

## A FROZEN VENEZUELA? THE 'RESOURCE CURSE' AND RUSSIAN POLITICS

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### Introduction

A growing body of empirical research suggests that countries endowed with great natural resource wealth tend to lag behind comparable countries in terms of long-run real GDP growth, a finding that has given rise to widespread debate about a so-called 'resource curse' or a 'paradox of plenty'.<sup>2</sup> Explanations of the resource curse focus on a wide range of economic and political factors. The most prominent lines of argument emphasise the impact of resource wealth on the competitiveness of other non-tradables ('Dutch disease'); the impact of commodity-price volatility, particularly on fiscal revenues; the interaction of commodity-price volatility with financial market imperfections, which can lead to inefficient specialisation; and the impact of resource wealth on the quality of institutions, political processes and governance.<sup>3</sup> Significantly, the major *economic* explanations of resource-exporters' poor growth performance are all, at least in principle, treatable: governments have at their disposal policy tools to mitigate, if not eliminate, such economic hardships as 'Dutch disease'. The fact that they so often fail to do so suggests that consistent policy failure lies at the root of the problem.<sup>4</sup>

If this is indeed the case, then the most promising approaches to the resource curse are likely to be those relying on political economy explanations, for the key must lie in understanding *why* resource-based economies are more likely than others to suffer from bad policies. The answer must be that resource wealth somehow distorts their politics in such a way as to produce institutional and policy failures. A number of possible explanations for such a link have been proposed, but because the literature has focused on political and governance issues as *intervening* variables, there is often a tendency to infer causation from association rather than to explore the causal links between economic structure and either the nature of the political system or the quality of governance. This tendency is particularly pronounced in large-scale cross-national studies, which are by their very nature ill equipped to examine actual political processes closely in order to assess the extent to which they conform to the hypotheses advanced on the basis of quantitative analyses of data.

This chapter seeks to examine closely the links between resource wealth and politics in the context of contemporary Russia. It addresses two relatively simple questions. First, do we have compelling reason to believe that Russia's political life would have been substantially healthier – that politics would have been more democratic or governance less corrupt and more effective – if Russia had begun its market transformation without such large minerals sectors? Secondly, what can we say about the impact of Russia's natural resource endowments on its political development?

## **Russia's resource riches: a political curse?**

At first glance, the answer to the first of the two questions posed above would seem to be a resounding 'yes'. Russia undoubtedly suffers from many of the governance problems identified in the political economy literature as typical of resource-rich states. To some, indeed, it seems to present a perfect illustration of the political economy of the resource curse at work.<sup>5</sup> Presidential advisor Andrei Illarionov has taken to speaking of Russia's 'petro-politics' and of the 'Venezuelanisation' of Russia.<sup>6</sup> For Illarionov, 'Venezuelanisation' suggests a combination of stalled reform, populist spending and growing nationalisation of energy-sector assets. Nevertheless, a close examination of the Russian case suggests that it is difficult to attribute too much significance to Russia's resource-dependent economic structure when explaining the ills that afflict its body politic. Indeed, there is little reason to believe that the Russian polity would be substantially healthier had the country begun its market transition with less resource wealth.

The discussion that follows considers Russia in relation to a number of specific hypotheses advanced in the political economy literature on the resource curse. It finds that Russia does *not* conform to the expectations generated by several important strands of the literature. In a number of other cases, Russia does indeed appear to confirm the theory, in that it suffers from the kind of political pathologies associated with resource-based economies, such as pervasive rent-seeking and corruption. However, some of these problems would appear to be over-determined in the Russian case – we would expect to find them even in a resource-poor Russia.

### ***Russia as a resource economy***

On the measures conventionally employed in the resource curse literature, Russia undoubtedly qualifies as a heavily resource-based economy. Fuel and metals together accounted for an estimated 65% of value added in industry in 2000. In 2003, hydrocarbons, metals and other raw materials accounted for 76% of total exports, equivalent to 31.5% of GDP.<sup>7</sup> This undoubtedly qualifies Russia as a resource-based economy on the criteria used by such authors as Sachs and Warner (2001), Auty (2004), and Narain *et al.* (2003). However, Russia is not a 'typical' resource-based economy. Much of the literature assumes, implicitly or explicitly, that the typical resource-dependent economy is a developing economy, with a large agrarian sector, low levels of urbanisation and low overall levels of education. Russia's situation is more analogous to that facing highly industrialised economies following the discovery of major new resource wealth, such as The Netherlands or the United Kingdom in the 1970s and 1980s. The 'resource shock' in Russia resulted not from the discovery of new resources but from the adjustment of relative prices at the start of the post-Soviet transition. The relative prices of primary raw materials, having been held at artificially low levels under central planning, soared after prices were freed and foreign trade was liberalised. This triggered a radical reallocation of the resource rents derived from Russia's primary sector, a reallocation that is still being contested.

Clearly, a country's *ex ante* institutions will have a powerful impact both on how new-found resource wealth is used and on how it affects politics. It is therefore worth identifying a few of the peculiar features of Russia's institutional environment that might be relevant. First, as an economy in transition, Russia is – quite apart from its resource endowments – an extremely 'rent-rich' environment. Property rights are still relatively weak and fluid, and the economic distortions inherited from the Soviet system – or created by incomplete reforms – have generated substantial 'transition rents'. Secondly, Russia started the post-Soviet period

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with a large state bureaucracy but, paradoxically, a weak state.<sup>8</sup> Finally, political accountability, social capital and the rule of law – the three main sanctions against anti-social governance – are all in short supply.

The foregoing suggests that many of the political pathologies that are identified in the resource curse literature and that are found in contemporary Russia are probably over-determined. There is no doubt, for example, that struggles over control of Russia's resource wealth have generated large-scale corruption. But it seems overwhelmingly likely that Russia would have had very high levels of corruption in recent years anyway – as even a cursory look at some of its resource-poor neighbours would seem to confirm. Similarly, state weakness tends to increase agents' incentives to engage in rent-seeking rather than production, whatever the sphere of activity (Chakraborty and Dabla-Norris, 2005).

### ***Rent-seeking***

The simplest line of argument linking natural resource dependence to poor governance is that which argues that resource wealth tends to create incentives for rent-seeking. Both state and private actors in resource-rich economies may focus on capturing the resource rents rather than on wealth creation and may favour the development of institutions geared to rent-seeking rather than entrepreneurship.<sup>9</sup> Control contests over resource rents may well constitute the central axis of political conflict. Economic performance is likely to suffer, since such contests are unproductive.

The nature of the resources in question matters. Case studies suggest that an abundance of point resources, such as mineral deposits, is more likely to lead to weak political systems and consequent economic disadvantage than are diffuse resources, like fisheries or forests (Deacon and Mueller, 2004:26). Point resources are potentially easier to monopolise,<sup>10</sup> so contests to control them are more likely to be zero-sum and more likely to be won by whoever is in control of the state. Larger, more concentrated rents are thus likely to give rise to greater polarisation and fiercer, more protracted control contests than smaller, more diffuse ones (Auty, 2004).

A related, but nevertheless distinct, issue concerns the capital-intensive nature of resource extraction in many sectors, which is likely to mean that resource industries will tend to be dominated by fewer, larger firms.<sup>11</sup> This, in turn, increases the incentives for state elites to nationalise those industries, especially where they loom very large in the national economy. Otherwise, political leaders may fear that such powerful private companies could prove 'unmanageable'. It is perhaps not surprising, then, that so much of the resource curse literature focuses on minerals: they are point resources, with highly capital intensive production and, in many cases, substantial scale economies. Such sectors are likely to be characterised by higher levels of (state or private) ownership concentration than most others. Given Russia's enormous mineral wealth (chiefly hydrocarbons, metals and precious stones), the literature would lead us to expect fierce contests over rents.

Of course, the implications of such conflicts for politics and governance depend on the pre-existing institutional environment (Deacon and Mueller, 2004). Rent-seeking is likely to be especially attractive in any environment in which property rights are weak and institutions are unstable. In such an environment, agents will have good reason to discount the future heavily. This shortening of time horizons will tend to make rent-seeking more attractive than production, since the immediate pay-offs will be greater.<sup>12</sup> In such a situation, a weak legal order will probably be unable to contain control contests, which will then be settled by extra-

legal means. Those in power are likely to focus on capturing resource rents and using them in order to shore up their own positions.

This is precisely what we find in Russia. Conflict over resource rents has been one of the central facts of Russian political life over the last decade and more. Such conflicts must, however, be seen in the context of Russia's transition, which has provided opportunities for rent-seeking in virtually every sector and which has witnessed contests over the property rights to every imaginable sort of enterprise, large or small. In such an environment, contests for control over oil or aluminium deposits are likely to be longer and perhaps bloodier than those waged over local shops, but the roots of the problem lie in the general weakness of property rights rather than the nature of the assets. This becomes clearer when we contrast Russia with Norway, a country characterised by democratic governance and the rule of law prior to the discovery of its North Sea oil. Norway has been able to manage its resources and to resolve conflicts over resource rents within a stable democratic framework.

### ***No representation without taxation?***

A second hypothesis holds that resource-rich states tend to suffer from under-developed extractive institutions.<sup>13</sup> The state's ability to derive substantial revenues from the primary sector reduces its incentive to develop any more elaborate fiscal institutions. This ensures that the state remains over-reliant on primary commodities for its revenue base – and may therefore be subject to sharp pro-cyclical swings in fiscal policy. Politically, the state's ability to run on resource rents may also serve to make it less accountable than it would otherwise be to those it governs.<sup>14</sup> While this freedom from constraint may suit rulers in the short run, the long-term cost can be considerable. North and Thomas (1973) argue that the flow of silver and gold from the New World in the 16<sup>th</sup> century freed the Spanish crown from the constraints of the Cortes. British monarchs, by contrast, had to negotiate tax rises with parliament. This ultimately strengthened the British state, since it gave rise to institutions such as annual parliaments and later helped secure property rights. The Spanish monarchy's freedom from such constraints contributed to institutional stagnation and thus to political decline. More recent work on rentier states focuses on the 20<sup>th</sup>-century petro-states of the Middle East and elsewhere, but reaches a similar conclusion: government is far less likely to be accountable to the governed when rulers can finance their activities – and even provide generous benefits to their subjects – without having to tax those whom they rule.<sup>15</sup>

Intriguing though they are, these arguments do not shed much light on post-Soviet Russia. Indeed, Russia's recent past has witnessed the opposite of what the literature suggests. Russia started the post-Soviet era with catastrophically weak extractive institutions. Instead of merely appropriating the surpluses generated by state-owned firms, the post-Soviet Russian state had to learn to tax effectively. This has not been easy and the process still has some way to go, but there is no doubt that the Russian state's extractive capabilities have improved dramatically over the last decade, in terms not only of its ability to raise revenue but of its ability to do so without unnecessarily distorting markets or restricting economic activity.

Nor are Russian fiscal institutions too specialised on capturing resource rents. Indeed, Russia initially focused on introducing a wide range of general taxes and arguably paid too *little* attention to capturing resource rents. Vasil'eva and Gurvich (2005) find that the total effective tax burden on the fuel sector in 2000 amounted to just 31.8% of the sector's value added. The corresponding figure for non-fuel industry was 43.7%, while that for transport

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and communications was 40.8%. Non-fuel resource sectors also enjoyed far lower effective tax burdens than did major manufacturing sectors.

Tax changes introduced during 2000–03 served to correct the situation somewhat, as the effective tax burden on the fuel sector rose by an estimated 7.7% while the burden on non-fuel industry fell by 8.4% of value added. Quite apart from formal changes in tax legislation, the Yukos affair brought about both a change in the informal rules governing oil companies' tax behaviour and an increase in the state's ability to appropriate oil rents directly as a result of its expropriation of Yukos assets. However, these changes have focused overwhelmingly on the fuel sector. No attempt has been made to capture a larger share of the rent in other natural resource sectors, which have enjoyed further tax reductions – the metallurgy and forestry, pulp and paper sectors now enjoy the lowest overall tax burdens of any major industrial sectors.

Finally, it would be hard to argue that Russia has become a rentier state, free of any need to negotiate the terms of extraction with society. While the state's income from resource extraction has grown markedly in recent years, in fiscal terms it is no petro-state. Export duties and resource taxes accounted for only about 20% of revenues in 2003, far less than either social taxes (22.2%) or taxes on consumption (29.5%). VAT remains by far Russia's most important single tax, accounting for 35.8% of federal revenues in 2004. And while there has been a definite authoritarian drift under Vladimir Putin, it would be difficult to link this with any changes in the structure of taxation. Indeed, the post-crisis period has witnessed a major effort to improve tax discipline across the economy.

If resource rents do indeed contribute to the erosion of political accountability in Russia, this probably owes less to the nature of taxation than to state elites' ability to appropriate and allocate resource revenues by other means. On this view, the increase in direct state control over oil-sector assets, in particular, should cause some concern: whatever the defects of Russia's budgetary system, the overhaul of the tax system after 1999 and the establishment of a treasury system of budgetary execution do appear to have increased substantially the transparency and efficiency of fiscal processes. By contrast, the governance of state-owned companies remains opaque and there are doubts about to whom – and to what extent – insiders are really accountable. It is widely believed that such financial opacity enables Russia's rulers to use state-controlled companies to fund activities they prefer to keep off-budget. If resource riches are undermining political accountability, it is more likely to be via the growth of direct state control over resources than via the fiscal system.

### ***Policy complacency***

A third line of argument concerning the impact of resource wealth on politics and policy touches on what Ross (1999:309) calls 'myopic sloth'. In essence, the argument is that resource wealth gives rise to a certain complacency in policy-makers and/or private agents. Such complacency can lead to excessively lax policies and a neglect of structural and other measures needed to foster diversification. Excessive spending in the good times necessitates sharp retrenchment when commodity prices fall, thus aggravating the impact of shifts in the terms of trade. The evidence suggests that policy-makers in resource-rich countries appear to be well aware of the dangers of boom-and-bust cycles, but often find it difficult to resist pressures for fiscal relaxation.<sup>16</sup>

Here, Russia is no exception: the economic bloc of the cabinet is acutely aware of the need to maintain macroeconomic discipline across the commodity-price cycle, and during

1999–2004, Russia demonstrated exemplary fiscal discipline (Ahrend, 2004). The government, acutely aware of the lessons of the 1998 financial collapse, also undertook an ambitious and wide-ranging programme of structural reforms during 2000–03. Far from seeing the recovery of oil and metals prices after 1998 as an excuse to postpone reforms, the authorities initially seemed to view the boost to Russia's terms of trade as a window of opportunity to pursue reforms that would have been more difficult in other circumstances.

Nevertheless, there has been growing political pressure to spend an ever larger share of oil windfalls, as prices have remained high and memories of 1998 have faded. The government's fiscal hawks have come under increasing pressure to spend (or cut taxes) from the cabinet's spending ministries, from special interests seeking federal support for their priorities and from a Kremlin determined to maintain the pressure on the government to double GDP quickly. The real difficulty is that no one yet knows what part of the recent rise in oil prices will be more or less permanent. If the long-run average price has risen, then it makes sense for Russia to spend more, but betting too heavily on a much higher long-run price risks creating serious problems when prices fall. Even as spending pressures have mounted, structural reform has stalled. It appears unlikely that further major reforms will be launched before the next electoral cycle.

Like rent-appropriation contests, policy indiscipline tends to be worse in a poor institutional environment. Time horizons are shorter in such circumstances, and the more heavily agents discount the future, the weaker are the incentives to remain prudent. Moreover, if rulers are uncertain of their own tenure, then they will have a greater incentive to appropriate and manipulate resource rents more aggressively in order to retain power. In Russia, it is not difficult to see such incentives at work in the growing tendency to use oil windfalls to shore up support for the regime via tax cuts and increases in budget-sector wages and pensions, as well as to appease social protest where it emerges. The reaction to the monetisation protests of January 2005 and the subsequent freezing of virtually all potentially sensitive reforms would tend to suggest that the authorities are indeed becoming more risk-averse, as Karl (1997) suggests, and starting to use oil windfalls for current consumption rather than to underpin forward-looking reforms.

### ***Bloated bureaucracies and rent-dependent industries***

The issue of what state leaders *do* with resource rents when they control them is the focus of a fourth set of arguments about the impact of resource wealth on governance. As noted above, rulers will rationally tend to use such rents to strengthen their hold on power. Robinson *et al.* (2002) emphasise the use of rents as a patronage resource, arguing that leaders' use of this resource tends to result in a politically motivated expansion of the state bureaucracy.<sup>17</sup> The rent-driven growth of the bureaucracy, however, is only part of the story. Auty (1994, 2004), Mahon (1992) and others emphasise the use of resource rents to sustain a growing subsidy- and/or protection-dependent secondary urban sector. The growth of a secondary sector that relies on protection and/or subsidies will affect politics, for it will give rise to a social constituency with a vested interest in the *status quo*. Thus, numerous studies of import-substitution industrialisation in Latin America suggest that the beneficiaries of subsidies and protection were a major source of resistance to reform.<sup>18</sup>

At first glance, Russia seems to conform all too well to the model just outlined. The growth of the state bureaucracy since 1992 has occasioned much comment, and resource rents have indeed been used to prop up distressed non-resource sectors. On closer inspection, however, the picture in Russia looks rather more complex.

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The size of the bureaucracy has indeed grown, but by no means as rapidly as many think. In fact, the number of officials employed in public administration grew by just about 13.6% during 1994–2001, with sub-national administrations accounting for most of the increase. The number of federal employees posted in the regions grew slowly, while the central federal administrative apparatus actually shrank. In fact, the public administration overall employs an unusually small portion of the labour force when compared with most OECD and transition countries, which makes it difficult to argue that Russia conforms to the rent-bloated bureaucracy hypothesis.<sup>19</sup> A large part of the growth at regional level appears to have resulted from the desire of financially *weak* regional authorities to extract subsidies from the federal centre – which means that it is unlikely to be related to resource wealth.<sup>20</sup> Nevertheless, a look at regional-level data suggests that resource wealth may play a role in fuelling the growth of sub-national bureaucracies. Between 1995 and 2003, employment in regional and municipal administrations grew by 22.5% across the federation. In the ten federal subjects with the highest ratio of minerals extraction to gross regional product (GRP), however, the corresponding figure was 51.6%, reaching 68% for the six federal subjects in which minerals extraction accounted for over 30% of GRP.<sup>21</sup>

The issue of the protected secondary sector is particularly interesting in the Russian case. On the whole, Russia's secondary sector has enjoyed surprisingly little formal protection – trade policy since 1992 has generally been fairly liberal, although informal barriers have sometimes made the Russian market less open than it appeared to be on formal criteria. Nevertheless, a large part of Russian industry was kept afloat via subsidies throughout the first decade of transition. This reflected both the power of industrial managers as a lobby and fear of the social consequences of structural change. Direct subsidies from the budget and soft credits from the central bank had largely been eliminated by the mid-nineties, but they were increasingly replaced by implicit subsidies, the most important of which involved unpenalised arrears and non-monetary payments to the state-controlled gas and electricity monopolies.<sup>22</sup> After the crisis, cash payments rapidly became the norm again, but gas and electricity prices were frozen for several years and thus fell sharply in real terms, dropping well below cost-recovery levels.<sup>23</sup> By contrast, the oil industry's support for the secondary sector was minimal. Since the authorities were officially committed to curtailing explicit subsidies, all that could really be done was to use restrictions on exports to hold down the domestic prices of crude oil and petroleum products. Given that Russia consumes far less crude than it does gas, this constituted a less onerous burden on the industry. Other major resource sectors – notably timber and metals – appear to have done even better, as they shared in the subsidies provided to the secondary sector.<sup>24</sup>

Up to this point, Russia might appear to conform quite well to hypotheses about a dependent urban sector. However, since 2000, there has been the dramatic reduction in the implicit subsidies provided to Russian industries and households. As OECD (2004) shows, the gas and electricity subsidies have been diminishing rapidly in recent years, while Russian enterprises' payment discipline – with respect to the budget, employees and suppliers – has greatly improved. It remains to be seen if this progress will be sustained through the next downturn, but recent years have seen a marked shift away from the subsidy-dependent industrialisation model.

Any discussion of Russian leaders' use of resource rents to secure political support would be incomplete without a discussion of privatisation. At first glance, Boris Yeltsin's readiness to privatise Russia's oil and metals industries so quickly – and so cheaply – might look rather surprising, especially as his administration was not even able to tax them effectively. In the case of Gazprom, Yeltsin simply allowed insiders to appropriate a large

share of gas rents, even while the company remained in state ownership. The political leadership seemed to surrender these spectacular rents without a fight. One might, of course, simply put this down to the weakness of a regime that had in any case found it impossible to assert effective control over state enterprises or to resist pressure to alienate its most valuable assets. However, Yeltsin's behaviour may make sense if one assumes that his time horizons were relatively short. Whatever its economic merits, the rapid privatisation of the state's most valuable companies offered two major political benefits to Yeltsin as he fought for his political life in the mid-1990s. First, it helped secure the support of the country's richest tycoons for his re-election. Secondly, it helped ensure that, even in the event of defeat, his opponents would face powerful opposition to any attempt to reverse course in economic policy.<sup>25</sup> Putin, by contrast, has hitherto faced no such immediate threat to his tenure, and he is thus more interested in securing control over a much larger share of Russia's resource rents on an on-going basis, whether by means of taxation or direct state control over assets.

### **Corruption**

A number of authors argue for a link between resource wealth and official corruption, not least because of the temptation to manipulate state institutions to secure resource rents.<sup>26</sup> However, the link between resource wealth and corruption in the Russian case is anything but clear. There is compelling evidence to suggest that the problem of official corruption has grown markedly worse since 1991,<sup>27</sup> but it would be difficult to attribute this development to the resource curse, given the many other factors at work.

If there were a strong link between mineral resources and corruption, we might expect to find that corruption was worse in resource-rich regions than elsewhere. The *Regional Corruption Indices 2002* of Transparency International–Russia are the one relatively rigorous assessment of corruption at regional level based on comparable sociological data. Unfortunately, they are available for only 40 of Russia's 89 federal subjects, and many of the most resource-dependent regions are not covered (Transparency, 2002). Nevertheless, they do not, at first glance, provide any support for the proposition that resource-rich regions are more corrupt than others. The most striking feature of TI-Russia's 'corruption map' is that corruption appears to be substantially worse in border regions than elsewhere – hardly a surprising result, given the scale of contraband trade in Russia and the fact that ports in most countries tend to have higher levels of crime and corruption than other cities. This is not to say that resource regions are *not* corrupt – one of the striking features of the indices is the limited degree of variation among federal subjects. On most indicators, corruption was found to be high across the board, and the best regions were not a great deal better than the worst.

The recent joint study by the polling institute VTsIOM and the small business lobby OPORA likewise fails to show much of a link (OPORA Rossii, 2005). Their survey of small and medium entrepreneurs did not ask about corruption specifically but rather asked respondents about 'transaction costs' incurred when interacting with the bureaucracy. This rubric covered not only bribes and kickbacks, but also such issues as procedural violations during inspections and difficulties with registration. To the extent that it taps forms of official predation, however, the transaction costs indicator looks like a reasonable proxy for corruption. Ranked on this indicator, Russia's most resource-dependent regions range from sixth to 78<sup>th</sup>. There is no evident clustering of metals- or fuel-producing federal subjects in the distribution. The survey results do, however, show that the propensity of officials to take 'illegal payments' from businesspeople is far greater in the Southern Federal District (not a resource-rich region) than anywhere else in Russia.



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The failure to establish any apparent link between resource wealth and corruption levels does not by any means imply that competition for resource rents has not fuelled corruption in Russia. It may be that the inclusion of more resource-dependent regions in the sample would have yielded a different result; the index does not cover many of the most resource-dependent economies in Russia. Moreover, contests over resource wealth may be concentrated at the federal level and thus have little impact on regional perceptions of corruption. However, it seems likely that corruption in Russia is simply over-determined. Had Russia embarked on its market transformation with no significant resource endowments, one would still expect to find high levels of corruption during the transition – and, indeed, Russia's resource-poor CIS neighbours do not appear obviously less corrupt than Russia.

The growth of official corruption since the late 1980s reflects a large number of factors, including the breakdown not only of the political and bureaucratic controls that existed in the Soviet system but also of the norms and beliefs that supported the old order.<sup>28</sup> Another critical factor is the very low pay received by officials, particularly as many low-paid functionaries find themselves disposing of very valuable state assets or managing substantial financial flows. Corruption is also facilitated by the traditional opacity of state bodies in Russia.<sup>29</sup> More generally, cross-country research shows that both the rule of law and the development of civil society (including a free press) are strongly and negatively correlated with the level of corruption.<sup>30</sup> Their weakness in post-Soviet Russia has probably facilitated the growth of corruption. In short, the larger institutional environment within which officials operate in Russia is relatively 'corruption-friendly'.

### **Resource wealth and Russian politics: a 'Tillyan' view**

Clearly, then, there are good reasons to be sceptical about some of the hypothesised links between Russia's resource wealth and its politics. Yet it would be a mistake to conclude that no significant links exist. If politics is, in the conventional definition, about 'who gets what, when, how', then it would be surprising to find that the economic structure of a polity did *not* have an impact on its political institutions and practices. The nature of the principal sources of national wealth in any society – not only one heavily dependent on resource extraction – is likely to affect the framework for political decision-making, including goal formation, the locus of authority and the types of institutions adopted or created (Karl, 1997:44–5). With respect to resource-based economies, in particular, one might expect their natural endowments to affect the dominant mode of resource extraction employed by rulers. The discussion that follows seeks to understand the relationship between resource extraction and governance in contemporary Russia, drawing in particular on the work of Charles Tilly (1992) on the emergence of state structures in Europe.

### ***State-building and modes of appropriation***

Tilly views the state as a mechanism for appropriating resources and directing them towards the ends determined by the elite – the 'dominant elite project'. Since Tilly's focus is on the rise of the early modern state, the dominant elite project is more or less given: it is war. Much of Tilly's work therefore addresses the other half of the equation – elite strategies for the appropriating the goods of others. One critical question must therefore be: where are the resources which dominant elites strive to appropriate 'located' (in socio-economic no less than spatial terms) and what does it take to 'extract' them? Tilly's argument is that elites need to enter into a variety of social relations to secure the resources they need and that these varying modes of engagement propel the rise of different types of structures that may be used as instruments of governance. For our purposes, it is not necessary to delve into the

detail of Tilly's three-fold classification of extraction strategies in the early modern period. The critical point is to recognise that the nature of the resources to be appropriated can shape the extraction strategies that elites pursue. Thus, the possibility of extracting large resource rents at relatively low cost is likely to shape the kinds of institutions political elites create.

The characteristics of the resource sectors in question may also play a role here. Shafer (1994) argues that when a state's production and export profile is highly concentrated, the characteristics of its leading sector can significantly influence its political economy. Where the leading sector is dominated by a small number of players, with high barriers to entry and exit, and a high degree of asset specificity, Shafer argues, it is likely to be both politically powerful and rather inflexible. Powerful but inflexible sectors in turn are likely to place exceptionally strong demands on the state. The state is likely to suffer from an erosion of its own autonomy, and state capacities are likely to be distorted, as the state develops specialised institutions and practices to deal with the leading sector while failing to develop effective mechanisms for governing, or addressing the needs of, other sectors. Intuitively, one would expect this to be especially true of minerals sectors, such as oil, gas and metals – as noted above, they are point resources, with highly capital intensive production and, in many cases, substantial scale economies, making entry difficult and increasing the likelihood that they will be dominated by a few large players.

Jones Luong (2004), however, focuses not on the nature of the industry *per se* but on the question of ownership and control. She argues that the choice of governance structure is largely determined by domestic politics, rather than factors intrinsic to the nature of the sector, such as capital intensity or concentration. While her analysis of the domestic political determinants of such choices is illuminating, the predominance of state ownership in major minerals sectors over the last forty to fifty years – despite wide variation in the political circumstances of minerals-exporting states – suggests that the characteristics of minerals sectors are nevertheless important in structuring the choices politicians make in response to the kind of domestic political opportunities and constraints she describes.<sup>31</sup>

It may well be that the presence of large, concentrated sources of rent, such as are found in many minerals sectors, constitutes a political problem to which the easiest (if not the most economically efficient) solution for many states is nationalisation. The capital intensive nature of most large-scale resource extraction is likely to mean that the sector will be dominated by a small number of very large players, whether private or public, domestic or foreign. If private ownership prevails, the danger for state elites is that the political system might not be robust enough to contain conflicts among such influential private agents or that the state might not have the capacities needed to regulate the behaviour of private resource companies and to capture resource rents effectively. Provided the state disposes of the necessary force, nationalisation may simply be easier than trying to govern powerful private players. Moreover, greater direct control will undoubtedly make it easier for state elites to appropriate and allocate resource rents than such indirect means as taxation and regulation. The irony here is that while weak states may be more likely to opt for nationalisation precisely because of their limited capacities, under-developed state capacities make it more likely that nationalised resource industries will be poorly managed.

### ***The state-ownership curse?***

This point is extremely important in the larger resource curse debate, as Jones Luong (2004), Auty (2004), Ross (1999) and others suggest that state ownership rather than resource wealth *per se* lies at the root of resource exporters' apparently chronic under-

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performance. State ownership of resource industries may soften states' budget constraints and encourage fiscal indiscipline. In any case, there are grounds for thinking that state-owned minerals producers are likely to be less efficient and less transparent, and also to be subject to more political interference. The resource curse might well be a state ownership curse. This proposition has not undergone much empirical analysis, for the simple reason that most of the literature focuses on minerals sectors in the period from the 1960s through the 1990s – a time during which the vast majority of mineral-rich countries opted for state ownership and control of mineral reserves.

While one cannot generalise on the basis of a single case, Russia's experience would seem to be entirely consistent with this view. OECD (2004) contrasts the striking divergence in performance between Russia's oil and gas sectors. The oil sector was broken up and privatised, while the gas sector remained a state-controlled vertically integrated monopoly. The obviously flawed nature of oil privatisation notwithstanding, the result was a dynamic oil industry that emerged as the most important driver of Russia's strong post-crisis growth. The gas industry's overall contribution to growth during 1999–2004 appears by contrast to have been slightly *negative* (Gurvich, 2005).

Our concern, however, is with politics. If the presence of rich natural (and particularly mineral) endowments tends to create incentives for politicians to pursue state ownership, this will undoubtedly have consequences for politics. However, the nature of these consequences will depend on the existing political order and the quality of the institutional environment. A country such as Norway, where the democratic accountability of the rulers to the ruled is well established and the rule of law is relatively strong, has a far better chance of creating a reasonably well governed country.<sup>32</sup> Where political accountability and the rule of law are weak, however, the creation of large state companies in the most lucrative sectors is much more likely to be associated with greater opacity, corruption and rent-seeking by insiders. Politically, the resources placed at the state elite's disposal in this manner may well make it easier for them to resist, or buy off, pressure for change. In short, one might hypothesise that direct control over large resource rents would enable the governing elite both to enrich itself and to entrench itself, especially if the mechanisms for monitoring the management of those rents are weak or non-existent. None of these conclusions are likely to sound in any way surprising or controversial to observers of Russia's gas monopoly or other large, state-owned oil and gas companies in the CIS.

But the argument goes even further. Jones Luong (2004:11) argues that each of her four forms of ownership and governance 'fosters a different set of incentives for institution-building by creating a different set of primary actors and form of business-state relations'. She continues:

Three basic patterns emerge. First, 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 in terms of both their ability to constrain and predictability.... Second, where the main actors are state elites and domestic owners, business-state relations are clear and symmetrical, and thus, their incentives for building institutions that act as formal guarantees are likely to converge such that strong (i.e. broadly effective and stable) institutions emerge. And third, where the main actors are state elites and foreign investors, business-state relations are clear and asymmetrical; their incentives for institution-building are thus likely to diverge,

resulting in hybrid institutions – or institutions designed specifically for the mineral sector that are effective but not stable.

The foregoing would suggest that the institutional implications of growing state control over Russia's major resource sectors are disturbing indeed.

These claims take on added significance if we accept that the institutional requirements of the 'leading sector' are likely to shape the economic and, to some extent, the political institutions of the society as a whole. A development strategy based largely on state control over natural resource sectors (or, for that matter, over the other 'commanding heights' of the economy) is likely to be far less demanding in its institutional requirements than many other development paths (Ahrend and Tompson, 2005a). The development of civil society, the quality of the contracting environment (and, hence, of the rule of law), the security of property rights and the development of human capital all matter less than they would in an economy seeking to develop on the basis of private enterprise. The relatively lax institutional requirements of this strategy may, indeed, make it more attractive to rulers in settings where institutions are *ex ante* weak. The problem is that, in addition to being a strategy which is less promising in economic terms than many others, it is one which tends to reduce the incentives for *improving* institutions. The coping strategy thus risks becoming an impediment to any real resolution of the problem of weak institutions.

### ***Russia reconsidered***

The argument towards which the foregoing has been leading us thus runs something like the following. The rulers of a resource-rich state will understandably be concerned to capture a large share of the economic surplus generated by its resource sectors. While personal cupidity and corruption (of politicians or officials) may play a role, it need not: following Tilly's logic, the focus on appropriation of resource rents is the obvious, rational strategy for state elites to pursue. However, the mechanisms of appropriation they employ will depend on the tools at their disposal: it is here that the nature and quality of institutions comes into play. States whose regulatory, administrative and other capacities are generally weak are more likely succumb to the temptation nationalise outright, or at any rate to rely on their coercive power to sustain a tight grip over the resource sector. Such a solution is likely to prove economically inefficient but it has undoubted political advantages for rulers.

How well does this line of argument fit contemporary Russia? Vladimir Putin's 'dominant project' comprises the reconstitution of state power in Russia and the restoration of Russia's international 'great power' status following the travails of the 1990s. Moreover, he has publicly expressed his view that Russia's hydrocarbon wealth, in particular, is critical to re-establishing its geopolitical position in the world. It is therefore hardly surprising that Putin has been concerned to tighten the state's grip on Russia's resource-exporting oil and gas sectors, which constitute the single biggest potential source of wealth to sustain both his state-building project at home and his drive to enhance Russian power and prestige abroad. Putin, after all, inherited a state that had only a short time earlier been effectively bankrupt and that was still in a precarious financial position. The question of resources was thus an urgent one. And there can have been little doubt about where to find the richest resources he might hope to tap – in Russia's export-oriented natural resource sectors and, above all, in its hydrocarbon sectors. He had already expressed quite clearly his own belief that the state should appropriate a larger share of the economic surplus generated by these sectors and that such a step was critical to Russia's long-term revival.<sup>33</sup> The question facing him, therefore, was how best to secure that surplus.

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Economically, the optimal solutions would probably have involved a market-oriented restructuring of the largely unreformed gas sector,<sup>34</sup> along with better regulation and taxation of the predominately private oil industry. Instead, Putin moved to tighten his grip on the vertically integrated state-controlled gas monopoly, OAO Gazprom, and to expand considerably the state's direct involvement in the management of the oil sector. In the case of Gazprom, which had become something of a state within the state during the 1990s, this proved difficult enough: the new management team installed by Putin in 2001 did not find it easy to secure real, effective control over the company, but gradually the old guard was displaced. As is well known, Putin initially did little to regain control over the oil sector, but from mid-2003, the state reasserted itself in somewhat ham-fisted fashion. By late 2005, around 15% of oil production had shifted, or was in the process of shifting, from private to state hands, and there was every likelihood that, when the onslaught against Yukos was finally over, the state would have raised the share of oil production directly under its control from around 17% in 2003 to perhaps 45%.<sup>35</sup> At the same time, the formal tax burden on the oil sector had been raised substantially, while tax administration had grown tougher, thus ensuring that the state would capture a much larger share of oil windfalls than previously.

A great many things seem to have influenced Putin's approach to the energy sector, including conjunctural political factors and his own ideological predilections. There has been nothing inevitable about the state's expansion into the oil sector: political leadership and choice remain key variables. Nevertheless, it would be a mistake to overlook the importance of both the sectoral characteristics described above and the weaknesses of Russian state institutions. The Russian state's administrative and regulatory capacities were and are weak. Its extractive capacities – its ability to tax effectively – have improved dramatically in recent years but are still rather clumsy. Hence the reliance in many cases on forms of taxation that are acknowledged to be economically sub-optimal but that are easier to administer and collect.<sup>36</sup> However, whatever its other weaknesses, the Russian state's coercive capacities are considerable. They are, indeed, developed out of all proportion to any of its other capabilities. And if all the state is really good at is coercion, then one can expect the state to coerce. To be sure, forceful methods undoubtedly serve the interests of many who are close to Putin, but it is difficult to deny that there is a large element of truth in Kraus's (2004) assertion that, in taking forceful action against Khodorkovskii and Yukos, Putin was merely employing the only really effective tools at his disposal. A state characterised by weak regulatory and rule-enforcement capabilities but enjoying a hypertrophied capacity for the use of force can be expected to use force.

This suggests that the roots of the problem lie, in the final analysis, in Russia's institutional weaknesses. These weaknesses did not predetermine the course of action taken by the Kremlin towards the oil industry in 2003–05, but they certainly made it a relatively more attractive option – quite apart from the personal and factional interests involved. It is not hard to see the vicious circle that may now take shape. Weak institutions prompt rulers to opt for feasible, if sub-optimal, solutions – in this case, a reliance on direct control and coercion rather than contract, regulation and taxation. The solutions adopted, in turn, create obstacles to institutional improvements, as second-best solutions often help to entrench the very weaknesses that gave them birth. And those very same institutional weaknesses ensure that, from an economic point of view, those most likely to nationalise are those least equipped to manage nationalised industries well. For a time, before 2003, Russia appeared to be struggling to break this mould – to create institutions capable of regulating, and mediating conflict within, a powerful, dynamic and privately owned oil industry. The events of the Yeltsin era and the early years of Putin show that this was never an easy process – the oil

barons would not be so easily ‘tamed’. In the end, therefore, the authorities seem to have fallen back on time-honoured methods of coercion and direct control.

This does not by any means imply that economic reform in Russia is dead, or that Russia is racing headlong back into the Soviet past. The authorities’ approach to other sectors remains much more liberal and market-friendly. In principle, it is possible that the state might try to create different institutions for, and to pursue different policies towards, non-resource sectors. As Sutela (2005) observes, Russia cannot be another Kuwait; it is simply too big to prosper on the basis of natural resources alone. The country needs a successful secondary sector that can provide employment if the great mass of its population is to enjoy a decent standard of living. As noted above, one danger is that protection and subsidies will be used to foster the development of this ‘B’ sector, as Sutela calls it. Alternatively, the authorities could try to create conditions for the development of an open and competitive sector of small and medium-sized businesses. Given the dual structure of the economy, Sutela argues that there is not *necessarily* a contradiction between two lines of policy that have emerged in recent years – the tightening of the state’s grip over the resource sector, on the one hand, and attempts to create a better environment for SMEs on the other.

There are, however, good reasons to doubt that such a ‘neo-NEP’ would work in practice. First, much of the non-resource sector will continue to push for protection and, given its socio-political importance and economic weakness, it may get it. Yet such protection is more likely to impede than to facilitate the development of new activities and products that might be more competitive. Secondly, as Sutela observes, the dividing line between the ‘A’ and ‘B’ sectors is fluid and actions taken with respect to the former could have unexpected knock-on effects for the latter. To take but one recent example, the central authorities’ use of the tax service and the prosecutors against the country’s largest private company does appear to have encouraged lower-level officials to step up the pressure on small and medium businesses. Finally, there is a very real danger arising from the fact that the notion of ‘strategic’ sectors is proving rather elastic and may come to be applied to an ever larger part of the economy – as already appears to be happening in fields like metallurgy, machine-building, aviation and even banking.

## **Conclusion**

Claims that Russia is turning into a frozen Venezuela are greatly exaggerated. Viewed from a political perspective, what is striking about Russia is not how well it conforms to the stereotype of a resource-based political economy but how successfully it has so far resisted many of the institutional and political pathologies commonly associated with resource-based development. In many cases, moreover, there are good reasons to believe that a resource-poor Russia would suffer from many of the same problems. Nevertheless, it seems that Russia’s resource wealth does pose dangers to its political development. The crucial issue is not the nature of the resources themselves but the location of those resources in an institutional environment that is ill-equipped to cope with the pressures and problems that such wealth can create.

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### NOTES

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1. Senior Economist for the NIS and South-east Europe, Economics Department, OECD ([william.tompson@oecd.org](mailto:william.tompson@oecd.org)). The opinions expressed in this paper are those of the author and do not necessarily reflect the views of the OECD or its member states.
  2. See the classic statement of the resource curse hypothesis by Sachs and Warner (2001); on the ‘paradox of plenty’, see Karl (1999).
  3. For an overview of these explanations, with particular emphasis on the issue of weak financial markets, see Hausman and Rigobon (2003).
  4. See, for example, Lal and Myint (1996), who see policy failure as the prime cause of underperformance of natural resource-based economies. See also the overview of this literature in Ross (1999). Of course, part of the reason for this may be that less diversified economies have less margin for economic policy error: in other words, a highly resource-dependent economy arguably needs even *better* policy than a more diversified one (see Ahrend, 2005).
  5. See, for example, the views expressed by various analysts cited in Bush (2005). See also the discussion in Erochkin (2005). Illarionov presented his ‘Venezuelanisation’ thesis to the *Euromoney*-sponsored ‘Russia & The CIS Investment Forum 2005: Moving Towards A Balanced Economy’, at the Radisson Slavyanskaya Hotel, Moscow, 13 September 2005.
  6. Illarionov presented his ‘Venezuelanisation’ thesis to the *Euromoney*-sponsored ‘Russia & The CIS Investment Forum 2005: Moving Towards A Balanced Economy’, at the Radisson Slavyanskaya Hotel, Moscow, 13 September 2005.
  7. Oil and gas alone constitute over half the country’s export bill.
  8. McFaul (1997) identifies three criteria of state strength: internal ideological and institutional cohesiveness; relative autonomy from society (*i.e.* the degree to which state structures are or are not captive to particular interests); and the ability of the state to implement policy effectively. On all three counts, the post-Soviet Russian state was exceptionally weak.
  9. See, *e.g.* Auty (2004), Robinson *et al.* (2002), and the overview of the ‘rentier state’ literature in Ross (1999:312–13).
  10. Diffuse resources, of course, may pose a different problem: if they are open access resources, then failure to establish an effective property rights regime may lead to overexploitation and a ‘tragedy of the commons’.
  11. Capital intensity is partly a function of the nature of the resource, but it is also a function of technological change (fishing, for example, has become much more capital intensive in recent decades), and should therefore be seen as a distinct variable.
  12. In any case, productive activities, if successful, will tend to attract predators (Chakraborty and Dabla-Norris (2005).
  13. See, *e.g.*, Chaudhry (1989) and Karl (1997).

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14. See Ganev (2001:14): ‘Only when elites are forced to re-negotiate the terms of extraction will the “organisational residue” engendered as a by-product of the dominant elite project be harnessed for the purposes of good governance.’
  15. See, *e.g.*, Isham *et al.* (2003); Ross (2001); Entelis (1976); Vandewalle (1998); and Bazresch and Levy (1991).
  16. See Ross (1999:309), especially the references in notes 40–42.
  17. This view is shared by Auty (2004), among others.
  18. See the overview of this literature in Ross (1999:310–11). See also Gelb *et al.* (1988) and Treisman (2002) on ‘dependent urbanisation’.
  19. See Brym and Gimpel’son (2004:92–100) for details. It should be noted that comparisons across time and countries are complicated by problems of definition, including the creation of new types of officials and the reclassification of others in conjunction with the transition.
  20. See Gimpel’son and Treisman (2002).
  21. Significantly, what matters here seems to be not the absolute volume of a region’s mineral (hydrocarbons and metals) production but the relative weight of that production in gross regional product. In other words, it is resource-*dependence* rather than resource wealth that counts.
  22. Enterprises also ‘borrowed’ increasingly from workers, the state and other suppliers, via wage, tax and payment arrears. For details, see Woodruff (1999) and Tompson (1999).
  23. For an estimate of the scale of this implicit subsidy in the early post-crisis period, see OECD (2002:121–32).
  24. Aluminium producers, in particular, benefited greatly from cheap electricity.
  25. When political leaders adopt policies that effectively curtail their own power, it is often because their tenure is uncertain and they hope to bind their successors.
  26. See, *e.g.* Mauro (1995); da Cunha Leite and Weidmann (1999); Easterly (2001); and Ahrend (2004).
  27. Estimating corruption levels is, of course, a notoriously difficult business, and few of the indicators available allow for an assessment of trends across time. Transparency International’s ‘Corruption Perceptions Index’, despite its limitations, does now at least offer almost a decade of coverage of Russia. It suggests some gradual improvement during 2000–2004, but Russia’s recent scores, in the 2.7–2.8 range on a ten-point scale, show that it continues to be regarded as a highly corrupt place.
  28. See Huskey and Obolonsky (2003). This is a key point: the role of informal norms has been little studied, but it is difficult to believe that changes in norms and values do not form part of the explanation here.
  29. Ahrend (2002).
  30. Brunetti and Weder (2003).



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31. Economically, of course, many developing countries were advised that nationalisation would help them gain independence from foreign multinationals and would better enable them to use resource rents for economic development. See, *e.g.* Cardoso and Faletto (1979), Hirschman (1958) and Baldwin (1966).
32. One should not, however, be naïve about the Norways of this world: decision-making in and around Norsk Hydro and Statoil can be as opaque as anything found in Russia.
33. This line of argument was advanced in the future president's candidate of sciences thesis on 'The Strategic Planning of the Reproduction of the Mineral Resource Base of a Region in Conditions of the Formation of Market Relations' at the State Mining Institute in the 1990s, and in an article based on the thesis that appeared in the institute's journal in 1999. See Putin (1999) and Olcott (2004).
34. On gas sector reform, see Ahrend and Tompson (2005b).
35. This is not the place for a detailed analysis of the so-called 'Yukos affair'. I have examined the case and its implications at length in Tompson (2005).
36. This is the main reason that oil-sector taxation, in particular, remains focused on turnover and physical volumes rather than profit.

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