

Oil and Freedom In the New Russia

Both the Russian government's attacks on civil liberties and its aggressive assertion of control over oil have recently created much stir in the global press. At a November 20 Policy Forum, Robert Amsterdam, attorney for jailed Russian oil tycoon Mikhail Khodorkovsky, and Andrei Illarionov, senior fellow at Cato and former chief economic adviser to President Vladimir Putin, discussed the connection between those two developments.

ROBERT AMSTERDAM: Russia is a great country and a great power attempting to reassert itself and find its place in the world. And in so doing, it has been making some choices that are truly creating problems for its own future growth and development: Russia has begun a war on the market.

We all understand the intimate connection between the marketplace of ideas and the marketplace of goods. We understand that people who close the marketplace of ideas, who destroy the newspapers, who attack journalists, who destroy federalism, who water down electoral results, and who change electoral law do not have a better idea. They have only one thing to sell, and that is generally fear.

"Sovereign democracy" is a theory that has been developed by Putin's deputy chief of staff Vladislav Surkov. What he is attempting to do through sovereign democracy is to give the West a rationale for its failure to attack Russia's departure from European values.

According to sovereign democracy, Russia is not ready for the separation of powers. Russia is not ready for the marketplace of ideas or the energy marketplace. Russia can meet the West only on its own terms. Sovereign democracy is an attempt to justify the asymmetry of Russian-Western negotiation.

Let us all understand the asymmetry. Russia demands access to Western markets, and Russia forecloses Western investors. Russia demands an equal seat at the table, and it imprisons Khodorkovsky. And it strands BP. And those victims of the Kremlin stay silent.

The silence of the West is a necessary part of sovereign democracy. That silence can be heard in Caracas as well as in Moscow. The world took a lesson from Yukos. It watched the largest taxpayer in Russia be grotesquely seized and expropriated for pennies on the dollar. It watched Western banks participating. And it watched the German chancellor, with no claim on moral principle, support the Kremlin and support the phony auction of Ukraine's Naftogaz, which led Andrei Illarionov to say, "Russia is no longer a free country."

The idea that the state needs to mobilize energy assets is fundamentally wrong. It is fundamentally wrong for a Russian leader, within 15 years of the end of the Soviet Union, to believe that it is the state that needs to bring Russia into the 21st century. It is as wrong for that leader as it was for Gerhard Schroeder, a German chancellor, to believe that what was important for Russia was stability and to make a Faustian bargain in hopes that an autocrat could

provide stability.

This is why the fundamental underpinnings of what is going on in Russia need to be understood by the West. The attack on Khodorkovsky and Yukos was an attack on property rights from which the West has not yet recovered. Putting energy companies in the hands of rival bureaucratic factions in the Kremlin has suppressed profits, suppressed efficiency, suppressed production, and jeopardized foreign relations with key powers such as Japan.

As the International Energy Agency suggests, Russia does not know what its oil reserves are. And you cannot plan if you do not know your reserves. And you cannot know your reserves if your government and your bureaucracy are turning more corrupt each day.

We need to understand that the attack on the rule of law going on in Russia leaves casualties. Men are imprisoned. Journalists are killed. Those are not crimes that are occurring in a vacuum. The poisoned psychology and the poisoned environment cannot be overlooked by the new leader of Japan any more than they can be overlooked by this U.S. administration, no matter how inconvenient that may be.

I come from a country, Canada, that is also known as an energy superpower. And when Canada decided it wanted to establish protection for its future, it did not expropriate companies. It did not take the best and the brightest and throw them in the gulag. It negotiated the North American Free Trade Agreement with its biggest customer and decided to share the wealth for the benefit of its customers and itself. There is a lesson for Russia in the Canadian experience.

It is very important to understand that Russia does not need the West to inculcate democratic values. The nation of Natan Sharansky needs no Western ideologist to tell its people about the rule of law and

democracy. They have it. It is innate within them that freedom exists. Anna Politkovskaya and many others in Russia who today are fighting against the fairly draconian changes that have occurred in the last few years are not some foreign virus. They are native-born.

Russia does deserve to be in the World Trade Organization, but it has to adopt the rule of law. It must engage in the rule of law not as an ego-building process for the leadership but as a system-building process for the businesses in Russia that are growing more and more corrupt each day.

The World Bank has stated that Russia today is 151st in the world in terms of rule of law and political participation. It is on a par with Swaziland. Those issues need to be addressed when the European Union and Russia meet to negotiate a further partnership agreement.

We cannot exclude the rule of law. We can never separate human rights and the rule of law from energy or any other commodity. The transparency that is reflected and developed by a free press, proper corporate governance, and the division of institutions in a country is necessary for accountability to exist. The president of France should be ashamed of himself, as should the foreign minister of Germany, for once again kowtowing to those who want to buy the West's acquiescence with energy.

Another aspect of sovereign democracy needs to be understood: the belief that the existence of energy within Russia somehow gives Russia power. That is actually not the case. Never has it been proven that having assets in the ground gives anyone power. Those assets give Russia power only if they can be mobilized and sold. And they cannot be mobilized and sold if foreigners will not invest the tens, if not dozens, of billions that it will take to actually have Gazprom meet even the requirements it has already agreed to all over the world.

Venezuelan president Hugo Chávez's defiant speech at the United Nations would not have happened had he not been in Moscow and signed a \$3 billion arms deal with the leader of Russia. What is happening with Iran would not be happening

if the Kremlin had not decided that Iran as a pariah state is far better in terms of energy competition than Iran as a functioning part of the international community.

I have made these comments about Russia, but I do not want to end before I speak about the man who is imprisoned in the gulag because he took on Russian officials. Mikhail Khodorkovsky intentionally



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went back to Russia, when he knew where Russia was going, to face down those who felt differently, to face down those who, behind the mask of sovereign democracy, are seizing assets, expropriating property, developing Russia in a way that was not intended in the post-Soviet era, and growing the bureaucracy massively.

I will end, speaking of Khodorkovsky, with the words of Pushkin: “Deep in the Siberian mind, keep your patience proud. The bitter toil shall not be lost, the rebel thought unbowed. The heavy hanging chains will fall. The walls will crumble at a word, the freedom reach you in the light, and brothers give you back the sword.”

ANDREI ILLARIONOV: Perhaps the best way to examine Russian energy policy over the last seven years would be to look at particular episodes that reveal actual policy much more clearly than does any official document.

1. *The “Electricity Reform” Affair.* If we go back to 2000–01, when the debate on electricity reform was hot, we find that it was a debate about the basic principles according to which a market economy could and should operate. Among the many issues that were under discussion at that time, the most important was: who can own the electricity grid?

There were two parties to this debate. One party stated that the electricity grid is no different from any other productive asset in the economy and can be owned by private entities. The other camp, led by the president of the RAO UES monopoly, Anatoly Chubais, claimed very strongly that the electricity grid should and must belong exclusively to the state. And in the particular circumstances of Russia, as well as perhaps of some other countries, that means that the electricity grid belongs de facto to the monopoly management.

The Russian authorities decided to take the side of those who advocated state monopoly. Private ownership of the electricity grid was legally forbidden. To make sure that nobody else would be able to own any part of an electricity grid, a strict provision was included in the Russian legislation: private companies are not allowed to own grid, are not allowed to build grid, and those private companies that might by some mistake build electricity lines will be forced to pass full control over those lines to RAO UES, a state-owned electricity monopoly. That was an important victory of the statist approach in ideology and practice over the free-market and competition approach.

2. *The Yukos Destruction Affair.* There are different hypotheses about what happened to Yukos. What is most important is that the official claims against Yukos and against its CEO Mikhail Khodorkovsky are completely false.

What reason was behind the assault on Yukos? Why has Khodorkovsky been

named a criminal? What particular crime has he committed? Semiofficially, several issues have been put forward.

First, Yukos was charged with tax evasion. But if we compare actual tax payments by Yukos with those of other energy companies, we find that Yukos was one of the largest and best taxpayers in the country. In any case, it certainly was a much better taxpayer per unit of value added than many other private energy companies and by far better than any of the state-owned companies, including Rosneft, Gazprom, and RAO UES.

Second, Yukos was accused of the barbaric exploitation of Russian national resources: allegedly, it was using the new, evidently predatory, technologies of oil extraction brought to Russia by foreigners, especially by Texans. A year after the core assets of Yukos were seized by the state-owned company Rosneft, we've learned that Rosneft is using the same methods on a scale much larger than Yukos was doing. Needless to say, the methods used by Rosneft are not called barbaric now.

A proposal by Yukos to build two pipelines, one to the Murmansk coast to supply oil to the United States and another one in the eastern direction to China and Japan, was denounced as treason. Now that Khodorkovsky is in jail, the Russian government and state-owned companies are hastily building both pipelines—which are proclaimed by state propaganda as noble projects of national importance.

Fourth, the alleged attempt to sell part of Yukos to foreign investors was presented by the authorities as an example of national betrayal. But an initial public offering (IPO) of Rosneft stock on the London Stock Exchange in July 2006, which led to the sale of a substantial amount of energy assets to foreign investors, was presented to the public as an almost heroic deed.

Fifth, Yukos managers were charged with financing political parties, including opposition parties. It is no secret that other big Russian companies are financing political parties, too, including opposition ones. For example, electricity monopoly RAO UES is financing political party SPS.

Whereas Yukos has been destroyed and Khodorkovsky has been sent to a Siberian camp, RAO UES has received massive government financing and Chubais has been warmly greeted by the Russian political leadership.

There is another important point of comparisons between Yukos and the people associated with Yukos, on the one



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hand, and other Russian companies, on the other—the fate of the production assets of Yukos. Although the predominant rule in a market economy is that ineffective economic subjects are absorbed by more effective ones, the opposite happens in today's Russia. The core asset of Yukos, Yuganskneftegaz, has been illegally confiscated by the Russian state and handed over to the most ineffective Russian oil company, Rosneft.

What explains the difference in these cases? What are the differences between Yukos and other Russian companies? The differences can be found in three main areas.

The first area is economic—economic efficiency, corporate governance, and public transparency. Between 2000 and 2003 Yukos became one of the most effective, best governed, and most transparent Russian companies.

The second area is related to Russian society—the scale of charity financially supported by Yukos. The company created Open Russia, a nongovernmental organization that taught tens of thousands of Russians democratic principles of organization for society and the state, mass media freedom, civil rights, how to operate in a free country, and how to create one. None of the other Russian companies has done anything similar to what was done by Yukos. That is why Yukos became one of the most dangerous enemies for those who did not want to see Russia a free country.

The third area is politics. Khodorkovsky himself openly challenged political monopolization. He stated clearly that he wanted to participate in the political process according, not to the rules set by the Kremlin administration, but to the rules that he saw as necessary elements of a politically free country.

Yukos was quite different from other Russian companies. None of them has done anything similar to what Khodorkovsky's company was doing. And as we can see, none of the other companies has been destroyed, none of the other entrepreneurs has been arrested and put in jail.

The main conclusion from the Yukos affair is that people who create effective, transparent, dynamic, charity-providing, and monopoly-challenging companies in Russia have a very good chance of going to Siberian camps.

3. *The Rosneft Affair.* This affair involves not only Rosneft's receipt of the stolen assets of Yuganskneftegaz. Resources from the Rosneft IPO went not to the Russian budget but to the company itself and its management. Most important and scandalous, though Rosneft was and still is presented to the public as a state-owned company, in fact, it is not. An announcement from the Russian government prior to the

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what has motivated suicide terrorist attacks and finds that we cannot simply say that they hate us for our freedoms. Suicide terrorism, he writes, is almost always a response to foreign occupation, and the terrorists behind the September 11 attacks had the clear goal of driving U.S. troops out of the Middle East. Pape thus argues that the presence of U.S. troops currently fighting in Iraq is more likely to increase terrorism than quell it. As an alternative, he presents an “off-shore balancing strategy” by which the United States reduces its occupying troops around the globe but maintains forces ready to intervene in emergencies that threaten vital U.S. interests.

Sticky Rice Policy

Rice is the third most consumed crop in the world, but it ranks first for the amount of taxpayer dollars and tariffs governments use to insulate it from global competition. In “Grain Drain: The Hidden Cost of U.S. Rice Subsidies” (Trade Briefing Paper no. 25), Daniel Griswold, director of the Center for Trade Policy Studies at Cato, explains how America undermines its own interests through heavy protection of rice. Since 1998 the United States has spent an average of \$1 billion a year on rice subsidies, and it also maintains heavy tariffs on

imported rice. Griswold argues that those policies drive up domestic prices and thus hurt consumers. Furthermore, America’s reputation suffers when rice subsidies suppress the global price and thus impoverish millions of farmers abroad. He concludes by urging policymakers to jettison the rice program, which would put the nation’s interests above the interests of the well-connected rice lobby.

Milking Taxpayers

The late Milton Friedman once said that “nothing is so permanent as a temporary government program.” A case in point may be the price supports for dairy products that were originally enacted during the Great Depression to help farmers but still remain with us today. Sallie James, trade policy analyst at Cato, argues in “Milking the Customers: The High Cost of U.S. Dairy Policies” (Trade Briefing Paper no. 24) that artificially high prices, along with \$4 billion a year in dairy subsidies, add millions of dollars to the grocery bills of Americans and invite scorn from our trading partners. To further debunk the necessity of the U.S. dairy program, James says that Americans can take comfort in the example of Australia, whose government phased out dairy sub-

sidies and deregulated milk pricing. She explains how the Australian dairy industry cooperated with those reforms and remained prosperous.

Power Corrupts Chávez

Hugo Chávez became president of Venezuela claiming that he would govern in the interests of the common man. But in “Corruption, Mismanagement, and Abuse of Power in Hugo Chávez’s Venezuela” (Development Policy Analysis no. 2), Gustavo Coronel, former Venezuelan representative to Transparency International, argues that few people have benefited more under Chávez than high-level government officials and their cronies. Coronel presents a mountain of evidence that the government has abused the lack of transparency created by Chávez. For example, he explains that, while the average salary of an official is only \$5,000 a month, officials are often found spending lavishly and living in ritzy condos that most Venezuelans cannot afford. Also, 95 percent of all government contracts are awarded without public bidding. Coronel looks at President Chávez’s expansion of the state and finds another confirmation of Lord Acton’s observation that absolute power corrupts absolutely.

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Rosneft IPO in July 2006 made it very clear that Rosneft is no longer owned by the Russian state. That means that almost \$100 billion in assets of the company has been transferred to unidentified non-government hands without even a penny going into the Russian budget.

4. *The G-8 Summit Affair.* The G-8 met in St. Petersburg just after the Rosneft IPO on the London Stock Exchange. Those two events turned out to be nothing more than the international legalization of ownership of the assets previously illegally acquired. Having destroyed basic legal and democratic institutions in Russia, the current Russian authorities searched abroad for the institutions that could protect their new assets. To secure their property, the Russian authorities needed to have

legal and political protection of those assets at a much higher and much stronger level than any Russian court or even the whole Russian legal system could provide. They searched for such protection and they found it—in the British legal system and the political arrangements of the G-8.

Therefore, I can conclude with a list of the most important milestones of Russian energy policy over the last seven years. They are monopolization of energy resources and infrastructure, confiscation of energy assets from Russian and foreign private owners, appropriation of those assets by groups of people currently in power, and, finally, international legalization of that through two of the most respected, influential, and powerful institutions of the Western world.

Cato Journal



Tax cuts have been some of the biggest political victories

for fiscal conservatives and libertarians in recent decades, but do they really reduce the size of government, as Milton Friedman predicted with his “starve the beast” strategy? In the Fall 2006 issue of *Cato Journal*, William Niskanen, chairman of the Cato Institute, and investor Jerry Tempelman present opposing arguments about whether tax cuts really do starve the beast. Niskanen recommends that fiscal conservatives focus on convincing voters that government services should be cut. Tempelman argues that spending and borrowing will always occur in response to demands of constituents, but cutting taxes can ensure that they occur at lower levels. Other articles in *Cato Journal* discuss U.S. economic policy toward China, regulation of tobacco consumption, and global warming.