should say, the day before it was finally over, Estonia and Latvia had already declared their independence. The coup was then defeated.

Ukraine held a referendum and voted to secede, and then Yeltsin met with the Ukrainian president secretly and agreed that the Soviet Union no longer existed. Gorbachev was still chasing the horse out of the barn that had long since left him behind, he declared the agreement illegal and dangerous. But in December leaders of the 11 remaining republic met in Alma Ata, now know as Almaty, in Kazakhstan to essentially declare the Soviet Union dead and constitute the CIS, the Confederation of Independent States. At that point Gorbachev realized he had no choice, and he resigned on what we think of as Christmas Day, but not Christmas Day in Russia, which comes later, and at the end of the month the Soviet Union ceased to exist. So why did the Soviet Union collapse? Any thoughts? What's the first thing that comes to somebody's mind when we ask, why did the Soviet Union collapse? - Arms race. - There was an arms race. And why would that have, we'd had plenty of arms races. We had arms races all through the Cold War, so it certainly contributed, but why else, yeah. - My parents remember how they were waiting to buy sausages, like in the market. You couldn't buy jeans. - The shops were empty, you couldn't buy anything, right, you couldn't buy anything, the GUM department store in Moscow, which is the biggest department store right off Red Square. Sort of six or seven store department store, was empty. There was nothing in it. You could buy things, there was a black market, you could buy things to some extent on the black market, but there's a hugely inefficient command system that had basically ceased to function. And the Soviet Union was dependent on this system but the great difficulty with a command economy, and we'll talk about this more

next week in relation to some of the other former communist systems, is that the people making the decisions have very bad access to reliable information. Prices are set by decree, not in response to supply and demand. There are very poor incentives to work.

And so the unsustainable economy had become steadily more unsustainable. So that's one part of it, but then I want to come back to the gentleman who mentioned the arms race. The other reason is that containment worked. Now containment had been the policy dreamed up by George Kennan, who had been a US Ambassador to Russia and eventually became the first head of the Policy Planning Staff, it was an office that was created for him in the Truman administration. And he was one of the first people, this is in the 1940s, he had been one of the first people to say the Soviet system is unsustainable, it's got a dysfunctional economy at home, and its international ambitions are such that it's going to pursue, it's gonna pursue foreign adventures that eventually it's not gonna be able to finance. And so all we have to do is contain it. We don't need to go to war with them, we just have to contain them, prevent their expansion, and wait. And he had, there were various disagreements about what containment meant, we'll talk next week, for instance he was opposed to forming NATO even, which he thought would unnecessarily militarize the conflict with the Soviet Union and eventually he resigned from the government and went off in a huff to Princeton. But very largely, the US in Europe did follow the policy of containment. What changed in the 1980s was two things, which increased the fiscal pressure on the already pressured, highly pressured Soviet system. One was that they got involved in a quagmire war in Afghanistan. They invaded Afghanistan in 1979, having failed to learn from the examples of the British and others who had tried to invade Afghanistan in the past, a very difficult country to invade given the terrain. They spent the entire 1980s embroiled in this war in Afghanistan. It was their fear of the rise of Islamic fundamentalism, which they thought would infect the other Asiatic, would start to infect the Asiatic republics of the Soviet Union, and so they were very nervous about it.

And it was a huge fiscal drain, a failed war. It was the Soviet Union's version of our Vietnam War. And then secondly, when Ronald Reagan came into office he announced Star Wars, which increased the cost of the arms race to the Soviets. By an enormous amount. So these were the reasons why the Soviet Union eventually just creaked and fell apart. We could spend the entire lecture unpacking them, but we're not, this is not a course about the Cold War. What I want to put our attention on is why was the collapse so peaceful. You know, you would think if somebody shoots an elephant it's gonna stumble around and do an awful lot of damage before it finally collapses. This elephant basically just knelt down and died. And that's quite remarkable. Any thoughts or intuitions about why it ended with a whimper rather than a bang? Yep. - There was a sense of desperation throughout the entire population, whether it was waiting in lines for any store, any product, or being overly bunched up in housing. The lack of jobs and the lack of innovation made the people very desperate and depressed. - People were desperate and afraid, but my real question is about the elites. Why did the elites give up power that they had guarded so jealously for such a long time. And after all there are many authoritarian systems in the world where there are angry, desperate populations and the elite clings to power and just becomes more and more repressive. Yeah. - I think they had prepared themselves for this having looked at what

happened in Berlin, they had already started making sure that if this came that their interests would be protected. - Who would be protected? - That the elites - Okay, that's part of it. So that the elites, just to repeat the comment in case some didn't hear it. The elites were looking for and seem to have found ways to protect themselves through the collapse. So what I'm gonna do here is introduce an analytical schema from the social sciences, this is actually from a famous economist, a development economist by the name of Albert Hirschman who published this book "Exit, Voice, and Loyalty" in 1970.

And he developed a framework for thinking about what happens when, as you can tell from the subtitle, firms, organizations, states, decline. How do people respond to decline. And the framework he developed I think is, I think this is, if you read no other book in the social sciences before you graduate, or this is certainly one of the two or three books you should definitely read. And we will use Hirschman's framework at various points in the course. And so what is, he said, well if you think about yourself if a declining organization, there are three things you can do. One is, you can leave, exit. Two is you can complain and try and get it changed, voice. Three, you can try to fix it yourself. You believe in the cause and you want to make it better. And a lot of Hirschman's analysis says that what mix of exit, voice, and loyalty people engage in is determined by the costs of those things. So for instance, if you think about a public company. If you're a shareholder in a public company and you don't like the way it's being run, you can just sell your shares and buy shares in a different company that you like better, right? So you don't have much incentive to go to shareholders meetings and trying to get the company, you maybe think it's got too much debt or something, you just buy shares in a company that has less debt. That's all you need to do, just exit, very low cost of exit. So people are not gonna engage in voice. Now of course you might care about the company, it might be ostensibly a green company and you might be holding the shares in the company because of your commitment to green energy. Then you might feel loyalty to the company and you will want to try and get it changed. Think about yourself as a worker, working for a company. If you don't like the way the company is being run unlike a shareholder you can't just pick up and leave, you've got, you know, you live in this town, you've got your family, your kids are in the schools and so forth.

The costs of exit for you are very high. So you're more likely to engage in voice, you're gonna go to meetings, you're gonna complain, you might form a union. You're gonna do things, or join a union. You're gonna do things to get the company to change its ways. So his book is an analysis of the ways in which exit, voice, and loyalty might be complementary in some circumstances, and might be competitors in some circumstances for the ways in which people respond to the decline of organizations. So the first thing to say about the Soviet Union in the 1980s and '90s is there was a substantial decline, almost disappearance of loyalty among both the elites and the citizens. And I got a firsthand view of this in March of 1991. There was a Yale delegate invited by the Communist Party of the Soviet Union to a conference in Moscow, actually the week before the referendum that I mentioned to you earlier. And we had been impressed by Gorbachev and so forth, but we didn't really have much knowledge about, I certainly was no expert on the Soviet Union, and most of the other people in the delegation were not, and we had this stereotypical picture of the KGB shadowing us around and telling us what to do. And we needed to be careful and so on. And

the first thing we noticed was widespread evidence of brazen corruption. I'll give you just two examples. We are all afraid of what the KGB people might be doing to us, the first KGB person I ran into was trying to sell me currency at black market exchange rates. And then secondly I went to a reception, and somebody came up to me with a translator and the translator said this gentleman wants to speak to you and he said, "Professor Shapiro, "I understand you're a South African." This is 1991, okay, it's before the collapse of apartheid, it's the beginning of the collapse of apartheid in South Africa, Mandela is being released from prison and so forth.

But the apartheid regime was still there and it was not clear how it was gonna play out. And so this person speaks in Russian, which I don't, I speak a little bit now but I spoke none then, and basically the translator says, this gentleman wants to know how to make, if you can facilitate this making a connection with the government of South Africa because he has access to weapons which he would like to sell to them. And we regard apartheid as a domestic matter, we don't care what's going on in the country, but I can sell all kinds of weapons, including nuclear weapons. Which might have been nonsense, but this is quite, actually South Africa's one of the few countries that had actually given up its nuclear arsenal as the, that's another story which we'll get to later, but so I was stunned by this and I said, "I think maybe you mis-translated what he was saying to me, "could you ask him to say it again?" And he said it again, exactly the same thing. And so I said very nice to meet you and goodbye. So that was, this was, the levels of brazen, you know, it wasn't, nobody was trying to hide what they were doing, it was completely public, this is in March of 1991. We then had a meeting with Vadin Zagladin, a politburo member and he was at that time essentially the secretary of state for Europe. And he gave a speech, and he said we have concluded that the Soviet system is unsustainable, it's got to be replaced from top to bottom. And we were stunned by this. That a leading official in the Politburo of the Communist Party of the Soviet Union was essentially saying the system is bankrupt. He gave a speech and we went around the room and it was clear it was the kind of situation where you're only gonna get one question, so you better think about what the right question is. So when it came to my turn, I said, "Mr. Zagladin, "when did you conclude that the Soviet Union "was unsustainable?" And he didn't blink, he said, "1978".

He said, "I was in a Young Communist League "actually with Gorbachev and there was a whole cohort of us "who concluded that the Soviet Union was unsustainable." So here you had a country led by a cadre of elites who didn't believe in the public ideology of the country. And so of course they had no loyalty to the public ideology of the country, it simply had dissipated. And then some of our hosts invited us to meet with various radical, more radical factions of the Communist Party of the Soviet Union who were more like activists and so on, and by then we'd been there for about a week and we thought, you know, we were getting some grip on this situation, so I met with this group of, they were members of the Communist Party, political activists and I had the temerity to say, well wouldn't it maybe a good idea to transform this economy in an ordered and gradual fashion. And they started screaming at me, calling me a Stalinist and a reactionary, and so it was just, these are just three pieces of evidence but everywhere you went, there was nobody who was defending the idea that, you know, whatever the sorts of, nobody had the sort of attitude that

Gorbachev was expressing in that final video where he said, I am a loyal member of the Communist Party and we have to fix it, even though it had turned on him. So in terms of loyalty, Hirschman's category of loyalty, by 1991, loyalty was pretty thin on the ground. But let's think about exit. Exit in some ways turns out to be even more interesting. So as I said with the example of a company you don't like, you can just sell the stock. If the costs of exit are low and you don't have any loyalty why waste your time trying to change an organization? And so what was it that reduced the costs of exit? So there were some fortuitous political things. So if you think about I already mentioned, Boris Yeltsin had been a member of the Soviet hierarchy for much of his career, but he had the opportunity to go off and be in the Russian Federation and eventually become President of the Russian Federation.

Eduard Shevardnadze who had been the Foreign Minister of the Soviet Union could go off and become President of Georgia, which he did. So there were places for these people to go, and these of course are the high visibility people, but many of the lower visibility people in their entourages and so on, could go with them. So there were opportunities for political exit for the leading figures and subordinate figures in many of the figures of the Soviet hierarchy. But what I want to spend more time is that the economic costs of leaving, of giving up, had reduced, had come down. And this leads us into the discussion of the rise of the oligarchs. The rise of gangster capitalism. So where did the oligarchs come from? They came from a variety of places. Just to mention some. One was the dynamics of the collapse itself. This is described in Karen Dewisha's book, the first chapter of Karen Dewisha's book, which I put on the syllabus. During the late 1980s as things were getting more and more extreme in terms of the fiscal pressure on the Soviet government, various ministries including the KGB started shifting a lot of money offshore and putting hard currency in bank accounts in Western banks. And some of the motivation for this was from loyalists actually. They thought Soviet Union's gonna collapse, we want to be able to live to fight another day, they sort of saw themselves as like, you know, the latter-day version of the French Resistance if you like, and they were gonna need resources. But others maybe have had different motives. But what happened in the August 1991 coup attempt was that the Soviet bureaucracy disappeared. And suddenly there were all kinds of people who found themselves with the control over these bank accounts, and they were now completely unsupervised. And so one relatively small, but not inconsequential, source of money from former Soviet officials was the money in these offshore bank accounts.

And some people decided to, to make off with it. And that money resurfaced later, at later times. But by far the bigger source of oligarchs was essentially the theft of state assets. And so here for example, a gentleman by the name of Rem Vyakhirev, who had also been a Soviet apparatchik, he'd been the Deputy Minister for oil and gas in the last years of the Soviet Union. He was put in charge of Gazprom, which is a large state venture controlling gas in the Soviet Union. But what did he do with this power that he had? He essentially started giving away large amounts of its assets to friends and relatives through various schemes. So they would, they would essentially let friends and relatives buy gas at below market prices and then sell it and pocket difference. And they even did this with large numbers of gas fields. And so we started to see the emergence of people making huge



amounts of money from these dirty transactions. And essentially the looting of state assets by people who were put in charge of them. So somebody like Vyakhirev was able to do this because he was strategically placed in order to be able to facilitate it. But a second, a third if you like, source of oligarchical power was derived from the fact that Russia had inherited a weak and bankrupt state. And I want to say a little bit about what I mean by a weak and bankrupt state. So much of the 1990s had been a period of fiscal crisis for the old Soviet Union. There had been massive debt racked up by the government. They were heavily dependent on oil revenues, which I'll talk more about in a little while, and when the price of oil gyrated, they would suddenly lose massive amounts of income. And this had all come to a head in 1998 when Russia eventually, when the Soviet Union, I'm sorry, when Russia by then, defaulted on its debt and had to be bailed out by the IMF. And so throughout the 1990s the Russian government was fiscally strapped. And so what happened was that people took advantage of this fact.

Mikhail Khodorkovsky, who would later become famous for his ownership of Yukos, the private oil company, which I'll also have a little bit more to say about, he started a bank called Menatep Bank. And what he basically did was he, he speculated against the ruble, he would get the government to deposit large numbers of rubles in his bank, he would then, he would exchange them into hard currency and he would have a commitment from the government not to demand them back for four months, or six months, or eight months, and so essentially could speculate against the ruble, making large amounts of money. And he would pay it back later in less valuable funds. So there were people doing that kind of thing. And then there was the so-called loans for shares scheme, which is how he got control of Yukos and this was in the mid-1990s, once the sort of bloom was off the rose of the revolution and people were starting to get angry. Things weren't improving fast enough. Population was hungry. And it didn't look like, it didn't look good for Yeltsin's reelection. There was looming elections in 1996 and there had been something of a communist resurgence. They did extremely well in the 1995 legislative elections. And so the oligarchs who had started to emerge and who'd get control of these various assets realized that for them it would be a disaster if the communists came back into power. And so they decided to get massively behind Yeltsin, and they did two things. One was the so-called loans for shares, where they essentially lent the government money in return for shares in state companies, and Khodorkovsky did this with respect to oil, and of course later on the government couldn't repay the loans and so they would get to keep the shares. And so this was another way in which a lot of these state assets were looted. But then they also just poured money into Yeltsin's reelection campaign in 1996 and he was handily reelected against the communist candidate in the second round.

So basically the oligarchs managed to emerge by taking advantage of the fact that the former Soviet Union was broke, and Russia in particular was broke for the vast majority of the 1990s. Then at the end of the 1990s, as I said, by then even the Communist Party had sort of gotten religion about capitalism. Yeltsin had reappointed many former communists to his government, but they got behind the reforms anyway, and so we saw that capitalism was not going away in Russia any time soon, even though the country was staggering from debt crisis to debt crisis pretty much for the bulk of that decade. In comes Putin, and now

we start to see a very different politics and economics emerging. And so what I want to do now is focus on how Yeltsin, how Yeltsin's oligarchs if you like, were rather different from what was coming down the pike. So what I've said so far is that the Soviet Union at the end of its years and certainly Russia in its first decade as a sovereign country, had a very weak state. The party had been strong and the state had been weak in the Soviet Union, but the party had essentially disintegrated. But I haven't defined my terms. So I probably should have done this earlier, but what do we mean when we talk about a state being a weak state, what makes a state weak? Yeah, you're gonna have to yell. - Lack of a rule of law? - Lack of the rule of law. That would be one symptom certainly of a weak state. What else would be a symptom of, yeah. You gotta yell. - No control over violence within its borders or with its borders themselves. - That would be another sign. Any other signs of a weak state, yeah. Somebody's point, yeah. - Finances. - So one sign, yeah, of a weak state is that, an inability to tax. A low capacity to raise revenue. And the Russia that Putin inherited had a very, very bad tax system, very low enforcement. So for example, in the oil industry, which is the most important industry in the Soviet Union, they taxed output and exports, not profits because they didn't have the auditing capacity to see whether people, you know, profits are revenue minus costs, and they didn't have the capacity to audit, to stop companies from hiding profits.

And so they would tax in a very inefficient way because that creates very bad incentives as well to innovate. So they didn't have the capacity to raise revenue very well, and indeed throughout the 1990s the oligarchs, led by Khodorkovsky by the way, had waged war on efforts by the Russian government to improve the capacity to tax. They had constantly lobbied for, and been successful in getting, the parliament not to improve the capacity to tax, and when Yeltsin came into power, in January of 2000, his first speech was mostly about taxation. He said that he was determined to reform the finances of the Soviet Union and he was going to completely reform the tax system, which he did. They had a very complex, multi-tiered system with huge deductions. He brought in a 13% flat tax, kept taxes low across the board with no exceptions, and he greatly simplified corporate taxation as well. So one of his big missions was to put Russia's fiscal house in order. And indeed, he partly got lucky because the price of oil went up, but they used a lot of that money, they created a sovereign wealth fund for a rainy day, knowing about the volatility of oil prices. And indeed, when the financial crisis finally hit, later in the decade, Russia was pretty well placed to weather that storm. So that's one thing that Putin did in the first decade of this century to try, and people thought at the time that he was strengthening the Russian state. But the other side of a weak state is the haphazard use of power. And by this I'm referring to the idea that when a government's capacity to enforce things is low, it has to compensate by being unpredictable. So for example, in a famous article about 18th century England, there were no police in 18th century England, they didn't get police until the 19th century.

1834, I believe, or 1832, somewhere around there. But if you look over the course of the 18th century in England, the number of capital offenses went up massively. You could be hanged for being a pickpocket. But the number of executions remained constant. They didn't actually execute more people. So basically what would happen is that the assizes would come into town, they would string up a few people, and then they'd go off to the

next parish. Because that was the only capacity that they had, so there's a kind of trade off. But one symptom of, one symptom of a weak state, is the haphazard and often dramatic use of power in this way. And anyone who's read Foucault's "Discipline and Punish" the opening pages of a gory execution of somebody on the scaffold is again an illustration not of a strong state, but of a weak state. Again, when you see the Egyptian government sentencing hundreds of people to death on one day, almost none of whom end up being executed, it's a sign of a weak state, not a strong state. So haphazard use of power. And you look at Putin's early moves, and they underscore this. The most important thing he did was he took down Khodorkovsky. Khodorkovsky by then was the most wealthy Russian oligarch. Owner of Yukos, and Putin threw him in prison. He was charged with various forms of fraud and eventually, when he'd already been in prison for about a year he was finally sentenced to nine years of imprisonment. And this got the attention of many of the other oligarchs. Nobody thought that Putin would have the temerity or the capacity to do this, but because of his KGB background, he had been a KGB officer in East Germany before he came back to the new Russia, he was able to do that. And then not only did he throw, not only did he throw Khodorkovsky in prison, he basically seized back through a complex transaction, which I'm not gonna describe, much of Yukos, and claimed it for Rosneft, the state oil company. And then he took down Vyakhirev, who, as I said to you earlier, he had essentially been giving away gas fields and profits and so on.

And William Browder, about who I'm about to tell you a little bit more, had exposed this. William Browder was the head of the Hermitage hedge fund and he had done a lot of research on the way in which these gas fields were being given away and published them in the New York Times and elsewhere. And Wall Street Journal, Financial Times, and so on. And everybody thought this guy is crazy. He's gonna get himself killed. But Putin responded instead by firing his chief of Gazprom and again reclaiming many of the assets that had essentially been given away at bargain basement prices. So Browder's worth pausing to think about for a minute. He was actually the grandson of Earl Browder, who had run as the communist representative against FDR for the US presidency in 1940. But he didn't get along with his family traditions. His parents had also been very much on the political left, and he didn't get along with his parents, and he thought, how can I annoy them the most and the way I can annoy them the most is by becoming a capitalist. And so he had gone to Stanford business school and worked for Boston Consulting Group and got himself to be in on the ground floor for the first privatizations in 1989 and 1990, and then he had gone to Russia. And he became involved essentially in, he built up the biggest, at that time by far the biggest hedge fund in the Soviet Union, it soon became worth well over a billion dollars. And the way he did it was by taking on Russian corruption in firms. So the first company he bought, he bought an oil company and he had some shares in this company, and, the management of the company decided to respond to this by diluting his shares, essentially they were gonna offer a whole block of new shares, but not allow him to buy any. So effectually diluting the value of his shares. And he filed a shareholder's lawsuit, again people said you're crazy, you're gonna be killed.

And he prevailed. And the share dilution scheme was stopped. And again, when he went after Gazprom and exposed what they were doing, he was convinced that he had figured

out what he could do and that he was immune because he was a foreigner. He's a famous person today for reasons that will be obvious from this video clip. - Joining us first on CNBC to react, the man in question Bill Browder, Hermitage Capital Management. Bill, good to have you here, I bet you're not surprised to hear Vladimir Putin refer to you directly. - It's not the first time and it won't be the last time. Vladimir Putin is very mad at me. He's mad at me because of the Magnitsky Act. The Magnitsky Act is a piece of legislation named after my murdered lawyer Sergei Magnitsky. He was murdered after uncovering a \$230 million Russian corruption scandal. Some of that \$230 million went to Vladimir Putin himself. And so Putin feels personally exposed and potentially at risk of having his assets seized in the West, and so every chance he gets he tries to get foreign countries to come after me. This is just one of many of his attempts. - He leveled an accusation at you, that you funneled, and helped funnel lots of money to Hillary Clinton, did you? - I did not. I did not, I'm not a US citizen, I don't live in the United States, I've been living in Britain for 29 years. I make no campaign contributions. And so that's not true, I should also point out that Vladimir Putin and his regime have accused me of serial killing, of being a CIA, MI6 agent, and about a thousand other things, and so they just kind of, he's kind of unhinged in these accusations. - You said before, Bill, that this is not the first time that President Putin has mentioned you, has called you out. What is your reaction in terms of your personal security after such a news conference, do you increase it, do you look behind you when you're walking down the street a little bit more often? - Well my personal security has been at risk for a very long time.

This is not, this struggle that I'm having with Putin has been going on for 10 years. I mean, just a month ago on May 30th in Madrid, I was arrested on a Russian Interpol arrest warrant by the Spanish police. Thankfully I was, Interpol contacted them two hours after I was arrested and made sure I was released, but the Russians have been coming after me for a long time and so I'm not surprised, it doesn't change anything. I'm always on high alert. And there's a lot of people around the world, governments, people, who are looking after me. - So what had happened with Browder was that he believed in these early years of the Putin regime, he believed that it was all due to his own acumen as an investor and his status as, at that time he was a US citizen, that he was able to go after these oligarchs. What he didn't understand, and that he learned later, was that he was pushing against an open door because he was going after Yeltsin's oligarchs which Putin also wanted to get rid of. But once he started going after Putin's oligarchs he ran into a brick wall. His accountant and lawyer, Magnitsky, was killed by the Russian police in a horrific scheme that's described at great length in his book "Red Notice" and he then went on this crusade to get the Magnitsky Act passed, which enables the US government to seize the assets of oligarchs who are involved in illegal activities, and which was used after, after the invasion of Ukraine in 2014. And that's what the famous 2016 Trump Tower meeting was about, that the Putin regime was trying to get Trump to promise that they would repeal the Magnitsky Act. And so that saga is ongoing. So Russia, one of the most corrupt countries in the world, you can see here it's up there with countries like Nigeria. This is one standard measure of corruption from Transparency International. You can see this is subjective perceptions of corruption in Russia

that people think, the vast majority of people think the vast majority of the Russian state is highly corrupt.

And one question is well why is it so corrupt? One obvious answer is a kind of path dependence story that we've talked about, that the fact that all these assets could be seized by former Soviet bureaucrats on the way out, or could be extracted from this very weak state, particularly in the 1990s, is a big part of the story. Secondly, there's this notion of a resource curse, which is often called the oil curse. And here, this is the political economist's story. Now the Russian economy at first glance doesn't look like it's so completely dominated by the oil sector. You can see here at least half of the Russian economy is services, but if you start to look a little bit more closely you see that while there are, you know, many different sectors in the Russian economy, one way or another the vast majority of them are connected to the hydrocarbon industry, three quarters of the Russian economy. So it's very oil dependent. You can see, and this is even more important, that the government's revenue is massively dependent on oil. The only countries that are more oil dependent for government revenue are places like Saudi Arabia, Iraq, Nigeria, Venezuela. The Economist magazine in 2016 estimated that 40% of the Russian government's revenue is from oil. And this of course makes for a lot of corruption because if the only way to get rich in Russia is to have access to the oil sector, then people who control that access can extract huge premiums for letting you participate. This is what makes Russian finances so dependent on the price of oil. And as you can, this is just another picture, which I will post these and you can peruse them at your leisure, but you can see that if oil prices fall, government revenues also fall with them. Which raises the question, why don't they diversify their economy? Why wouldn't they diversify the economy if it makes, they're so hostage to the price of oil. Quick suggestion, anybody? Why don't they? - They can't.

- Pardon? - They can't. They don't have the ability to move like that. - Why don't they? - Because their structure is just so incomplete. - So the beneficiaries, I would use beneficiaries where you use structure, the beneficiaries like it this way, they're making huge amounts of money out of it, right? The government needs it because it's very difficult for them to raise money in any other way. As I've said, the capacity, the institutional capacity of the Russian state to raise money in other ways is very constrained. But also, from the point of view of the government it's a source of geopolitical power. If you think about where does all of this oil go. Think about Western Europe, you can see here that three of the biggest companies selling oil to Western Europe are Russian companies. And if you look at where European countries get their oil, just look at Germany, it's the top importer of Russian crude oil in the world. And this is why the Russian invasion of Ukraine played out the way it did because not only oil, you can see here, Germany is the biggest consumer of Russian natural gas in the world. So if you think about Russia going into NATO and the NATO alliance, which we're gonna be talking about on Tuesday, putting together and speaking with one voice about responding to the Russian invasion of Ukraine, it's not gonna be something that's high on Angela Merkel's agenda. She needs Russian oil and gas, she can't afford to antagonize the Russian regime. And so it was not surprising that the response to NATO was a lot of hand wringing and strong statements, but nothing more than that. So it's because it's a source of

geopolitical power for a weak state that it's very desirable from the point of view of Putin to retain this powerful sector.



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