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## Postrevolutionary Stabilization: 1999–2003

Moscow was awful in September 1998.<sup>1</sup> The financial system had stopped functioning. Credit cards and the many ATMs could no longer be used. I was organizing an international conference in Moscow, and we had to pay for everything with cash. The ruble had collapsed, and hyperinflation was an evident threat. The talk of the town was whether Russia's market economy experiment had failed. The *New York Times Magazine* carried an article by John Lloyd (1998) titled "Who Lost Russia?" Russia's postcommunist transformation looked like a complete failure.

On August 23, 1998, six days after Russia's financial crash, President Yeltsin sacked Prime Minister Sergei Kirienko and his cabinet. The public mood called for old, experienced hands. Yet, when Yeltsin nominated Viktor Chernomyrdin, whom he had dismissed five months earlier, Moscow laughed in sad disbelief. Had Yeltsin lost his senses? Few were as guilty for the August crash as Chernomyrdin. The communist-dominated Duma turned Chernomyrdin down twice. On September 10, Yeltsin reconsidered and nominated his minister for foreign affairs, Yevgeny Primakov, who had previously been head of SVR, Russia's foreign intelligence service. Primakov was the single survivor from Gorbachev's time and close to the communists, who happily confirmed his appointment the next day.

Primakov formed a cabinet tainted by Soviet nostalgia. Nikolai Ryzhkov's old chairman of Gosplan, Yuri Masliukov, an unreformed communist, was appointed first deputy prime minister for economic affairs. Viktor Gerashchenko became chairman of the central bank for the third time, as if

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1. Overall references for this chapter are Baker and Glasser (2005), Shevtsova (2005), and Jack (2004) for politics; and Åslund (2004) for economics.

he had not done enough damage already. Gennady Kulik, my old antireform friend from the Soviet Ministry of Agriculture, became deputy prime minister for agriculture. The prime minister and the Duma had taken over power, marginalizing Yeltsin. Yet, quite a few ministers remained in office, notably Mikhail Zadornov as a sensible minister of finance.

Rarely has a situation turned into its opposite faster than after August 1998. Russia's market economy had not failed but graduated. Its apparent devastation was nothing but a catharsis. Finally, Russia attained sound financial stabilization and steady economic growth started.

The last year of Yeltsin's presidency, 1999, saw no fewer than three prime ministers, and Yeltsin selected the last of them, Vladimir Putin, as his successor. Putin started a relentless rise in popularity and power. His advance was driven by dark events—the bombing of apartment houses with hundreds of victims, and a large armed incursion into neighboring Dagestan by Chechen rebels. The Kremlin used these tragedies to justify a second war in Chechnya that was as brutal and bloody as the first one. Putin used this war as his election campaign.

The Duma elections in December 1999 and the presidential elections in March 2000 were nothing but Putin's coronation, and the newly elected president used this mandate to impose major changes. Politically, Putin favored centralization and authoritarianism. He broke the back of the media oligarchs, chasing them into exile, while gradually consolidating his power. The Russian federal-regional relations had never worked well, and Putin chose a far-reaching recentralization, which he called strengthening the "vertical of power." Economically, however, Putin promoted market reforms. The many unfulfilled reform projects were put into a comprehensive reform program, and many impressive reforms were undertaken. Putin also launched an extensive judicial reform that he called "the dictatorship of law." Russia undertook serious attempts to join the World Trade Organization (WTO) as well.

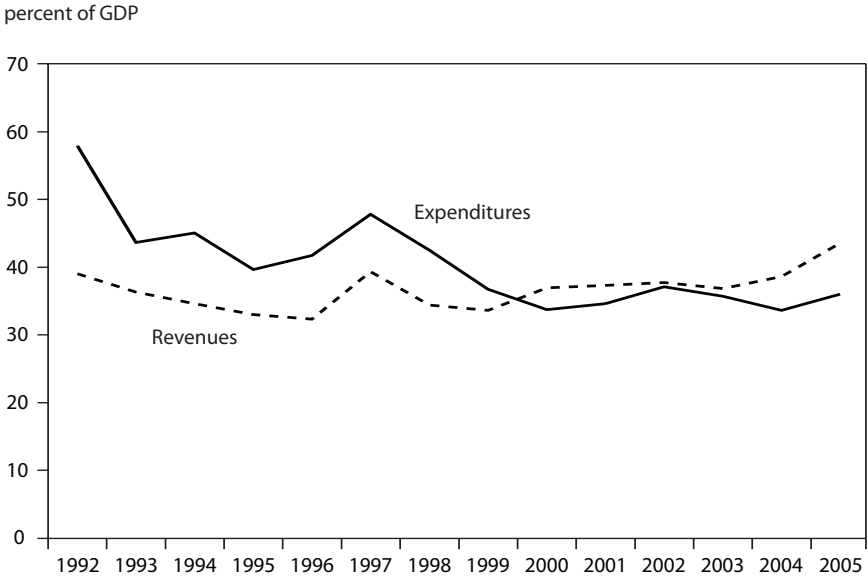
The Russian state was back. Putin had turned the tables on the oligarchs, and he had consolidated power, but the question remained: What kind of Russia did he want to build?

## **Finally Financial Stabilization**

During the first half-year after the crash of August 1998, the new Primakov government did not really have any policy. It was governed by necessity and prior reform proposals, especially the substantial program the Kirienko government had concluded with the IMF and the World Bank in July 1998.

The default forced vital fiscal reforms upon the country. As no financing but tax revenues was available any longer, the budget deficit had to be eliminated. Renewed external default loomed if the government failed

**Figure 6.1 Consolidated state revenues and expenditures, 1992–2005**



Sources: EBRD (2000, 205; 2003, 187; 2005, 173; 2006, 169).

to service the country's foreign debt. Russia's apparent political inability to balance its budget disappeared because the only alternative was hyperinflation, which nobody wanted. Hence, no money was available for the expensive public investment program or for industrial subsidies, which Masliukov spoke about, or even for prior social transfers. The government imposed new controls over both revenues and expenditures.

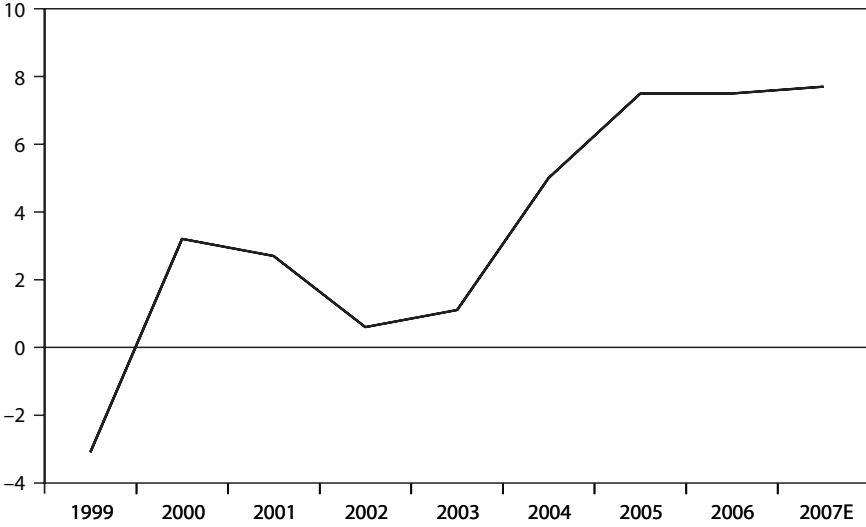
First, the Primakov government undertook a major fiscal adjustment entirely through expenditure cuts, slashing Russia's consolidated state expenditures by no less than 14 percentage points, from 48 percent of GDP in 1997 to 34 percent of GDP in 2000. All arguments about the impossibility of reducing public expenditures fell by the wayside. Enterprise subsidies of little or no social benefit were eliminated, which leveled the playing field for Russian business. Much more controversial was the reduction of real pensions by about half from the summer of 1998 to early 1999, by not allowing them to rise with inflation.

Revenues, by contrast, varied little (figure 6.1). The previously chronic budget deficit turned to the opposite. Since 2000, Russia has had persistent budget surpluses (figure 6.2).

Second, the financial crash reinforced central state power. The watershed was the budget of February 1999. It stipulated that offsets could no longer be used for payments to the federal government, which hit big corporations and regional governments (Owen and Robinson 2003, 37–38).

**Figure 6.2 Budget surplus, 1999–2007**

percent of GDP



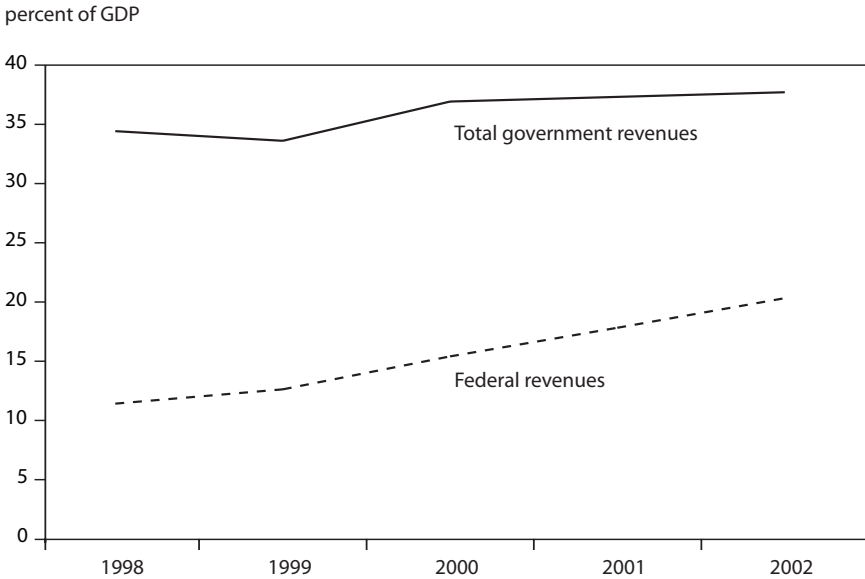
E = estimate

Sources: EBRD (2005, 173; 2006, 169); Bank of Finland Institute for Economies in Transition, Russia statistics, [www.bof.fi](http://www.bof.fi) (accessed on July 31, 2007).

From 2000, the requirement of only cash payments was imposed at the regional level, and the government ordered public utilities to do so as well. Bankruptcy legislation had long been on the books, but helped by a new aggressive bankruptcy law of 1998, the government started pursuing its claims with rigor. Barter and offsets were eliminated, clearing up chains of arrears. Barter payments between Russian industrial enterprises fell from a peak of 54 percent of all interenterprise payments in August 1998 to 14 percent in the fall of 2001, because barter had become unprofitable (figure 5.2). Large enterprises could no longer extract tax rebates through offsets, and regional governors could not divert federal funds. Arrears of pension and state wages dwindled. The monetization also leveled the playing field. As a result, many enterprises changed ownership, which revived them. Typically, old managers were forced to sell to hungry young entrepreneurs at rock-bottom prices.

Third, the Primakov government continued the tax war on the oligarchs that the reformers had launched in 1997–98, and the newly strengthened state could beat the weakened oligarchs. The government started applying the tax laws to big enterprises, especially the oil and gas companies, which had previously enjoyed individually negotiated taxes.

**Figure 6.3 Total and federal state revenues, 1998–2002**



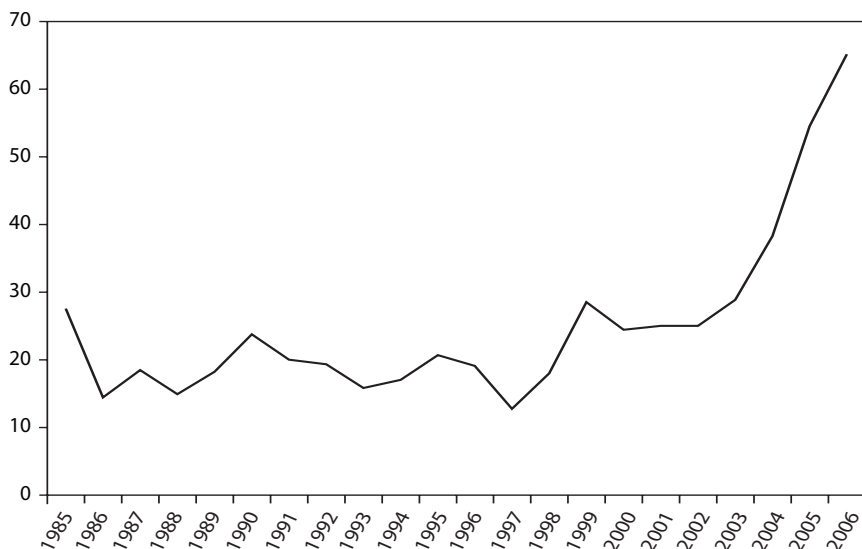
Sources: Bank of Finland Institute for Economies in Transition, Russia statistics, [www.bof.fi](http://www.bof.fi) (accessed on June 20, 2007); EBRD (2006, 169; 2004, 169).

A fourth measure was a radical centralization of government revenues to the federal government from both the regions and extrabudgetary funds. Federal revenues almost doubled from 11 percent of GDP in 1998 to 20 percent in 2002 (figure 6.3). The powers of the federal treasury were reinforced through the adoption of the new budget code in 2000. All state agencies had to make all their transactions through accounts with the federal treasury (Diamond 2002). Some extrabudgetary funds were abolished and all were put under federal treasury control. The previously sizable road fund and the small employment fund were eliminated, while three social funds (pension fund, medical insurance fund, and social insurance fund) were financed by a unified social tax collected by the new tax ministry, which further enhanced the federal government's leverage (Owen and Robinson 2003, 34–39). Russia's fiscal dimensions became reminiscent of the United States, with total fiscal revenues of about one-third of GDP and federal revenues of some 20 percent of GDP.

The federal treasury was also reinforced by the vagaries of the world market. With the devaluation, foreign trade taxes, which were valued in foreign currency, increased sharply. In addition, the government introduced high export tariffs to tax the natural resource companies. The wind-fall gains from rising world oil prices went to the federal treasury. The international oil price that had touched \$10 a barrel during Russia's misery

**Figure 6.4 Spot crude oil price, 1985–2006**

Brent, US dollars per barrel



Source: BP historical data, [www.bp.com](http://www.bp.com) (accessed on July 18, 2007).

in 1998, began a relentless rise to \$70 a barrel in 2006 and 2007. However, it lingered around \$25 a barrel until 2003, so high oil prices did not cause Russia's fiscal cleanup or economic growth (figure 6.4).

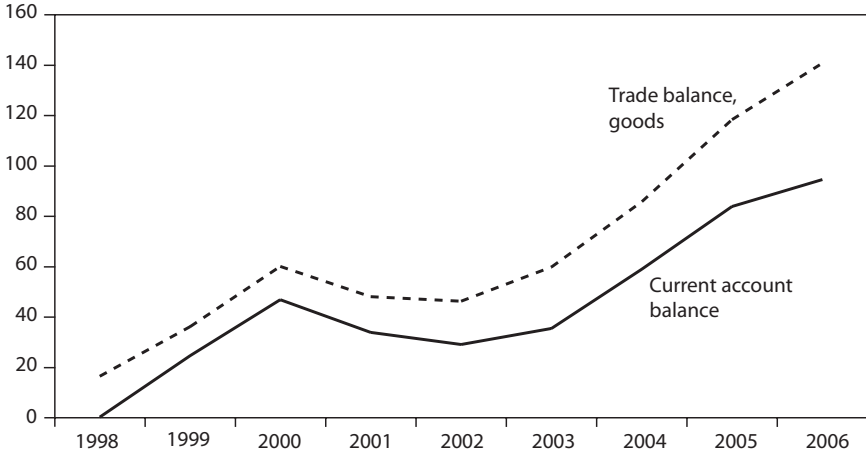
Trade and current account surpluses increased sharply and are still rising (figure 6.5). Russia's public foreign currency debt fell from 100 percent of GDP in early 1999 to 9 percent of GDP at the end of 2006, and its international reserves have reached a reassuring level exceeding \$400 billion in the spring of 2007, the third largest in the world (figure 6.6). The sharp devaluation kickstarted the economy and helped put the foreign account right. Russia also received a windfall gain of about \$60 billion as its default on its domestic treasury bills (GKO) left it with minimal liabilities.

The financial stabilization, monetization, and devaluation were the main catalysts for Russia's high and steady growth of nearly 7 percent a year from 1999 (figure 6.7). All the main requirements of economic growth that Gaidar had formulated were finally in place: "macroeconomic stability and low, predictable rates of inflation, and open economy plus access to promising markets, clear-cut guarantees of property rights and a respectable level of financial liability, high levels of individual savings and investments, and effective programs to aid the poor and to maintain political stability" (Gaidar 1999, 210).

Russia had a steady government budget surplus, but inflation continued apace in the low double digits until 2006 (figure 6.8), because of the

**Figure 6.5 Trade and current account balances, 1998–2006**

billions of US dollars

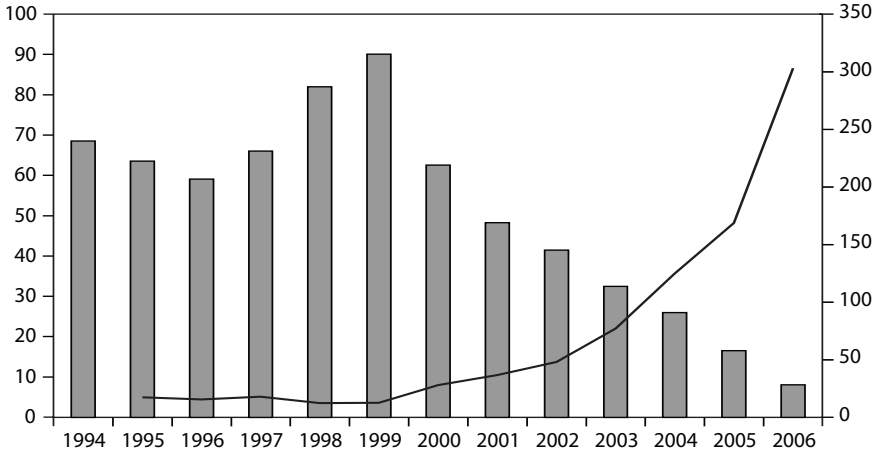


Source: Bank of Finland Institute for Economies in Transition, Russia statistics, [www.bof.fi](http://www.bof.fi) (accessed on May 30, 2007).

**Figure 6.6 Public debt and international reserves, 1994–2006**

percent of GDP

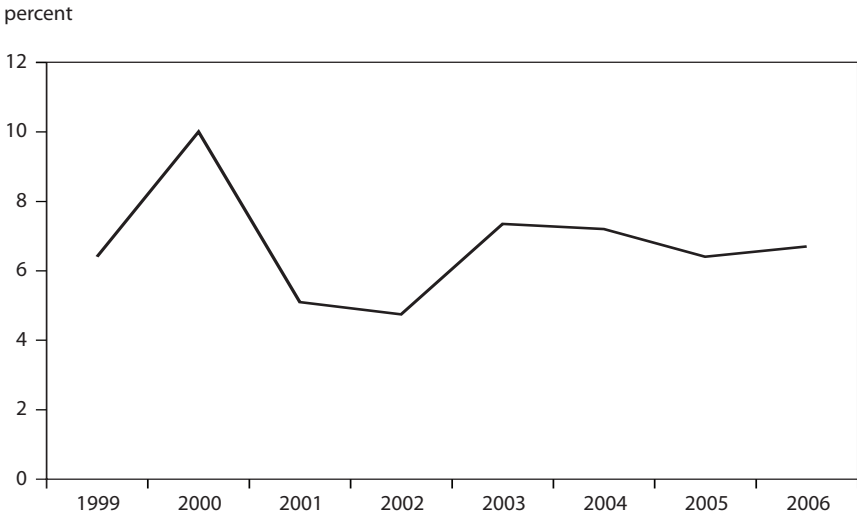
billions of US dollars



Note: The bars show public debt as percent of GDP (left axis). The line tracks international reserves in billions of dollars (right axis).

Sources: Bank of Finland Institute for Economies in Transition, Russia statistics, [www.bof.fi](http://www.bof.fi) (accessed on May 30, 2007); EBRD (2006, 169; 2005, 173; 2004, 169; 2003, 187; 2002, 193).

**Figure 6.7 GDP growth, 1999–2006**



Source: UN Economic Commission for Europe online database, [www.unece.org](http://www.unece.org) (accessed on May 23, 2007).

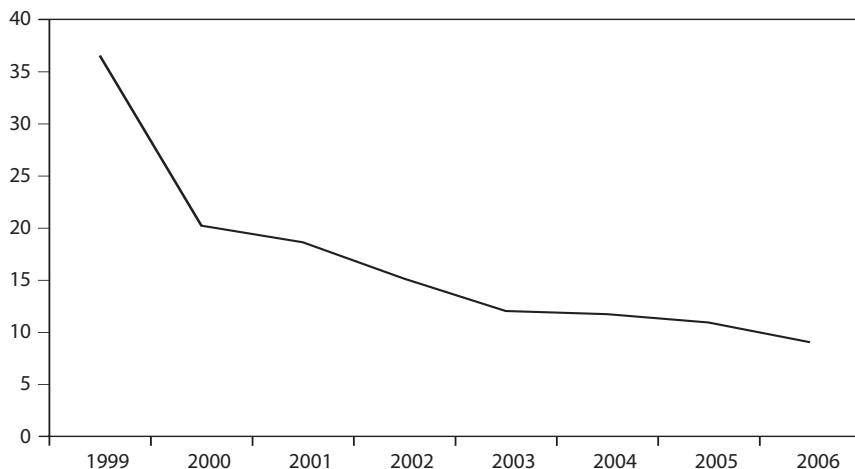
huge current account surplus, which boosted the money supply, and the Balassa-Samuelson effect, which states that the productivity of tradable goods rises faster than the productivity of domestic goods and services. Therefore, the prices of nontradable goods and services rise to compensate their producers on the common labor market. Frightened by the apparent overvaluation of the ruble in 1998, the government kept the nominal exchange rate low by buying international reserves, but it could do little about the real exchange rate, and the lasting high inflation reflected the real appreciation of the ruble.

After the crash of August 1998, all enterprises faced hard budget constraints and the playing field was leveled. The minimization of enterprise subsidies and the improvement of payment morals benefited small and medium-sized businesses as well as the federal government. The regional barriers that had been almost insurmountable even for the big industrial groups broke down after 1998 (Dynkin and Sokolov 2002).

Not everything was done right. Gerashchenko was back as Russia's central banker. He did not restart excessive monetary emission, but he nationalized most of the banking system by offering privileges to state banks. Initially, only the state savings bank (Sberbank) guaranteed deposits, and the state banks were offered substantial discretionary credits, whereas most big private banks collapsed. As a consequence, Russia's bank system would be state-dominated for the foreseeable future.

**Figure 6.8 Inflation rate, 1999–2006** (consumer price index, end year)

percent



Source: Bank of Finland Institute for Economies in Transition, Russia statistics, [www.bof.fi](http://www.bof.fi) (accessed on May 30, 2007).

The financial stabilization shifted power over economic policy. The main losers were old managers and oligarchs, who had lived on subsidies and tax rebates extracted through barter or collusion with the government. The regional governors also lost both power and financial resources to the federal government. A third group of losers was the communists, who were marginalized by the Duma elections in December 1999. Their ideology of extensive government intervention had failed, giving way to a more liberal ideology. Before the Duma elections in December 1999, the communists revised their party program to embrace the market economy.

The August 1998 crash had broken the overwhelming resistance that had kept market economic reforms at bay since 1994, as suggested by Drazen and Grilli (1993). For the first time, a clear majority for a free market economy prevailed in the Duma. After years of vacillation, Russia started undertaking one big reform after another. Putin is often praised for these achievements, but the financial stabilization was undertaken in 1998–99 before Putin became prime minister, and Russia was already growing fast. Putin was lucky to arrive at a laid table.

## President Yeltsin's Final Days

Yeltsin had been counted out many times, but he was an old fox, who did not give up. In the spring of 1999, when Russia's economic recovery be-

came evident, conflicts between Yeltsin and Primakov were mounting. Primakov showed no loyalty to Yeltsin, whom he clearly intended to succeed as president, but his anti-Western and procommunist values were alien to Yeltsin. Primakov had also instigated corruption investigations against Berezovsky, publicly threatening him, and the investigation could touch the Yeltsin family.

In March 1999, the Kosovo crisis erupted. Yugoslav President Slobodan Milosevich invaded Kosovo, and NATO bombed Yugoslavia. Russian public opinion was pro-Serb and appalled. Primakov was more critical of the West than Yeltsin, who sent his loyal Chernomyrdin to persuade Milosevich to give up, which succeeded. Yeltsin had outflanked Primakov.

In the Duma, the communists wanted to impeach Yeltsin on purely political grounds, and Primakov did nothing to oppose them. This was the last straw for Yeltsin. On May 12, he sacked Primakov. As his replacement, Yeltsin nominated Minister of Interior Sergei Stepashin. He was a Yeltsin loyalist who had held numerous senior positions, including chairman of the FSB. Although he had made his career in the ministry of interior, Stepashin was relatively liberal and friendly with almost everybody. The Duma accepted his candidacy.

Stepashin was supported by Anatoly Chubais, but he was challenged by the Minister of Railways Nikolai Aksenenko, who was promoted by Berezovsky and Roman Abramovich. Aksenenko was seen as extremely corrupt. It was rumored that he had bought his post as minister of railways for \$70 million in an outright auction organized by the presidential administration.<sup>2</sup>

At this time, everybody talked about “the family,” which meant the Yeltsin family and a few close officials and businessmen. The backbone of the family was Yeltsin’s daughter Tatyana Dyachenko and his former chief of staff Valentin Yumashev, soon to be Tatyana’s husband. The two top businessmen in “the family” were Berezovsky and Abramovich, and the foremost officials were Yeltsin’s new chief of staff, Aleksandr Voloshin, and the new minister of finance, Mikhail Kasyanov, but “the family” was a flexible concept. The reformers, led by Chubais, Boris Nemtsov, and Yegor Gaidar, were rivals of “the family,” which was perceived as anticommunist but corrupt. Yeltsin himself was seen as close to “the family” but above the fray.

On May 15, 1999, the communist-dominated Duma impeached Yeltsin on five charges. He was accused of having unconstitutionally broken up the Soviet Union in 1991; illegally shelled the Supreme Soviet in 1993; permitted the deterioration of the military; allowed genocide through the massive rise in Russian mortality rates; and started the illegal war in Chechnya in 1994.

The communists failed to mobilize the necessary two-thirds majority, because the presidential administration resorted to gross bribery. Vladi-

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2. Personal information obtained during a trip to Moscow, May 23–28, 1999.

mir Zhirinovskiy had developed the habit of selling his LDPR faction's votes wholesale, and his large faction was absent (Klebnikov 2000, 291–92). It was rumored that individual deputies sold their votes for \$30,000, a new record. The payments were made by private businessmen close to the presidential administration. Political corruption was becoming pervasive. This was the communists' last act of defiance.

At this time, Moscow Mayor Yuri Luzhkov emerged as the mainstay of opposition to Yeltsin. Luzhkov had been mayor since 1992 and largely loyal to Yeltsin. Until 1998, he had not engaged in national politics, gaining popularity as an effective, apolitical, and unscrupulous manager of Moscow City. Luzhkov secured his popularity by not allowing any criticism of himself, suing anybody who criticized him for libel, and he always won since he controlled the Moscow courts.

After Primakov's demise as prime minister, he and Luzhkov formed an alliance, calling their centrist political party Fatherland-All Russia. They mobilized numerous governors for their budding party of power. Yeltsin and "the family" felt threatened. On August 9, 1999, Yeltsin fired Stepashin and nominated Putin as prime minister, and he was swiftly approved by the Duma.

## **Vladimir Putin: KGB Lieutenant-Colonel**

Vladimir Putin was everything that the Russian revolution was not. He had no clearly pronounced political views and his greatest loyalty was to the KGB. One of the great ironies of the Russian revolution was its hijacking by Putin, and that he was Yeltsin's choice. Like so many successful politicians, his greatest quality was his ability to make people underestimate him. Another skill was to flatter his superiors. The mystery is that this forgettable mediocrity of dubious reputation advanced to become president of Russia. His rise signaled that Russia's democratic revolution was over, and that the country had entered the stage of postrevolutionary stabilization, when people were tired of politics and wanted little but calm and economic growth (Mau and Starodubrovskaya 2001).

Putin's main claim to fame was that he had been first deputy mayor of St. Petersburg, 1991–96, under the democratic mayor Anatoly Sobchak. After Sobchak lost the mayoral elections in May 1996, Putin had little choice but to move to Moscow. He ingratiated himself with Pavel Borodin, the powerful Kremlin property manager and Yeltsin's drinking buddy, who had a reputation of being particularly corrupt. Borodin made Putin his deputy (Baker and Glasser 2005, 47–48). Klebnikov (2000, 295) observed: "Borodin's department seemed to epitomize the corruption of the Yeltsin government." From 1999, Swiss prosecutors sought him for kickbacks of \$25 million in connection with the renovation of the Kremlin (Baker and Glasser 2005, 91). Putin was also helped to the

Kremlin by Aleksei Kudrin, another first deputy mayor of St. Petersburg under Sobchak.

In the presidential administration, Putin was noticed and appreciated by Yumashev, who became Yeltsin's chief of staff in 1997. Yumashev introduced Putin to Berezovsky. Putin's big break was when Yeltsin promoted him to chairman of the Federal Security Service (FSB) in July 1998. Putin had two features that were attractive to Yeltsin and the "family": he was loyal and tough. He had proved his loyalty by standing with Sobchak until the end. In early 1999, Prosecutor General Yuri Skuratov investigated corruption of Yeltsin's "family," opening several criminal cases, including one against Berezovsky. When Berezovsky's ORT responded by broadcasting a videotape with a naked Skuratov indulging himself with two equally bare prostitutes, Putin publicly vouched for its authenticity. He had proved his loyalty and firmness to Yeltsin.

Five people selected Putin: Yumashev, Tatyana, Berezovsky, Abramovich, and Voloshin, the heart of "the family." Chubais, by contrast, made a desperate attempt to retain Stepashin (Klebnikov 2000, 297; Baker and Glasser 2005, 50–53). In his last memoirs, which were considered largely ghostwritten by Yumashev, Yeltsin (2000, 327, 329) made these implausible statements:

[T]he more I knew Putin, the more convinced I was that he combined both an enormous dedication to democracy and market reforms and an unwavering patriotism. . . . Putin was the man of my hopes. He was the man I trusted, to whom I could entrust the country.

Possibly, these sentences indicate that Putin was a capable influence agent, reflecting what people wanted to see, but during his last one and a half years as president Yeltsin was so ill that his "family" made many decisions for him (Tregubova 2003).

Putin's background is uncommonly devoid of attractive features and is outright frightening. Whereas both Gorbachev and Yeltsin had close relatives who had suffered under Stalin's repression, Putin's grandfather had been a cook at one of Stalin's dachas, which was an NKVD job. During World War II, Putin's father had served in the infamous NKVD troops, who killed Soviet soldiers that did not advance fast enough.<sup>3</sup> Putin was a lone, late child to old, austere, and poor parents living in a "communal" apartment, shared by several families, in Leningrad. He grew up as a semicriminal streetfighter not even accepted into the pioneers, which almost all Soviet children were. As a student, Putin was mediocre. His highest aspiration was to join the KGB, which he did as soon as he could. In its service, he participated in the persecution of dissidents in Leningrad and the spying on foreign visitors, which he described with delight in his interview book *First Person* (Putin 2000, 41–42, 49–50).

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3. NKVD was the predecessor of the KGB.

In the KGB, Putin was no success. He was not sent to the challenging West, but to East Germany, and even there he was sent to the backwater of Dresden. After six years of undistinguished service, he was disposed of into the reserve as a mere lieutenant-colonel, a near failure (Baker and Glasser 2005, 40–43).

Back in his hometown, however, Putin made two masterstrokes. First, he turned to his old professor at the Leningrad State University, Anatoly Sobchak, who was about to be elected the democratic mayor of St. Petersburg. Putin rose with Sobchak, becoming first deputy mayor of St. Petersburg, 1991–96.

Second, Putin made good use of the many business opportunities in Russia's biggest port city after the collapse of communism. His responsibilities as first deputy mayor—foreign trade and foreign direct investment—were among the most corrupt spheres in Russia's criminal capital. A prominent liberal politician in St. Petersburg, Marina Salye, investigated Putin's licensing of exports of \$92 million of oil products, timber, metal and other goods in exchange for imported food in 1992, alleging gross embezzlement. Her report was never made publicly available, and Salye has disappeared from the public eye (Baker and Glasser 2005, 47).

According to the Finnish government, Putin visited Finland 60 to 70 times during his five years as deputy mayor, and the Finns investigated his links with organized crime in Turku, Finland.<sup>4</sup> Both Swedish and Finnish businessmen complained about Putin squeezing out their companies, mainly through persecution by the lawless tax police, to the advantage of companies with which Putin was friendly.<sup>5</sup> Several of his close collaborators worked in the St. Petersburg Port, which was considered to be run by the Tambov group, the dominant mafia group in the city. Apparently, it merged with the city administration.<sup>6</sup> Several visitors noted with surprise that Putin did things without asking for a bribe, which was uncommon for such an official, but he appears to have focused on major deals.<sup>7</sup> Putin has never been prosecuted for corruption, but nor has any other Russian official that remains in a high position.

Yeltsin's selection of Putin was probably his greatest mistake. To the extent he made decision himself, he seems to have been preoccupied with loyalty to his family and the ability to win elections. Putin's values seemed

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4. Personal information from four senior Finnish diplomats.

5. The most prominent example was Grand Hotel Europe, whose Swedish management company Putin forced out with the tax police.

6. Dixelius and Konstantinov (1998), Volkov (2002), and information on the Gazprom management board from Gazprom's official website, [www.gazprom.com](http://www.gazprom.com) (accessed on June 30, 2007).

7. Personal information from annual visits to St. Petersburg.

to be a subordinate issue to Yeltsin, but as Yeltsin belatedly would realize, when he became healthier after retirement, they were the opposite of Yeltsin's.<sup>8</sup>

## The Second Chechnya War

In the summer of 1999, Russia was marred by strange and tragic events. On August 7, several thousand armed men, led by the feared Chechen warlord Shamil Basayev and an Arab commander known as Khattab, staged an armed incursion from Chechnya into the neighboring Russian region of Dagestan. Their proclaimed goal was to unite the two republics as an Islamic state. They encountered little Russian resistance and quickly captured several villages. Two days later, Yeltsin replaced Stepashin with Putin as prime minister.

On September 4, an apartment building in the Dagestan town of Buinaksk was blown up, killing 58 people; on September 9, an apartment block in a working-class district of Moscow exploded, killing nearly 100 people; and four days later another Moscow apartment block was bombed, killing another 124 people. Finally, on September 16, a last apartment bombing occurred in Volgodonsk. More than 300 people died in these four residential bombings, which all occurred in the middle of the night to maximize the number of victims. These terrorist bombings were truly shocking, being so ruthless and unexpected. The otherwise calm Russians were close to panic. Nobody ever claimed responsibility, but Russian politicians blamed Chechen terrorists, arousing popular support for a second military campaign against Chechnya (Jack 2004).

After the Khasavyurt armistice was concluded in August 1996 by then-secretary of the Security Council Aleksandr Lebed, Yeltsin and Chechnya's President Aslan Maskhadov signed a formal peace treaty in May 1997. But Maskhadov failed to impose any state authority in Chechnya, which was outright criminalized, a hideout for criminals and illegal trade. Kidnappings and even slave trade proliferated. The promised Russian aid to repair the destruction from the 1994–96 war never arrived, or was stolen.

As a result, radical factions in the Chechen separatist movement grew stronger, and the Chechen independence movement fractured over the role of Islam and relations with Moscow. In early 1999, Maskhadov announced that Islamic shariah law would be introduced gradually, which aggravated tensions with Moscow. The official pretext for the second Chechen war was retaliation for the invasion of Dagestan and the Russian

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8. Several confidants of Yeltsin reported that he had the most devastating things to say about Putin during his last years.

apartment bombings. Its goal was to eliminate Chechnya's de facto independence (Trenin and Malashenko 2004).

Chechen motivations for the attack on Dagestan remain unclear. Basayev might have tried to consolidate his influence in Chechnya and replace Maskhadov. Some suspect that Basayev's incursion into Dagestan was paid by Russia's FSB, which sought a pretext to launch an already planned invasion into Chechnya (Trenin and Malashenko 2004). In 2000, Stepashin told *Nezavisimaya Gazeta* that plans for invasion were drawn up in March 1999, and would have proceeded even without official pretext. Members of the Maskhadov government insisted that they repeatedly warned the Russian authorities of the upcoming attack. Although the Russian intelligence most likely knew about the raid in advance, they actually withdrew border guards just before the raid (Jack 2004, Baker and Glasser 2005).

The apartment bombings remain even more enigmatic. A number of *wahhabis* (fundamentalist Muslims) from Dagestan were sentenced to prison for the bombings, but innocent people are often jailed in Russia. Basayev usually claimed responsibility for his terrorist acts. Some suspect that the FSB carried out these bombings to create a populist wave of support for Putin that would sweep him into office (Jack 2004, 103–104).

In the Russian city of Ryazan, the authorities at first claimed that they had averted a similar terrorist bombing, but then police and journalists discovered that the preparations had been undertaken by nobody but the FSB. The hexogen explosives to be used in Ryazan were the same as in the Moscow, Volgogradsk, and Buinaksk bombings. Once the FSB involvement became known to the authorities, they confiscated all evidence, including the hexogen bags. The new Chairman of the FSB, Nikolai Patrushev, a friend of Putin from the Leningrad KGB, claimed that they contained only sugar and that the averted bombing was a training exercise (Baker and Glasser 2005, 55). According to David Satter (2003, 33), "it seems very plausible that the successful bombings of the buildings in Moscow, Volgogradsk, and Buinaksk, in which hundreds died, were also carried out by the FSB." After the Ryazan revelation, the bombings stopped as mysteriously as they had started.

In August 1999, Putin asserted, almost as foolhardily as Minister of Defense Pavel Grachev had in 1994 before the first Chechen war, that the second conflict "will be resolved within a week and a half or two" (quoted in Baker and Glasser 2005, 54). He turned the war in Chechnya into his election campaign.

Russia started a full-blown military offensive first in Dagestan and then on Chechnya. On September 24, Russia launched the second Chechnya war. Both sides committed widespread human rights violations during the conflict, as the civilian population got caught in vicious clashes between federal forces and rebels. Russian troops drew international condemnation for forced disappearances, extrajudicial, summary, and

arbitrary executions, looting, torture, and other abuses. Russian soldiers regularly conducted *zachistki* (cleansing) operations in which many Chechens were summarily executed for the mere suspicion of sympathies with the rebels. The exact death toll from this conflict is unknown, but the likely losses were in the tens of thousands of Chechen civilians dead or missing. Official sources put the number of Russian military casualties at 4,249 dead, with the number of separatists killed at about 13,000, but human rights activists maintain that the losses were much greater (Shevtsova 2005, 251).

Putin developed a steely strongman attitude to the Chechen “terrorists.” One statement came straight out of criminal jargon: “We will pursue the terrorists everywhere. . . . [I]f we catch them in the toilet, we’ll wipe them out in the outhouse” (quoted in Baker and Glasser 2005, 55). Such crude and intemperate statements were to become Putin’s hallmark. He prided himself on having led the war in Chechnya as prime minister, and he said about the war: “I do not have a second of doubt that we are doing the right thing. Maybe we should be even tougher” (Putin 2000, 142).

After relentless bombing, Russian troops took the Chechen capital of Grozny in early February 2000, and acting President Putin declared direct rule from Moscow. Later, he appointed former Chechen mufti Akhmad Kadyrov as the head of the Russian administration in Chechnya, as the Kremlin started a policy of “Chechenization,” gradually transferring power to Chechens loyal to the Kremlin, using rigged elections to ratify its chosen leaders. Large-scale military actions ended in 2002, but guerilla war in Chechnya continues and casualties mount. What was supposed to be a “small, victorious war” turned into a long-lasting dirty war (Politkovskaya 2001).

During this war, Chechens started using suicide bombings in Russia proper, especially in Moscow. Chechen terrorists bombed trains, planes, subways, and other public places. Usually, the suicide bombers were “black widows,” widows of fallen Chechen fighters dressed in black. About 1,000 Russians died in terrorist attacks over 2002–04 (Baker and Glasser 2005, 176).

Most spectacularly, in October 2002, a group of 50 Chechen hostage takers seized a theater in the center of Moscow, a mere three miles from the Kremlin, where the musical *Nord-Ost* was being performed. They held some 900 people hostage and demanded that Russian troops withdrew from Chechnya within one week, but Russian special forces poured a mysterious gas into the building and later stormed it, killing the hostage takers but also 130 hostages, who died because they did not receive adequate medical assistance in time. Television coverage was suppressed (Baker and Glasser 2005, 172).

Afterward Putin expressed his relief: “We achieved the nearly impossible, saving hundreds and hundreds of people. We proved that Russia cannot be brought to its knees.” He remarked briefly: “We could not save

everybody.” Then, he profusely thanked the “special forces, who without hesitation, risked their own lives, while fighting for saving people” (Putin 2002b). Those “heroic” forces, secrecy, and mismanagement had just caused nearly 130 unnecessary deaths.

## **Putin’s Assumption of Power: Elections of 1999 and 2000**

In the summer of 1999, the Yeltsin era seemed to be over. The new party Fatherland-All Russia was gathering the regional elites under the experienced leadership of Primakov and Luzhkov. They expected to win the Duma elections scheduled for December 1999.

But in the fall of 1999, “the family”—Yumashev, Tatyana, Berezovsky, Abramovich, and Voloshin—who had promoted Putin, also decided to form a government party, Unity. This centrist party expressed as few political views as Fatherland-All Russia. Rather than experienced political leaders, it sought well-known and popular nonpolitical personalities as candidates, because Russians were no longer interested in politics. It was a feat of public relations specialists, who were convinced that they could sell anything after Yeltsin’s victory in 1996 (Colton and McFaul 2003, 33–35).

The all-dominant theme during the fall of 1999 was the second Chechnya war, which amazingly turned out to be popular because Russians wanted the Chechens to be punished, in sharp contrast to 1994, when the war appeared to be a Russian mistake. Politically, the second Chechnya conflict was the desired “small and victorious war.” Putin’s popularity rating surged from nothing in August by a couple of percent each week (Shevtsova 2005).

Television dominated the campaign, which became a duel between Russia’s two foremost anchormen, Sergei Dorenko at ORT and Yevgeny Kiselev at NTV. Every Sunday each presided over his own weekly political program. Like his master Vladimir Gusinsky, Kiselev supported Primakov and Luzhkov, and Dorenko promoted Putin and Unity, on Berezovsky’s command. Traditionally, Kiselev had been the star, but this time Dorenko won.

Dorenko’s great advantage was that Luzhkov had prohibited criticism of himself, and few had criticized Primakov. Dorenko dug some skeletons out of Luzhkov’s closet, such as an unexplained murder of an American businessman in 1996 and his wife’s fortune, and he presented Primakov as the retired apparatchik he was. Dorenko had a field day, goading Luzhkov into losing his temper in public and thus undermining his popularity. Neither side used political arguments, because the political consultants argued that Russians were tired of politics (Colton and McFaul 2003).

**Table 6.1 Results of election to the State Duma, December 19, 1999**

<b>Party</b>	<b>Percent of votes</b>
Communist Party of the Russian Federation	24.8
Unity	23.8
Fatherland-All Russia	13.6
Union of Right Forces	8.7
Yabloko	6.1
Liberal Democratic Party of Russia	6.1
Others or against all	17.0
<i>Voter turnout</i>	62.0

Sources: Colton and McFaul (2003, 8); Inter-Parliamentary Union, [www.ipu.org](http://www.ipu.org) (accessed on June 13, 2007).

The communists won the Duma elections on December 19, 1999, with 25 percent of the votes, but it was their last hurrah. The real duel was between Unity, which received 24 percent, and Fatherland-All Russia, humiliated with only 14 percent. Three more parties entered the Duma: Gaidar's Union of Right Forces (SPS) with 9 percent and Yavlinsky's Yabloko and Zhirinovskiy's LDPR, each with 6 percent (table 6.1). The red-brown dominance was broken. For the first time, the Russian Duma had a solid centrist-liberal majority.

SPS and Yabloko expected that Unity would form Duma committees together with them, but Putin preferred an alliance with the communists. The opportunists in Fatherland-All Russia, including Luzhkov himself, soon joined Unity, and Putin had a big ruling party with a near majority in the Duma.

Previously, oligarchs had often bought specific votes from deputies. Now, the presidential administration monopolized its deputies and paid them all a supplementary salary that was initially \$5,000 a month, no longer allowing competition from oligarchs. Zhirinovskiy continued his practice of selling LDPR's votes wholesale, preferably to the presidential administration, for specific votes, but his bargaining position was weakened. Large-scale corruption of deputies by big businessmen continued but only when the presidential administration permitted. The highest payment I heard of was a gross total of \$200 million for major structural legislation.<sup>9</sup>

Yeltsin reckoned he could relax and retire. His chosen successor had proven his electoral acumen. With his sense for the dramatic, Yeltsin de-

9. Multiple private conversations with Russian parliamentarians in 2000–2003; cf. Baker and Glasser (2005, 85).

cided to retire on the last day of the millennium and say farewell to his people with a very personal, televised speech:

I want to ask you for forgiveness, because many of our hopes have not come true, because what we thought would be easy turned out to be painfully difficult. I ask you to forgive me for not fulfilling some hopes of those people who believed that we would be able to jump from the grey, stagnating, totalitarian past into a bright, rich and civilized future in one go. I myself believed in this. But it could not be done in one fell swoop. In some respects I was too naive. . . . But I want you to know that I never said this would be easy. (Yeltsin 1999b)

Russians cheered as they heard of Yeltsin's resignation. They were happy to see this drunken embarrassment go. His preterm departure made Prime Minister Putin acting president. Putin's first act was to sign a decree that granted Yeltsin and his family decent material conditions as well as legal immunity. He followed the example Yeltsin had set, by leaving the former president living well and peacefully in his land. He never reneged on his promise to Yeltsin, as Yeltsin had not abandoned his pledge to Gorbachev.

Putin's new position gave him a great advantage for the presidential elections, which were moved up three months to March 26, because the constitution stipulated they must be held within three months after the presidency had become vacant. The surprise change of the election date made it exceedingly difficult to mobilize any resistance to Putin.

Once again, Gennady Zyuganov was the main competitor in a field of 10 candidates, with Yavlinsky and Zhirinovskiy coming next, but without a chance. Primakov chose not to run. They all looked tired and uninspiring. Putin made a point of not having any election program and of not campaigning, but only pursuing his ordinary work, showcasing his importance. As Lilia Shevtsova (2005, 70) wrote: "The vagueness of Putin's political image made him a *tabula rasa*." His main campaign performance was to fly to Chechnya in an SU-27 fighter plane in the copilot's seat. He won the first round with 53 percent, which corresponded to the opinion polls. Zyuganov obtained barely 30 percent (table 6.2). Since Putin had gained an absolute majority of the votes, no second round was required. Voter participation was respectable at 69 percent. Putin's approval rating hovered around 70 percent, as Russians were happy to see a young and energetic president who was sober and worked hard.

Alas, Yeltsin turned out to be wrong in his optimistic assessment of Putin's values. Yeltsin had talked about democracy without attributes, but soon after his inauguration on May 7, 2000, Putin's concept became known as, "managed democracy" (*upravlyayemaya demokratiya*). It did not sound good, nor was it. Like Gorbachev, Putin chose new words that did not have a clear ideological connotation and gradually altered their meaning. Gorbachev had made his concepts ever more liberal, but Putin did the opposite. Putin's favorite democracy was no democracy, and he moved on to the term "sovereign democracy," which seemed a synonym for authoritarian rule.

**Table 6.2 Results of presidential election, March 26, 2000**

<b>Candidate</b>	<b>Percent of votes</b>
Vladimir Putin	53.4
Gennady Zyuganov	29.5
Grigory Yavlinsky	5.9
Vladimir Zhirinovskiy	2.7
Others or against all	8.5
<i>Voter turnout</i>	68.6

*Sources:* Colton and McFaul (2003, 10); Election Guide, [www.electionguide.org](http://www.electionguide.org) (accessed on June 25, 2007).

Initially, Putin was vague and took a long time to make decisions because he was a micromanager who wanted to know all the details first. He acted slowly but deliberately. After a decision, Putin was adamant. He divided people into friends and foes, and he persecuted his foes without mercy. His psyche had been formed by the KGB. He was extremely suspicious and thought in terms of conspiracy theories. He did not believe in open sources, which he considered disinformation, but only in intelligence. He loathed any dissent, and acted in secret until he made his decision (cf. Shevtsova 2005, 81).

To begin with, he had selected a few themes for immediate action: the war in Chechnya, media control, centralization of federal power, and economic reform. During his first term, Putin continued to be everything to everybody, and he was an avid reader of opinion polls. His selection of national symbols was characteristic: He chose the tsarist double eagle as the coat of arms, the liberal Russian tricolor of 1896–1917 as the flag, and the Hymn of the Soviet Union as the national anthem. Their common denominator was that each of these national insignia enjoyed a popular majority support.

## **Muzzling of the Media**

In the late 1990s, it was an intellectual delight to open one of Moscow's score of daily newspapers or watch the news and analytical programs on the three main TV channels. It was media competition at its best. Journalism had rarely been that good anywhere. Naturally, there were shortcomings. The analytical programs tended to be partisan and opinionated rather than objective, but they balanced one another. The circulation of the outstanding newspapers was limited, harming their finances. The worst shortcoming was that journalists often sold themselves to offer both good

and bad publicity, blurring the line between advertising and journalism. But these were minor concerns.

Gusinsky was an outstanding media entrepreneur. The best TV channel was his NTV and the best radio channel was his Ekho Moskvyy. However, Gusinsky was also highly political. He usually supported Moscow's Mayor Luzhkov and Yabloko leader Yavlinsky, and after 1996 he opposed the Kremlin. Thanks to his support during the 1996 presidential elections, the Kremlin granted Gusinsky's Media-Most company a few hundred million dollars of financing from Gazprom, in return for 30 percent of its stock. Gusinsky's Most Bank collapsed in the financial crash of 1998, and Gazprom helped him out with a loan of \$262 million. Nevertheless, NTV provided critical coverage of the second Chechnya war and supported Luzhkov and Primakov during the 1999 election campaign.

Four days after Putin's inauguration, masked and armed tax policemen stormed Media-Most offices. They harassed Gusinsky, and on June 13 he was arrested on charges of embezzling funds from the state and kept in jail for three days. To regain his freedom, he had to give his media empire away to Gazprom and he fled from Russia for good. The official explanation was that Media-Most was bankrupt, although the company was not under serious duress. Putin, who was traveling in Spain at that time, claimed that he knew nothing (Remington 2006, 230). Yet, he seemed to order the repression in detail. He invited prominent NTV journalists for a meeting, revealing his detailed knowledge. Altogether Media-Most was raided 35 times, which can only qualify as harassment (Baker and Glasser 2005, 82–83, 91–93).

In short, Media-Most, Russia's finest media company, was confiscated for political reasons. Public protests were still possible at that time, but they were limited. Russians were tired of politics, and the confiscation process was so complex and gradual that it was not obvious when to mobilize for a protest. Cleverly, Putin muffled NTV step by step, sacking one manager and journalist after the other.

In 2004, the European Court of Human Rights in Strassbourg tried the case of Media-Most's confiscation in *Gusinsky v. Russia*. That court is attached to the Council of Europe, of which Russia is a member. It found that the prosecutor general of the Russian Federation had used power of incarceration to achieve economic objectives. It established that Gazprom asked Gusinsky to sign a commercial agreement when he was in prison and that a state minister endorsed it and "that a State investigating officer later implemented that agreement by dropping the charges strongly suggest that the applicant's prosecution was used to intimidate him." In sum, Gazprom and Russia's media minister colluded with law enforcement to seize Media-Most. The court ruled that the Russian state had to pay damages to Gusinsky.<sup>10</sup>

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10. *Gusinsky v. Russia*, European Court of Human Rights, May 19, 2004 (Application no. 70276/01), <http://cmiskp.echr.coe.int> (accessed July 30, 2007).

The performance of the Russian state remained miserable. On August 12, 2000, the nuclear submarine *Kursk* exploded in the Barents Sea. Putin was on holiday in Sochi at the Black Sea, and he stayed there. A score of men had survived in the sunken submarine, but nothing was done to rescue them, and the whole crew of 188 men died. In traditional Soviet manner, the military presented one lie after another, but NTV and Berezovsky's ORT, which were still quite independent, exposed the military's and the government's incompetence and lies.

After the tragedy, Putin fumed about television, exclaiming: "They are lying, lying, lying." He attacked the media oligarchs: "There are people in television who bawl more than anyone today and who over the past ten years have destroyed the same army and navy where people are dying today. . . . It would be better for them to sell their villas on the Mediterranean coast of France [Berezovsky] or Spain [Gusinsky]. . . . We would then ask them where the money came from" (quoted in Baker and Glasser 2005, 89–90).

Berezovsky went to the Kremlin and saw Putin, who, according to Berezovsky, told him candidly: "I want to run ORT." In parallel, the authorities were going after his control of Aeroflot. Berezovsky, who had seen Gusinsky's fate and knew more than most, understood that he had better escape abroad. In October, he was forced to sell his shares in ORT to Abramovich, his erstwhile partner, who later passed them on to the state, and Berezovsky wisely left Russia for good (Baker and Glasser 2005, 90–91; Shevtsova 2005, 93–94).

Several excellent NTV journalists, especially Yevgeny Kiselev, made repeated attempts to maintain independent media. The first one was called TV-6 and its majority owner was Berezovsky, but 15 percent of the shares were owned by Lukoil's pension fund, which filed a suit to force TV-6 into bankruptcy, but obviously this was no financial issue (Remington 2006, 230). Kiselev's next attempt at independent television was called TVS and financed by a broad group of oligarchs, but they split under pressure from the Kremlin (Baker and Glasser 2005, 95). Putin also sorted out a few smaller TV channels.

Within a year or so, Putin had suffocated the independent television, and he continued his endeavors deliberately and conscientiously. One newspaper and magazine after the other was bought by businessmen close to the Kremlin, who knew how to please Putin. Not only publishers and editors but also ordinary journalists were persuaded to censor themselves.

Through a painful process, Russia's foremost journalists were excluded from the public eye. They tried one project after the other, which Putin closed down. The old celebrities were replaced by young, pugnacious journalists who entertained rather than informed. Superficially, Putin's dumbing down of the Russian public was reminiscent of the qualitative decline of Western commercial television, but its end result was confusingly similar to Soviet television. By 2007, the only serious electronic media outlet of

significance was Aleksei Venediktov's independent radio channel Ekho Moskvy, which had a star-studded cast, being the only place left where outstanding journalists were allowed to work.

Putin's personal involvement and his aim of full censorship were evident, but he never said so. He always alleged that he knew nothing about the actions of state agencies and that they were independently acting according to the law. He always blamed something nonpolitical—a bankruptcy, a flawed privatization, a commercial takeover, or a lapsing license. Putin reestablished the public lie as the standard as in the Soviet Union.

Not everything is under Putin's control. The Russian blogosphere, serious journals, and books remain reasonably free of censorship, although the Kremlin controls many websites. The combination of the words "Putin" and "corruption" yields hundreds of interesting articles, not all of them true, on Russian search engines.

Ironically, Putin was a major beneficiary of the excellent Russian media that especially Gusinsky had developed, because the media maintained their credibility for years after their content had become "Soviet" again. Today, each newscast starts with several protocol clips about the president's glorious day. The lively commentary has turned into pro-Putin propaganda, often with militant nationalistic ingredients.

## Centralization of Federal Power

Six days after his inauguration, Putin passed a decree imposing more central control over Russia's federal system. Since 1990, Russia's 89 regions had been freewheeling out of the Kremlin's control. The regional parliaments adopted their own laws, which often contradicted federal laws, to which the regional governors paid little attention. Although the regional governments were supposed to pass on most state revenues to the federal treasury, they did not. Nor did they deliver federal payments, whether subsidies to coal mines or pensions, to the intended beneficiaries. The regional governments were even less transparent and more corrupt than the federal government.

The Russian Federation was neither here nor there. The constitution told the federal and regional governments to share many obligations. The federal government demanded nearly complete centralized control as in Soviet days, but it no longer had the strength to enforce its formal powers. The imbalance of formal and actual powers was especially evident in the financial sphere. The regions and the center were supposed to share a score of different taxes, the ratios of which varied with tax and regions. The regional governments were the winners until 1998 (Shleifer and Treisman 2000, OECD 2000).

Regional and local taxes had proliferated. Although a handful of federal taxes reaped more than three-quarters of state revenues, Russia had

200 different taxes in the late 1990s because each region invented its own taxes to cover its needs. Usually, these taxes were licensing fees or penalties, burdening successful enterprises (McKinsey Global Institute 1999). The number of tax bases proliferated too, as did the tax collection services. As a result, profit-making enterprises without political protection were overgrazed, often fatally so. The disorder bred corruption (OECD 1995).

The World Bank initially favored revenue sharing in Russia because regional income inequality was so great that the World Bank reckoned that the federal government needed to serve as an equalizing force (Wallich 1994). This argument might have sounded laudable, but it presupposed an orderly government, while the all-dominant need in Russia was clear and simple rules to minimize corruption. The mixed Russian system of fiscal federalism was too dysfunctional to last.

The issues of federalism were the same in Russia as they had been in the newly independent United States. Some order was necessary, but the new system could be either centralized or decentralized. Shleifer and Treisman (2000) drew the logical conclusion, proposing a decentralized federal system with clear lines of responsibility. They took the division between the federal, regional, and municipal levels even further than in the United States, arguing that tax bases, taxes, and tax services should be clearly divided between the center, the regions, and the municipalities. Each level of government should be in full charge of certain taxes. Similarly, the responsibilities for various kinds of expenditures should be strictly divided between different levels of government.

Putin chose the opposite—far-reaching centralization. He justified his decision: “[F]rom the very beginning, Russia was created as a supercentralized state. That’s practically laid down in its genetic code, its traditions, and the mentality of its people” (Putin 2000, 186). “Everyone was saying that the *vertikal*, the vertical chain of government, had been destroyed and that it had to be restored” (Putin 2000, 129). Here as everywhere, Putin advocated a strong *vertikal* of power, which meant all power to himself.

The prevailing mood favored centralization. On May 13, 2000, Putin changed Russia’s federal order with a decree that mounted a full-fledged attack on the regional governors. Besides the oligarchs, they appeared to be the epitome of the corruption that had unleashed the financial crash of 1998. Putin eliminated them from the Federation Council, where they had been sitting *ex officio* since 1995, and reserved for himself the right to appoint senators, depriving the Federation Council of all political significance. He introduced a new administrative level, dividing the country into seven large regions, each headed by a new presidential envoy or supergovernor, appointed by himself. They were to supervise the still-elected governors and bring regional legislation into line with federal law. Putin assumed the right to sack governors who violated the law, which every governor had to do because Russian legislation remained so inconsistent. Putin attacked fast and hard, which was the most effective way to beat the

governors, because they were more accustomed to subverting the implementation of the Kremlin's decisions than to organizing outright opposition (Shevtsova 2005, 91–93).

Minister of Finance Kudrin undertook many fiscal measures to bring the regions under federal control. Most regions received federal transfers, and the federal treasury was finally able to condition these transfers on the abidance of federal law by the regional governments. The Ministry of Finance imposed federal treasury control over all state budgets. Under Yeltsin, the three autonomous republics of Tatarstan, Bashkortostan, and Sakha (Yakutia) had managed to negotiate preferential tax deals. Under Putin, these agreements were dismantled. The City of Moscow had long benefited from receiving all the tax revenues from the corporations headquartered in the capital. Not least to punish Luzhkov, Putin made enterprises pay taxes in the regions of their activity instead (OECD 2002, Papernaya 2004, Gaidar et al. 2003).

Within a few years, most legal rights of the regional governments had been abolished. The old ambiguities in the distribution of federal-regional rights were eliminated, and instead a strictly centralized system had been chosen. It is doubtful whether Russia can be considered a federal state any longer.

Putin was reluctant to use his power to sack corrupt or criminal governors. Instead, the Kremlin worked hard manipulating and interfering in the gubernatorial elections in an illegal and heavy-handed fashion to gain full control. These elections were spread out over time. Most incumbents were reelected, usually after the incumbent governor himself had joined United Russia and become Putin's obedient servant. The Kremlin controlled most elections to such an extent that hardly any democracy remained (Fish 2005, Shevtsova 2005).

When Vladimir Lisin, the popular billionaire owner of the Novolipetsk Metallurgical Corporation, entered the Lipetsk gubernatorial elections in 2002, the Kremlin persuaded him to withdraw (Fish 2005, 65). In Primorsky krai, Kursk, North Ossetia, the Ingush Republic, and Rostov, Fish (2005, 66) reported: "Leading contenders were disqualified for purely political reasons in the waning hours of election campaigns on the basis of absurdly trivial or fabricated technicalities." They complained to the courts of justice, but nobody ever won a political case against Putin's state. Ruthlessly, the Kremlin seized full control over the governors by denying alternative candidates the right to run thanks to its reinforced federal control over law enforcement.

On the odd occasion, independent candidates still won. In October 2002, the raw material-rich Krasnoyarsk region held gubernatorial elections. The two dominant corporations in the region, Russian Aluminum (Oleg Deripaska and Roman Abramovich) and Norilsk Nickel (Vladimir Potanin and Mikhail Prokhorov), each put up their own candidate. The assumption was that Russian Aluminum would win because no business-

man was closer to Putin than Abramovich and Russian Aluminum ruled Krasnoyarsk, the regional capital. The surprise was that Aleksandr Khloponin, Potanin's local manager, won.

Russian Aluminum let it be known that Potanin had spent \$45 million on this election alone. When this was brought to Putin's attention, he reportedly responded sarcastically: "Olegu i Rome zhalko bylo?" ("Why were Oleg [Deripaska] and Roman [Abramovich] so stingy?") Norilsk Nickel paid more than half of all taxes in the region, while Russian Aluminum paid little, thanks to its political dominance. Russian Aluminum appealed to the regional election commission, which canceled the election because of alleged flaws, but the regional court surprisingly revoked that decision, after which the regional election commission renewed its cancellation. Then Putin stepped in and settled the embarrassment, decreeing that Khloponin had won.<sup>11</sup> The Krasnoyarsk elections showed that a minimum of pluralism persisted in regional elections, but the Kremlin regretted that it could still be beaten and that large sums were diverted to these elections.

## The Gref Program: Second Generation of Economic Reform

In 1999, McKinsey Global Institute (1999) published a major study of Russian industry. It concluded that Russia had sufficient physical and human capital to have a potential growth rate of 8 percent a year. The main problems were a distortional tax system, a poorly functioning government giving large subsidies to inefficient companies, and the absence of a land market. The report found that neither the banking system nor the legal system were significant impediments at Russia's stage of development.

After the 1999 Duma elections, Russia for the first time had a legislature that approved of a normal market economy, and Putin forcefully concurred. He relied on German Gref as his chief economic reformer. Gref was a young liberal lawyer who had worked with Putin in St. Petersburg. Immediately after Putin had become acting president, he founded the Center for Strategic Problems with Gref as director. The "Gref Center" became the brain trust for Putin's reform program, gathering the best and the brightest from Moscow's liberal think tanks.<sup>12</sup> By April 2000, this elite group of liberal economists had compiled a "Gref Program" of economic reforms. In May 2000, after having become president, Putin appointed Gref as head of a new superministry, the Ministry of Economic Develop-

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11. Personal information from contenders on both sides in Moscow, October 2002.

12. Gref drew primarily on economists from Yegor Gaidar's Institute of the Economy in Transition, the World Bank-financed Bureau of Economic Analysis, the Higher School of Economics, and Carnegie Moscow Center.

ment and Trade, and in July 2000, the Gref Program was adopted as the government's economic reform program.

Russia had seen many reform programs, but this was the most comprehensive and detailed, and it was the action program of the incoming president. It was a bureaucratic document of about 200 pages designed to instruct civil servants with proposals for hundreds of legal acts. Its goal was to boost economic growth to 8 percent a year through tax reform, bank reforms, deregulation, privatization, social reforms, accession to the WTO, judicial reform, and reform of the state. The program's weakness was that it was not very clear or concrete. Nor was it inspiring or even readable.

Gref's ministry became the center of reform, advocating comprehensive market economic reform. Strangely, Putin never made Gref deputy prime minister, which limited his bureaucratic leverage. The key powers in the government rested with Kasyanov and Voloshin, who were both liberal but considered members of "the family" and inclined to promote oligarchic interests.

In a typical bureaucratic fight over economic reform in Putin's first term, Gref advocated a reform, with sympathy from Kudrin and strong support from reformers in the Duma, but he was opposed by the branch ministry concerned and sometimes by oligarchic interests in the Duma. Eventually, Kasyanov or Voloshin mediated a decision. Often, Putin weighed in, usually tipping the decision in a more reformist direction, but cautiously avoiding technical details. The Federation Council rarely mattered, and the main strife took place within the government. A steady flow of reform legislation was adopted in 2000–2003.

## **Radical and Comprehensive Tax Reforms**

After the government finances had been balanced, a radical tax reform became possible. The prior tax system was unwieldy, arbitrary, inefficient, and unenforceable. Of the 200 taxes, approximately 30 were federal and some 170 local or regional. Multiple tax agencies competed over the same revenues (Shleifer and Treisman 2000). The enforcement of the tax laws was as haphazard as it was brutal. The tax inspection and the competing independent tax police harassed businessmen. The more a businessman paid in taxes voluntarily, the more he could be extorted. For a businessman, the rational solution was to conclude a corrupt deal with the tax authorities.

The reform attempted to base the tax system on the sound principles of fairness, simplicity, stability, predictability, and efficiency. A draft tax code had been gathering dust in the Duma since 1997. Key provisions had been incorporated in the government-IMF crisis plan of July 1998, and the first part of the tax code was adopted and came into force in January 1999. It

contained definitions, procedural laws and provisions, and regulated the tax administration. The second part of the code, which reformed key federal taxes, such as the value-added tax (VAT), personal income tax, and excise tax, and introduced the new unified social tax, became effective in 2001, and the new corporate income tax in 2002 (Owen and Robinson 2003, 82–84). The number of taxes was reduced sharply to 16 in 2004, of which 10 were federal, reflecting the strong trend toward centralization. Small and inefficient nuisance taxes, which generated more corruption and hazard than revenues, were abolished. The tax reforms liberalized and stimulated the Russian economy, but they also strengthened the federal authorities' power over the state.

The key tax reform was the replacement of the progressive personal income tax peaking at 30 percent with a flat income tax of 13 percent as of 2001, notwithstanding opposition from the IMF, which feared that tax revenues would fall. Estonia and Latvia had already introduced flat personal income taxes in the 1990s, but they were higher. Russia's introduction of the low flat income tax was a major breakthrough. It eliminated the disincentives to work and encouraged citizens to bring their earnings out into the open, reducing illegality and corruption. For the state, this reduction in shadow earnings expanded the tax base. It provided a positive shock, boosting the revenues from personal income taxes from 2.4 percent of GDP in 1999 to 3.3 percent in 2002 (Goskomstat 2006, 606).

The corporate profit tax was reduced in 2001 from 35 to 24 percent. Far more important was that most ordinary business costs became deductible. This tax reduction made it possible to abolish most tax exemptions, leveling the playing field. The social taxes were payroll taxes paid by the employer to four different social funds, which were poor at collecting them. In 2001, the payroll tax was cut from a flat rate of 39.5 percent to a regressive tax with a top rate of 35.6 percent and an average rate of 26 percent, which was set to decline. The four social taxes were transformed into a unified social tax, which was collected by the federal tax ministry like other taxes. The greatest benefit to businesses was that the competition in tax collection ceased (Gaidar et al. 2003). As a result of the liberal tax reforms, tax collection improved, and the government could cut taxes further. The top VAT rate, which previously had been 20 percent, was reduced to 18 percent in January 2004.

The tax reforms reduced the threat to businessmen posed by tax inspection. The few, low, and simple taxes left less room for discretion for the authorities, making it possible to be an honest taxpayer. Small-scale tax violations were decriminalized, and became subject to civil rather than criminal law punished with moderate fines. The unification of tax collection by the tax ministry eliminated competition. Finally, the tax police (headed by Mikhail Fradkov), which represented arbitrary power of the bureaucracy over business, was abolished by presidential decree in March 2003, with the motivation that the tax police had not been “detect-

ing, preventing or interdicting tax crimes” but instead extorting money from businessmen.<sup>13</sup>

## Deregulation to Stimulate Small Enterprises

Russia finally woke up to its need for small and medium-sized enterprises. They were subdued by a madness of red tape and bureaucratic harassment. In 2000, an average small or medium-sized firm was inspected 37 times to check its licenses and 104 times to check certificates (Yasin 2002, 212). It was politically feasible to promote them because they threatened nobody. In July 2001, the Duma passed a package of laws that brought about major deregulation of small and medium-sized enterprises, by simplifying their registration, licensing, inspection, and certification (OECD 2002).

First, as before all enterprises in Russia were required to register with the state, but one new law simplified the registration of a business. Rather than having to be approved by several government agencies in a bureaucratic and time-consuming process, a businessman could register with one government agency. The mandated period of registration was sharply reduced from one month to a maximum of five working days, which reduced actual waiting time as well as possibilities for extortion by bureaucrats (CEFIR-World Bank 2003).

Second, about 2,000 business activities required government licenses from 37 federal agencies, and each agency had the potential to extort a bribe.<sup>14</sup> The new licensing law stipulated that a license would be extended from a maximum of three years to a minimum of five years. It also reduced the cost of a license and the number of business activities subject to licensing. When the licensing law came into effect in February 2002, it produced considerable improvements in the business climate (CEFIR-World Bank 2003).

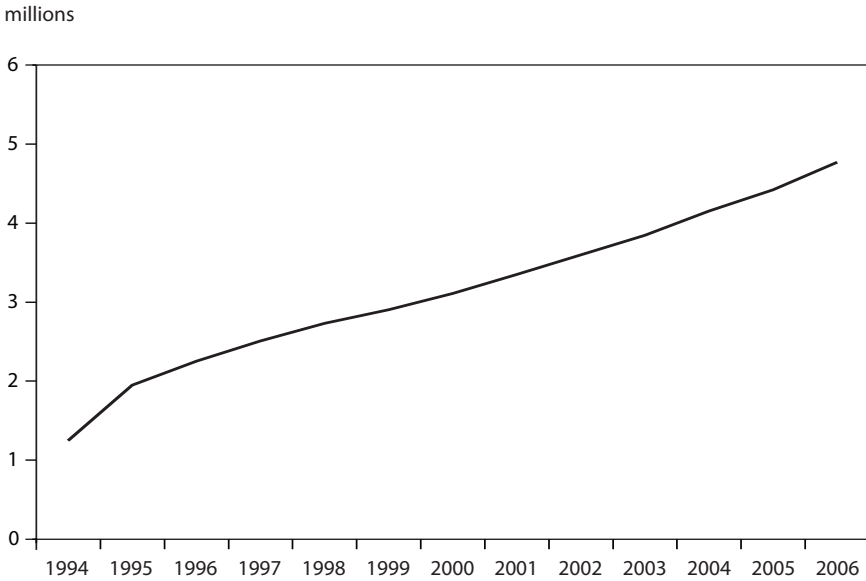
Third, Russian businesses were plagued by inspections, which were another tool for extortion (INDEM 2001). The new inspections law stipulated that a government agency could not conduct more than one planned inspection of a firm once every two years, although any number of unplanned inspections was allowed. As a result, the number of inspections of small businesses fell by 27 percent between 2001 and 2002 (CEFIR-

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13. Ukaz Prezidenta Rossiiskoi Federatsii N 306 “Voprosy sovershenstvovaniia gosudarstvennogo upravleniia v Rossiiskoi Federatsii” (Decree No. 306 of the President of the Russian Federation: Issues Concerning the Improvement of State Management in the Russian Federation), <http://nalog.consultant.ru/doc46925.html> (accessed on June 29, 2007).

14. *Perechen' federal'nykh organov ispolnitel'noi vlasti, osushchestvliaiushchikh litsenzirovanie* (List of Federal Executive Agencies which Carry Out Licensing), February 11, 2002, <http://nalog.consultant.ru/doc35719.html#43> (accessed on June 29, 2007).

**Figure 6.9** Number of registered enterprises, 1994–2006



Source: Goskomstat (2006; 1999, 273).

World Bank 2003, 2–3). Yet, law enforcement agencies were excluded from these restrictions.

A fourth important law on deregulation tried to simplify standardization and technical regulation.

This broad effort at deregulation was impressive. The situation improved, and the amelioration has proved sustainable, although it has been greater in more developed and pluralist regions (Yakovlev and Zhuravskaya 2007). Small enterprises have grown steadily. The number of officially registered enterprises has steadily increased by more than 7 percent a year, and by 2006 the total number of registered enterprises in Russia had reached almost 5 million, quite a respectable number (figure 6.9). Still, the patriarchic surveillance system remains in place, and more radical deregulation is needed.

## Land Reform and Privatization

The 1993 constitution proclaimed Russian citizens' right to own land as private property, but until 2001 the communists and agrarians in the Duma blocked the promulgation of a new land code, which aimed to legalize the private ownership of land. Putin avoided taking a public stand on this pivotal ideological question. Instead, the liberal Union of Right

Forces (SPS) repeatedly pushed it in the Duma. A new chapter in the civil code provided the legal basis for private transactions of land, and after a prolonged legislative battle a new capitalist land code was adopted on October 25, 2001, but it excluded farmland (Remington 2002).

The privatization of agricultural land was the last ideological barrier to break. On July 24, 2002, the Duma finally legalized the sale of agricultural land as well. It was a compromise, requiring each region to adopt a law to make the federal law effective. As a consequence, communist regions could withhold agricultural land from sale, while more liberal regions were allowed sell land (Kirchik 2004). In practice, the private ownership of agricultural land developed only gradually, and good connections with regional governors were vital for land purchases. As a result, big businessmen accumulated hundreds of thousands of hectares of agricultural land in huge estates, while family farmers often failed to acquire land.

In the aftermath of the financial crash of 1998, a strong public opinion demanded the nationalization of the oligarchs' properties. Putin did not adopt this line, but nor did he oppose it publicly. Privatization came to a near standstill. The only big privatization after 2000 was the oil company Slavneft, which was auctioned off in December 2002. In a rigged deal, two large private Russian oil companies, TNK and Sibneft, shared the company.<sup>15</sup> The state oil company Rosneft, whose privatization had been planned for years, was taken off the table. From 2003, the government emphasized what must not be privatized, notably the pipeline systems and majority ownership in big resource companies.

Formally, private property rights were reinforced through the promulgation of the civil code. In October 2002, a new bankruptcy law was adopted, because the old law had become a tool of corporate raiding of companies merely in a liquidity squeeze (EBRD 2003, 184).

## Labor Market and Pension Reforms

The Russian social sector is highly inefficient, while the supply of resources may be appropriate. The social systems involve millions of employees and even more recipients, rendering any change as complicated as controversial. The social reform agenda was largely drawn up in 1996, primarily by Mikhail Dmitriev, who was first deputy minister of economic development and trade in Putin's first term (Åslund and Dmitriev 1996). Putin undertook two social reforms in his first term.

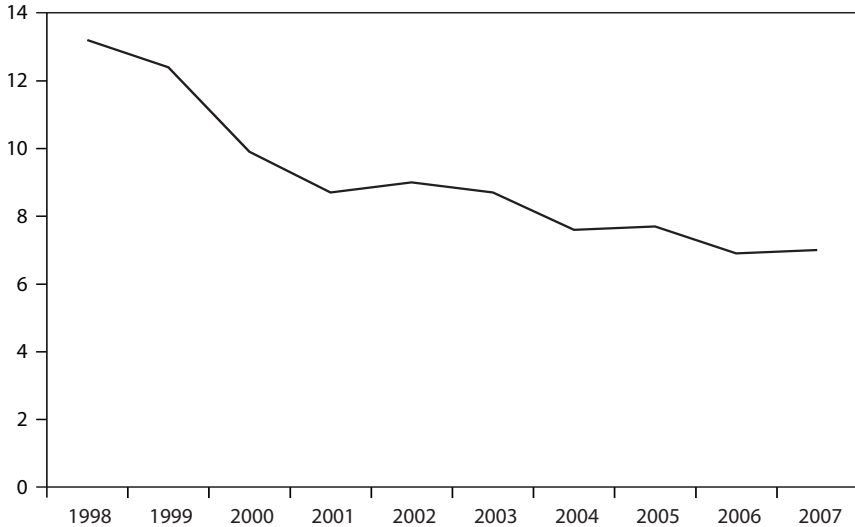
A new labor code was adopted in February 2002. It adjusted the regulation of the labor market to a market economy and reassured workers of their rights (EBRD 2003). It improved the old Soviet labor code and made

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15. At the time, TNK was owned by Alfa (Mikhail Fridman), Renova (Viktor Vekselberg), and Access Industries (Len Blavatnik), and Sibneft by Abramovich.

**Figure 6.10 Unemployment, 1998–2007**

percent of labor force



Note: 2007 statistics as of April 2007.

Source: Bank of Finland Institute for Economies in Transition, Russia statistics, [www.bof.fi](http://www.bof.fi) (accessed April 13, 2007).

it akin to an overregulated West European social democratic code rather than introducing the more liberal Anglo-American labor market philosophy. Old social benefits remained, even when their costs were excessive for employers, such as severance pay of three months' salary for employees laid off. In reality, however, Russia's labor market has persistently been quite flexible because of very limited unemployment benefits. Accurately measured, unemployment halved from 13 percent in 1999 to barely 7 percent in 2007 in spite of large-scale restructuring and considerable regional disparities (figure 6.10).

The biggest social reform during Putin's first term was the pension reform adopted in 2002. The old pension system was expensive and gave too small pensions to too many people. It was nearly egalitarian, leaving pensions barely above subsistence level, and everybody was dissatisfied. The new system was based on the World Bank (1994) model of "three pillars," that is, a minimal compulsory state pension for all, compulsory private pension insurance, and favorable tax treatment of voluntary private pension insurance. A minor share of the pension tax could be put into private accounts for the accumulation of pension savings. But the government deterred the public, successfully limiting private funds to merely 2 percent of those eligible (Aron 2007). In the end, little changed.

Other big social reforms were postponed until Putin's second term. The vast education and health sectors, together with housing services, remained among the least reformed parts of the Russian state, and hardly anything was done to improve them.

## Dictatorship of Law

After communism, the demands on the judicial system steadily evolved and the number of court cases grew, as both the state and businesses increasingly sued one another (Hendley 2002). However, as the courts gained significance, they grew more corrupt, because the market value of their judgments rose, while judges were quite independent.

From the outset of his presidency, Putin gave priority to judicial reform, but he favored the ambiguous "dictatorship of law," which sounded like a contradiction in terms. A lawyer himself by training, Putin asked one of his closest aides, Dmitri Kozak, a deputy head of his presidential administration hailing from St. Petersburg, to lead a presidential working group on judicial reform. A package of new laws on judicial reform was adopted in December 2001. They included a law to enhance the status of judges, better financing of the courts, and the renewal of all legal procedural codes.

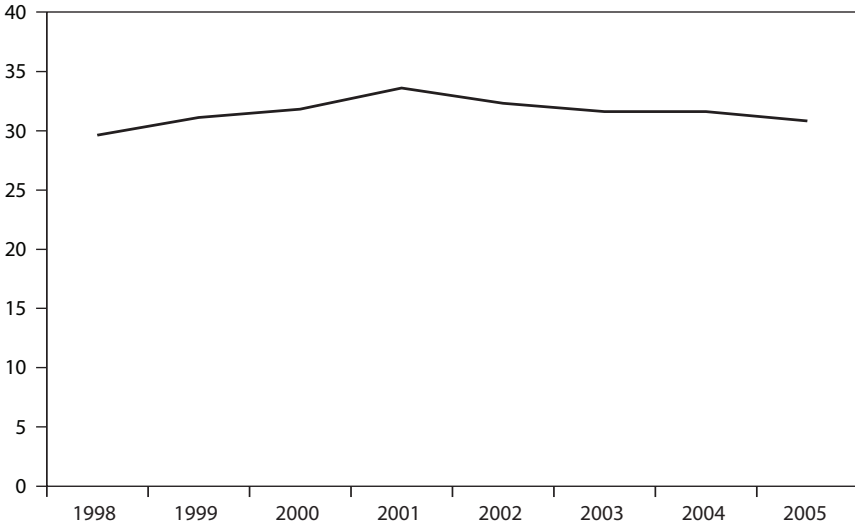
A key goal was to strengthen the independence of courts and judges. The judges' salaries were set to quintuple over five years, and the financing of the courts was greatly improved to make them independent of the regional authorities, which had provided supplementary funding. Judges already had steady tenure, but they needed to become accountable. The law on the status of judges of December 2001 weakened their protection from prosecution for criminal offences. Ordinary judges were still appointed without term limit, but they were forced to retire at 65 (Solomon 2002).

Under the Soviet system, judges had been subordinate to prosecutors. Their position improved greatly under Yeltsin, but prosecutors retained rights reserved for judges in Western countries, including the issuing of arrest and search warrants and the releasing of prisoners on bail. The 2002 criminal procedural code reinforced the powers of the judges and gave them the right to sign arrest and search warrants, and to decide on pre-trial detention (Buchanan 2003). With the powers of the prosecutors' offices trimmed, the chances of frivolous arrest and detention were reduced. In the first year with the new code, the number of arrests fell by 33 percent (McDonald 2003).

Another boon for defendants was the spread of jury trials in serious criminal cases, such as murder, terrorism, and espionage, from nine regions to the whole country. The initial jury trials showed that juries were much more sympathetic to the defendants than judges were, acquitting many defendants. Prosecutors reacted sharply, appealing to higher courts or asking for new trials, and they often triumphed. The judicial reform

**Figure 6.11 Homicides, 1998–2005**

total in thousands



Source: Goskomstat (2006; 2000, 243).

stopped far short of the declared intentions. Still, the caseload of the economic (*arbitrazh*) courts increased substantially, as they became more independent, competent, even-handed, and efficient (Hendley 2004).

The essence of judicial reform, however, was that judges became dependent on the presidential administration rather than on regional governors. This reform was another centralization. The crime rate has stayed high, and the Kremlin has, characteristically, responded by demanding less reporting of crimes. Russia's homicide rate has actually been higher under Putin than under Yeltsin, reaching an all-time high in 2001 (figure 6.11). The purpose of ample financing for law enforcement is evidently not to improve law and order but to reinforce the power of the Kremlin (Taylor 2006).

## Serious Efforts to Join the WTO

The Soviet Union was never a member of General Agreement on Tariffs and Trade (GATT), which it saw as no less capitalist than the IMF and the World Bank.<sup>16</sup> To join the IMF and the World Bank is easy, and Russia did so in 1992, but to accede to the WTO was much more complicated. In

16. This section draws on Åslund (2007b).

1993, Russia applied for membership of the GATT, which in 1995 became the WTO.

The WTO has three important functions. First, it is the forum for multi-lateral trade negotiations. Second, it is the depositary of numerous international trade conventions that are binding to all members. Third, it has an arbitration court for conflict resolution that is universally recognized. The chief reason for a country to join the WTO is to secure access to export markets. It is especially important for exporters of goods frequently subject to protectionist measures, such as steel, chemicals, and textiles.

In the 1990s, Russia's political leaders did not realize the importance of the WTO, devoting minimal political attention to it. One reason for this neglect was that 60 percent of the country's exports consist of oil and natural gas, which encounter minimal protectionism. After communism, however, Russia has become a major exporter of sensitive commodities, such as steel, chemicals, and grain, which accounted for 23 percent of its exports in 2005 (United Nations 2007). Even so, its losses from antidumping measures remain minimal.

Several studies sponsored by the World Bank and the Russian Ministry of Economic Development and Trade examined the potential effects of WTO entry on the Russian economy. Their overall assessment was that Russia's economic growth could be boosted by 0.5 to 1.0 percent a year in the medium term (Jensen, Rutherford, and Tarr 2004). These gains would come from the liberalization of barriers to foreign direct investment in service sectors, improved resource allocation because of lower Russian tariffs, and greater market access for Russian products (Yudaeva et al. 2002).

Russia's comparative advantage is overwhelmingly in hydrocarbons, other crude materials, and chemicals. Julian Cooper (2006a, 2006b) found that Russia had "revealed comparative advantage" (defined as a country's share of world exports of a particular good divided by its share of total world exports) in 70 product groups, of which only four were manufactured goods, namely nuclear reactors, condensers for steam boilers, rail freight wagons, and steam turbines. All were traditional Soviet products exported to former Soviet republics, showing that Russia was not breaking into new manufactured export markets.

The liberal economists had long advocated WTO membership but after Putin became president he energized Russia's efforts to join the WTO, committing himself to accession in 2003. In his annual address in April 2002, Putin (2002a) advocated the WTO at length: "The WTO is a tool. Those who know how to use it become stronger. . . . Membership in the WTO should become a tool to protect Russian's national interests on the world market." Russia was the only member of the G-8 that was not a member of the WTO, and China's entry in 2001 probably persuaded Putin to focus on WTO membership.

The Duma elected in December 1999 supported this endeavor. Little could happen, however, until the old Ministry of External Economic Re-

lations, headed by the inert bureaucrat Mikhail Fradkov, was abolished. Putin merged it into Gref's new Ministry of Economic Development and Trade, and Gref has persistently been Russia's chief advocate of WTO accession. The big exporters, especially the steel producers, supported WTO membership, and public opinion was positive. According to a nationwide survey by VTsIOM, at the time still headed by the revered Yuri Levada, in 2002, 54 percent of Russians thought that it was in their nation's interest to join the WTO, with only 18 percent disagreeing (VTsIOM 2002).

Negotiations on accession to the WTO have been pursued on two parallel tracks. Russia had to conclude a bilateral protocol with each of 61 interested parties on market access.<sup>17</sup> Because the WTO decides everything by consensus, each member can veto the entry of a new applicant. Russia's bilateral negotiations with the European Union were concluded in May 2004 and with the United States in November 2006. The second track is a negotiation of a multilateral agreement in the working party in Geneva, which is far from finished.

WTO accession became one of the major themes in Putin's extensive institutional reforms from 2000 to 2003. A major Western concern was the weakness of the Russian legal system. Laws were not perceived as transparent, uniform, or enforced. This applied especially to customs. Many key laws were adopted during this period, including the tax code, a new customs code (which came into force in January 2004), and several parts of the civil code. The new customs code reduced the massive corruption and long delays in the customs. A whole new set of legislation on intellectual property rights was adopted. The legislative agenda was tense but well managed. By 2003, Russia was close to joining the WTO, but then the political focus faded.

In substance, Russia's problems in entering the WTO were smaller than China's, because unlike China, Russia is a relatively open market economy with average import tariffs of around 12 percent and few quotas and licenses. The required adjustments were many but not all that great.

In 2003, however, Putin came up with a new gimmick and his interest in the WTO weakened. On February 23, 2003, the presidents of Russia, Ukraine, Kazakhstan, and Belarus declared that they wanted to form a new Common Economic Space. It was supposed to be a free trade area, a customs zone, and eventually a currency union, but it was also intended to coordinate the four countries' entry into the WTO. Given that these countries already had a free trade zone that did not work, and that all but Ukraine also belonged to the dysfunctional CIS Customs Union, this proposal made little sense. Their key trade problem was the dearth of a mechanism for conflict solution for their mutual trade disputes. They could have solved that problem by joining the WTO to use its well-functioning

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17. As of July 2007, protocols had not been concluded with Georgia, Cambodia, and Saudi Arabia.

arbitration. Yet, a four-nation agreement on the Common Economic Space was adopted in September 2003 and ratified by all four parliaments, and scores of agreements were concluded. Putin's real purpose for this new initiative appears to have been purely political—to woo Ukraine more closely to Russia before Ukraine's presidential elections in the fall of 2004.

## ***Siloviki*, Oligarchs, and Reformers: Who Is Mr. Putin?**

The permanent question during Putin's first term was: Who is Mr. Putin? As a trained KGB agent, he was all things to all people. He appealed to Russian nationalists and the Orthodox Church, but he also saw and nurtured Western leaders. Unlike Yeltsin, Putin did not antagonize the communists, but he also appealed to economic liberals with more market reforms. His open-to-all attitude did not seem convincing. It looked like a waiting game. Everybody asked: What will Putin do when he has consolidated power?

Only in one regard was Putin completely clear: he was a political authoritarian, although he did not say so. He muzzled the media, starting with television and proceeding with one newspaper after the other. He had brought the Duma under control, partly through democratic means, partly through gross corruption. The regional governors were brought to heel. Putin's loyalty to the KGB and its predecessors was unwavering, demonstrative, and frightening.

The clearest indication of Putin's direction was his appointments. They all came from a very narrow stratum of former colleagues in St. Petersburg, mainly from the KGB. KGB people are called *siloviki* in Russian, which means people belonging to the power ministries—the KGB, the military, and the police. Putin's associates were from both the FSB and the foreign intelligence service (SVR), but the FSB people dominated.

KGB officers from St. Petersburg were appointed to a plethora of top positions in the Kremlin, the government, the Federal Assembly, and state-dominated corporations. Putin's top people became: Igor Sechin and Viktor Ivanov, who were deputy heads of the presidential administration, Minister of Defense Sergei Ivanov, FSB Chairman Nikolai Patrushev, First Deputy Railway Minister Vladimir Yakunin, and Minister of Communications Leonid Reiman. Vladimir Kozhin replaced Pavel Borodin as Kremlin property manager, while Borodin was given the honorific post of secretary general of the Russian-Belarusian Union. Lower down, the whole government administration was packed with KGB officers, many of whom left well-paid jobs in the private sector to pursue public service (Krysh-tanovskaya and White 2003).

A minor group from St. Petersburg was made up of liberals, young economists and lawyers with whom Putin had worked in the mayor's office. Dmitri Kozak, Dmitri Medvedev, and Andrei Illarionov held senior

positions in the presidential administration. Other prominent St. Petersburg liberals were Minister of Finance Kudrin, Minister of Economic Development and Trade Gref, and Gazprom CEO Aleksei Miller. They were a junior group in Putin's sphere, specializing in economic reforms, but they were a fixture. Putin left Chubais as CEO of UES, the Russian power company.

A dominant question during Putin's first term was what he would do about Yeltsin's "family," the senior officials with oligarchic connections. The surprise was that Putin acted very slowly and largely allowed them to stay. He let Minister of Finance Mikhail Kasyanov succeed him as prime minister, and Voloshin stayed as head of the presidential administration. Vladislav Surkov, who had worked for both Alfa and Menatep, remained first deputy head of the presidential administration, where he fought with Putin's favorite Sechin. Only people who had been closely connected with Berezovsky, such as Minister of Interior Vladimir Rushailo and Minister of Railways Nikolai Aksenenko, were ousted. A large number of quite prominent businessmen joined the state administration under Putin (Werning Rivera and Rivera 2006). It is impossible to say how many of them were originally KGB officers, but this stream indicated that businessmen were attracted by state service and found it lucrative.

Throughout Putin's first term this triumvirate of forces was at play: KGB men from St. Petersburg, oligarchs, and liberals from St. Petersburg. The balance between them was most evident in the presidential administration, which became the heart of state power, because Putin was a micromanager who wanted to decide ever more things as he gained insight and knowledge. The economic reforms were spearheaded by reformers and oligarchs together, whereas the *siloviki* paid little attention. Domestic politics was run by the presidential administration with assistance from outside consultants. Foreign policy was managed by Putin himself.

Another big issue was how Putin would handle the oligarchs. Berezovsky and Gusinsky were always seen as a separate matter, because they were just too ostentatious. Berezovsky wanted to show that he controlled the state, and these two men ran Russia's biggest and best television networks. Putin's elimination of them was primarily a matter of authoritarian media control.

On July 28, 2000, Putin held a long-awaited meeting with 21 oligarchs in the Kremlin. Conspicuously, three oligarchs were missing. Berezovsky and Gusinsky were no longer welcome, whereas Abramovich was so close to Putin that he avoided public events. Putin's message to the oligarchs was: "You stay out of politics and I will not revise the results of privatization" (Baker and Glasser 2005, 86–87). His unspoken point was that the Russian state was back and that the era of the oligarchs was over.

The first response by the oligarchs was to unite and organize. They looked around for a suitable organization, and they chose the old Russian Union of Industrialists and Entrepreneurs (RSPP), traditionally the fortress

of the old state enterprise directors, as the strongest and broadest business association. The new big businessmen effectively bought the RSPP, put themselves on the board, and made it their central organization for advocacy and lobbying. But they kept old, wily Arkady Volsky as its president.

Until the end of 2003, the RSPP was a forceful body. The oligarchs met frequently in RSPP board meetings and discussed economic policy. Their views had changed as economic development had progressed. They had all become profit seekers, favoring a liberal market economy and providing forceful support for structural reforms. Their main concern was to secure their property rights.

The leadership of the RSPP reflected how Russian big business had developed. In June 2007, of its 24 businessmen, no fewer than nine were in metals (six in steel), five in finance, two in coal, two in high-tech, and one each in forestry industry, food processing, oil, gas, electricity, and railways.<sup>18</sup> Russia was still dominated by heavy industry, but also increasingly by the metallurgical industry and it was growing more diversified. Only four out of these 24 businessmen ran predominantly state-owned corporations.

Over time, however, the oligarchs differentiated also politically. The reclusive Abramovich, who had been close to the Yeltsin family, was one of the people who had selected Putin. He was closer to Putin than any other businessman, and he did everything differently. He was elected to the Duma in 1999.<sup>19</sup> Soon afterward he was elected governor of Chukhotka in northeast Siberia, spending vast amounts there, but he also benefited from the lowest taxes of all Russian oligarchs. Even so, he emigrated to London, while remaining governor of Chukhotka, and gradually sold off his holdings in Russia. Rising speculation had it that Abramovich shared his wealth with Putin as he was widely thought to have shared with the Yeltsin family.

Oleg Deripaska, co-owner of Rusal with Abramovich, was a real member of Yeltsin's family, because he married Yumashev's daughter from a previous marriage, and Yeltsin's daughter Tatyana married Yumashev. Abramovich and Deripaska were the main "family" oligarchs, but their

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18. The RSPP bureau has changed very little over the years. In June 2007, its 24 businessmen were Aleksandr Abramov (Evraz), Vagit Alekperov (Lukoil), Andrei Bokarev (Kuzbass-razrezugol), Anatoly Chubais (UES), Oleg Deripaska (Rusal), Mikhail Fridman (Alfa Bank), Anatoly Karachinsky (IBS), Oleg Kiselev (banking), Andrei Kostin (Vneshtorgbank), Vladimir Lisin (Novolipetsk), Aleksandr Mamut (Ingosstrakh), Andrei Melnichenko (MDM), Aleksei Miller (Gazprom), Aleksei Mordashov (Severstal), Vladimir Potanin (Interros), Dmitri Pumpyansky (TMK), Viktor Rashnikov (Magnitogorsk), Zakhar Smushkin (Ilim Pulp), Alisher Usmanov (Gazprominvest), Ruben Vardanian (Troika Dialog), Viktor Vekselberg (Renova), David Yakobashvili (Wimm-Bill-Dann), Vladimir Yakunin (Russian Railways), and Vladimir Yevtushenkov (Sistema). See [www.rspp.ru](http://www.rspp.ru) (accessed on June 22, 2007).

19. Berezovsky also was elected to the Duma in 1999. Several business groups had a senior partner, but not the top person, in the Duma or the Federation Council to secure their interests.

behaviors contrasted greatly. Deripaska maintained a close relationship with the Kremlin and Putin, but he kept a high public profile, loudly defending his business interests.

Mikhail Khodorkovsky of Yukos chose the opposite strategy. More than any other oligarch, he opted for legalization and gentrification. He and his co-owners publicized their ownership. Yukos cleansed its corporate structures and financial system, abandoning transfer pricing. The company was richly rewarded on the international stock market, and Yukos became the Russian corporation with the highest market capitalization of \$45 billion in 2003. Both Yukos and Khodorkovsky developed extensive charitable activities, donating some \$200 million annually by 2003, supporting health care and civil society. Other oligarchs followed Yukos, becoming transparent, publicizing their ownership, and developing extensive charitable donations, estimated at \$1.5 billion in 2006 (Finn 2006a).

Most of the oligarchs, however, preferred to lower their public profiles and be politically neutral. The old oligarchs who had participated in the loans-for-shares auctions were perceived as more suspect, notably Vladimir Potanin and Vagit Alekperov. The shares of their public and well-run companies Norilsk Nickel and Lukoil, respectively, traded with lasting "oligarch" discounts. The same was true of the joint venture TNK-BP for purely political reasons.

In the late Yeltsin period, the oligarchs had flocked to the Kremlin to gain commercial advantages. Putin turned the tables. All of a sudden, the oligarchs preferred not to go to the Kremlin, and they even stayed out of the country for extended periods not to be called there. Early in the Putin period, two oligarchs told me that when an oligarch was called to see one of the top figures in the Kremlin, he was asked to put up \$10 million or \$20 million in "donations," either for Putin's reelection campaign or for some charitable purpose. In the Yeltsin period, Mayor Luzhkov had persuaded the Moscow oligarchs to "donate" \$500 million to the reconstruction of the Christ the Savior Cathedral. Now, Putin attracted \$300 million in "donations" for the reconstruction of the Konstantinov Palace in St. Petersburg.

The state was back as the dominant power, but it was neither transparent nor democratic. The Kremlin treated the oligarchs as its self-service boutiques. A few major businessmen were rumored to make large-scale payments of hundreds of millions of dollars to the corporations belonging to Putin's circle in St. Petersburg.

The oligarchs looked at Putin and his KGB friends with increasing discomfort, recognizing their evident desire to make big money. To begin with, however, the Putin team did not know how to do it. A couple of St. Petersburg bankers close to Putin (Sergei Pugachev and Vladimir Kogan) were rumored to be coming oligarchs, but they never made it big. After two to three years, oligarchic representatives started talking of "the new family," meaning commercially inclined KGB officers close to Putin:

Sechin, Viktor Ivanov, Nikolai Patrushev, Patrushev's deputy Yuri Zaostrovstsev, and Prosecutor General Vladimir Ustinov, who had linked up with them. Zaostrovstsev was a major furniture trader in Moscow, and his oligarchic enemies leaked to the still-independent media that he imported furniture without paying import tariffs or the VAT. One of his major showrooms was bombed three times.<sup>20</sup> Pugachev was accused of racketeering in France and scrutinized in the French media. These oligarchs-in-waiting did not seem to be able to make it even with considerable state intervention. They needed another business model.

The alternative business model was evident: to take over the state-owned companies. After Chernomyrdin had been ousted as prime minister, the Gazprom management felt threatened and started massive asset stripping. Both minority shareholders and the Putin group cried foul. In the spring of 2001, Putin and his men carefully prepared the ouster of the Gazprom management, which controlled about 100 Duma deputies. Chernomyrdin was sent off as ambassador to Ukraine. The government owned the majority of Gazprom, and Putin sacked Rem Vyakhirev personally at a meeting in the Kremlin in May 2001. Putin appointed two of his closest collaborators to run Gazprom: His first deputy chief of staff Dmitri Medvedev became chairman of the supervisory board, and his former assistant Aleksei Miller was anointed chairman of the management board.

Usually, a Russian manager clears the deck and appoints his own people, but that did not happen in Gazprom. Its management board still consists of three mutually hostile groups. One is Miller's young economists, who had worked with Putin in the mayor's office in St. Petersburg and later in its infamous port. A second group consists of KGB men from St. Petersburg. Old Gazprom hands form a third group. Such a diverse group can hardly manage a major company, but that was Putin's intention. He runs Gazprom as his personal fiefdom, making all major decisions himself, with Miller and Medvedev as little but transmission belts. Russia's oligarchs dare not buy stocks in Gazprom because it would be perceived as a hostile act to Putin.

The litmus test of the Putin regime was how Gazprom would develop after the management change. Minority shareholders raised three issues. First, Gazprom was not run as a corporation but as a ministry. Considerable improvements were carried out for several years, resulting in Gazprom becoming Russia's most valuable company by 2005. Second, Miller focused on retrieving the assets that had been given away, and he managed to recapture most of them.

The third and most interesting test was what would happen to Itera, the trading company that skimmed off hundreds of millions dollars annually from the gas trade with Ukraine. The new management swiftly cut out Itera, but it did not clean up this trade. Instead, it established a similar

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20. I happened to rent an apartment above that store.

new intermediary, Eural Trans Gaz, which was rumored to be connected with Semen Mogilevich, a major international organized criminal residing in Moscow, and top officials in Putin's administration. In 2004 Eural Trans Gaz was replaced with another intermediary, RusUkrEnergo, which was better formalized. On the Russian side, the same people were considered to be involved. The new trading system simply transferred the skimmed profits from the Ukrainian gas trade to other individuals. This was the old model of transfer pricing that Russian state enterprise managers had indulged in. The Putin administration had revealed itself. Its aim was not to clean up Russian business but to transfer the skimmed profits to its own people (Stern 2005).

As Putin's first term was drawing to its close, his public profile was that of an authoritarian modernizer straight out of Samuel Huntington's (1992–93) modernization school. His combination of authoritarianism and a private market economy stood out. However, unlike Prussian Emperor Friedrich II, Putin did not say: "I am the first servant of the state." Instead, he took his cue from Sun King Louis XIV of France and claimed: "L'état, c'est moi!" Berezovsky reported that in a private conversation with him, Putin, using the royal "we," exclaimed: "But we are the state!" (quoted in Baker and Glasser 2005, 85).

The Russian state apparatus had become more efficient and rational, but probably for the first time the higher levels of the Russian government were pervasively corrupt. With the oligarchic representation still intact, the prevalence of corruption could be blamed on the oligarchs. However, many oligarchs were gentrifying, whereas Putin made no attempt to demote even the most blatantly corrupt members of his own team. The balance between the oligarchs and the *siloviki* was precarious. Could it last?

Ideology was strangely absent. The economic liberals believed in private property and a free market economy, but few stood up to defend civil or political freedoms. Yet, neither socialism nor nationalism enjoyed significant support. The old Soviet cynicism had returned, but the new cynics were so much wealthier.

During his first term, Putin's relations with Western leaders were excellent, although not very important for anything but his domestic image. He pampered four Western leaders with whom he got on royally: German Chancellor Gerhard Schröder, French President Jacques Chirac, Italian Prime Minister Silvio Berlusconi, and US President George W. Bush. After their first meeting in Slovenia's capital of Ljubljana, Bush famously said of Putin:

I looked the man in the eye. I found him to be very straightforward and trustworthy. We had a very good dialogue. I was able to get a sense of his soul, a man deeply committed to his country and the best interests of his country.<sup>21</sup>

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21. The White House website, [www.whitehouse.gov](http://www.whitehouse.gov) (accessed on July 3, 2007).

After the terrorist attacks on the United States on September 11, 2001, Putin telephoned Bush, and thanks to the old Cold War hotline he was the first international leader to get through, which Bush greatly appreciated. Putin allowed the United States to establish air bases in Central Asia for attacks on Afghanistan. He recast the conflict with Chechnya as part of the international war on terror, which he used as an excuse to reinforce his political repression.

In December 2001, Bush abrogated the Anti-Ballistic Missile Treaty of 1972. Putin called it a mistake but that was it. However, in 2002–03 Putin linked up with Chirac and Schröder, forming a strong international resistance against the coming US-led attack on Iraq, but the US criticism targeted France and Germany. Ironically, Russia benefited from the war in Iraq, because the Arab fighters who had fought the Russians in Chechnya preferred to battle the Americans in Iraq instead.

Although Bush embraced an international democracy agenda, he refrained from uttering a word of criticism of Putin's systematic dismemberment of democracy in Russia. On the contrary, on September 27, 2003, after having hosted Putin at Camp David, Bush stated: "I respect President Putin's vision for Russia: a country at peace within its borders, with its neighbors and with the world, a country in which democracy and freedom and rule of law thrive."<sup>22</sup>

Western leaders treated Putin as Yeltsin. They saw him as a man of similar values but unable to fully see their point of view and understand how things should be done. To a considerable extent, this had been true of Yeltsin, but Putin was the opposite. He was a man who knew the West quite well but opposed its values. Western leaders failed to notice the difference and misread Putin.

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22. The White House website, [www.whitehouse.gov](http://www.whitehouse.gov) (accessed on July 3, 2007).

