

Russia and the Caspian

GADDY, Clifford G. & ICKES, Barry W.: **Russia's Virtual Economy**, Brookings Institution Press, Washington, DC., USA (2002), pp.306 + xiv, £27.25, ISBN 0-8157-3112-4.

Russia's Virtual Economy is destined to become a classic in the field of post-Soviet studies. The book focuses on the unique economic formation that emerged from the wreckage of central planning (which bequeathed Russia a structure of production created without regard for opportunity costs, and hence fundamentally unviable in a genuine market context), the dogmatic but at the same time inconsistent and piecemeal application of shock therapy and, finally, the savage process of primitive capital accumulation that saw the plundering of Russia's productive apparatus and natural resource riches by a rapacious *nomenklatura*. This unholy chimaera is the *virtual economy*, which Gaddy and Ickes define as the set of informal institutions and rules that allow the production and exchange of goods that are worth less than the inputs used to produce them by means of a vicious circle of value destruction that is, in its turn, kept going by the three primary forces. On the one hand, there is the willingness (or resignation in the face of the inevitable) of many economic actors 'to accept fictitious...pricing of the goods at levels that mask their unprofitability', through the use of barter and other forms of nonmonetary exchange, as well as more intricate subterfuges' (p. 5). On the other hand, there is the resistance of the part of different levels of government to see value-destroying firms going to the wall, given the total inadequacy of resources to support even the most rudimentary social services outside the boundaries of the enterprises that were responsible for them during the Soviet era. Finally there is the continued infusion of fresh value into the system by Gazprom, a colossus that has thus far gone along with this mad game chiefly because, in exchange for its turning a blind eye to the nonpayment of gas by Russian clients, its management has been allowed to administer as it sees fit the colossal economic rents generated – in hard currency – by gas export sales to the West, with few questions asked.

Throughout ten densely packed chapters, Gaddy and Ickes weave an elegant and subtle, but at the same time forceful, argument. This centres on four key themes. Firstly, there are the unhelpful initial conditions that Russia had to face as it began its process of transition, especially the degree to which value adding activities in Russia were concentrated in the resource sectors (oil and gas above everything else), and the major welfare functions performed by hopelessly uncompetitive enterprises. Secondly, the way in which the impermissible nature of the consequences of serious reform policies (for the political class, the reconstructed entrepreneurial *nomenklatura* and the populace at large) doomed them to failure. Thirdly, there is the manner in which this in turn prompted behavioral adaptation by agents in the economy, giving rise to a mutant system with laws all of its own (chief amongst which is that those who try to play by the normal rules of the market will end up paying a terrible price relative to those who decide to play by the mutant system's bizarre rules). And finally there is the insidious pervasiveness of non-capitalist relations of production revolving around a 'loot chain' that produces and

distributes goods and services in and for the virtual economy, and whose key input (aside from unpaid energy) is the 'good will that [through coercion, political maneuvering, bribery, deception or whatever else] can be translated into the ability to continue to engage in production and exchange' (p. 56) by firms, without their having to incur the capital expenditure required to produce truly marketable goods. Summarising the contents of this complex albeit rich and rewarding book in any greater length than this would be doing in a disservice, though. Suffice it to say that it should be an obligatory future reference for anyone with even a passing interest in Russia. The vast number of potential readers to which this description applies seems to this reviewer to be nothing less than what the book deserves.

Although Gaddy and Ickes constantly remind the reader of the oil and gas sector's central key role as value pump in the virtual economy, they do not go into great detail as to what the virtual economy means for actors in this sector, apart from the fact that it makes it difficult for them to ever collect payments. Given the readership and objectives of this journal, it makes sense to spell out some other significant implications. Consider the issue of the competitiveness of the Russia oil industry. There is a widespread perception that these companies enjoy a very favourable cost structure. According to Morse and Richard, for instance, 'as long as costs are largely rouble-denominated and the rouble is stable, Russian industry is protected from low oil prices, while capital investment flows are sheltered from price volatility' (p. 31). After reading Gaddy and Ickes, one might beg to differ with this viewpoint, though. After all, many of the supposedly low cost rouble-denominated inputs used by Russian oil companies are produced and exchanged in the virtual economy, which means that their low rouble price is a fiction, and that investments which are predicated on their costs will be hostage to Gazprom not deciding to pull the plug on its delinquent accounts (and the problem with this, in turn, is that Gasprom has to invest heavily itself in the near future to stave off its production decline, which might mean that the day of reckoning for many firms may be approaching fast). Also, let us not forget that P/L figures are rendered meaningless when companies have the option of liquidating their obligations in kind with goods whose worth they have deemed themselves. For example, what should one make of the 1997 net income after tax figures of the Middle Volga Chemicals Plant (whatever these figures might have been), when one knows that the plant met some of its tax liabilities (in this case, overdue contributions to the State Unemployment Fund) by shipping to a destitute region ten tones of toxic waste which it shamelessly valued at 400 million roubles (p. 176)? And it is by no means the case that this intractable accounting problem only rears its ugly head where obscure and unimportant entities are involved: in an appendix to the book where Gaddy and Ickes review the findings of the special interagency commission created to study the problem of nonpayment of cash to the federal and regional budgets (known as the Karpov commission), one can see that among the most important cash-earning enterprises that were allowed to pay their taxes in noncash form is Samaraneftegaz, which is of course an integral and important part of Yukos, supposedly the most Westernised of all the Russian companies (pp. 247-50).

Take also the idea that the Russian government is somehow less fiscally dependent on oil export revenues than that of, say, Saudi Arabia. Gaddy and Ickes vividly demonstrate that a large part of the non-oil 'taxes' that the Russian federal government supposedly levies (and from which believers in its fiscal diversification obviously draw

much comfort), amount to nothing more than a particularly ramshackle Potemkin village (to use a Russian metaphor) behind which cowers a hungry and naked emperor. This reviewer's favourite example concerns the arrangement whereby a group of construction companies, deeply in arrears on their taxes to the local and city governments in Chelyabinsk, concocted a complicated scheme that saw the federal government canceling these tax arrears to offset overdue federal contributions to the Chelyabinsk oblast, in exchange for the construction (albeit highly unlikely completion!) of a subway system for that city (pp. 172-73). This case poignantly underscores how rare it is for the Russian government to hear the reassuring clink of metal upon metal when anything other than oil and gas taxation is involved, as a very high proportion of enterprises in what Morse and Richard somewhat uncritically call an 'economy governed by market forces' simply 'dump on the government whatever they happen to produce – whatever is easiest, cheapest – not what the society says it wants and needs arranged', all of it overpriced to a degree that 'is never clear to the outsider' (p. 173). This also explains why, now that the lame-duck and rudderless Yeltsin regime has left the stage, the Russian government has suddenly lost all of its previous enthusiasm for production sharing agreements (PSAs): cognizant of the fact that levies based on net income lend themselves quite well to tax optimization practices, it has wisely chosen to stick with more regressive gross income levies, reasoning that one bird in hand is worth more than five on the wing (as the latter will only be too happy to join the flock of fugacious taxpayers. Thus, companies who want to see a fully-fledged PSA regime in place before going into Russia should probably not hold their collective breath in anticipation of a positive outcome, lest they come down with a terminal case of anoxia (of late, BP has bravely decided to grab this particular nettle, in a bet played for the highest possible stakes). *Ditto* for those waiting for the government's hold on Transneft to be relaxed.