

Russia's Virtual Economy. By Clifford Gaddy and Barry W. Ickes. Washington, DC: Brookings Institution Press, 2002. pp. 306. \$19.95, ISBN: 0-8157-3111-6 (paper); \$49.95, ISBN: 0-8157-3112-6 (cloth).

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In trying to understand the seemingly intractable problems facing the Russian economy many scholars have resorted to the phrase “because it’s Russia.” To their credit, Gaddy and Ickes do not fall back on this explanation. Instead, they develop a model demonstrating that individual behavior in Russia is rational and stems from uncertainty about the future and a focus on day-to-day survival.

Gaddy and Ickes highlight the role that relational capital (personal links between enterprise managers and politicians that oils the wheels of the virtual economy) has on the survival prospects of negative value-added (NVA) enterprises – those enterprises whose output at current prices is less than the value (also at current prices) of their inputs. They also focus on how NVA firms affect the prospects for the capitalist market economy in Russia.

In a virtual economy, firms that create value added assist NVA firms in order to ensure their survival. This transfer of value is accomplished through non-transparent transactions at non-market prices; it boils down to accounting changes that reduce the burden on firms, creating value added, and avoids politically costly mass closures of nonviable enterprises. From the beginning of the transition process in Russia until the financial crisis of August 1998 the predominant mechanism for value transfer was nonmonetary transactions – mostly barter and debt offsets. After August 1998 these became less frequent, but the behavior characterizing the virtual economy remains.

The first two chapters analyze economic statistics in Russia, and demonstrate various measurement flaws due to the virtual economy. Because no cash is exchanged, prices are arbitrary, reflecting neither the physical value of the products exchanged nor the demand for them. Prices become mere accounting devices designed to make NVA enterprises appear viable and reduce the profits (and therefore the taxes) of value-adding firms. (The valued-added tax in Russia approaches 100 percent). For this reason, government statistics are unlikely to provide an accurate picture of progress toward the market in Russia.

In the next four chapters, Gaddy and Ickes develop an insightful model that supplements the traditional measure of firm viability, market distance (the amount of capital investment necessary for the firm to be perfectly suited for the market), with relational capital. In order to participate in the virtual economy firms need relational capital. Often this is embodied in managers; it can be traced back to the production relationships developed under planning. Relational capital is person-and firm-specific; and it operates most effectively where transparency is weak. For this reason, the enterprise manager becomes extremely valuable to an NVA firm. Furthermore, relational capital would be lost if the firm entered the formal market because of the irreversible increase in transparency – a financial statement cannot be undone once it is released. In Chapter 4, Gaddy and Ickes demonstrate how their hypothesis supports “Igor’s Rules” (five rules provided by the manager of a large firm in the Urals) about how to keep a firm afloat in the virtual economy.

The final four chapters examine what the future has in store for the virtual Russian economy. The most pressing issue concerns the point at which the economy runs out of value because of the non-market pricing that facilitates the transfer of value to NVA firms. For one of the major players, Gazprom, this could occur in the next few years unless there are major new discoveries of natural gas. As the system runs out of value, people will suffer as many NVA firms go belly up.

The serious consequences of running out of value demand radical action. Gaddy and Ickes first suggest providing subsidies to individuals and firms to encourage them to move to the South and West of Russia where the temperatures are mild. They argue that the Soviets placed too many cities in regions that are too cold and too remote. Their second suggestion flows from observations that the prospect of joining the European Union is one reason reform succeeded in many Central and Eastern European countries. While admitting many difficulties with this option, Gaddy and Ickes believe Russian accession to the European Union might be possible in the future.

Gaddy and Ickes' model of the virtual economy is clear and intuitive, and it will be a valuable source for understanding the continuing evolution of the virtual economy. However, most of the evidence they present is anecdotal; there is little formal cross-sectional analysis that tests for the existence of a virtual economy. This is more the result of lack of data than any flaw in the model. We are likely to see future work from Gaddy and Ickes providing a formal analysis of the existence and effects of the virtual economy on the transition experience in Russia.

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