

# Putin's Protection Racket

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# The Problem

- Russia went from a weak state with oligarchic power to a strong state with authoritarian power
  - How?
  - Standard answer, Putin and Siloviki
    - Does not fit with the evidence
    - Putin was not important or powerful in KGB
    - Putin has not eliminated oligarchs
    - If the conventional story is true why is Chubais a free man?
- Need to understand the nature of Putin's authority
  - The Protection Racket

# The Bad Equilibrium

- The initial condition of the 1990's is a weak state
- Mutual conflict equilibrium
  - The barons (oligarchs) cannot agree on how to settle their property (resource) claims, and they are engaged in offensive and defensive tactics against each other to maintain and advance their positions.
    - This wastes resources and threatens all of them.
  - Natural solution is the state
    - But they fear capture of the state by rivals
    - They each work to weaken the state, undermine the executive

# Mutual Conflict Equilibrium

- Simple Model

- Two oligarchs: each can allocate his resource for production, defense, or aggression. Thus, for  $i = 1, 2$

$$X_i + Y_i + Z_i \leq 1$$

- When the resource is allocated to production output is  $(X_i)^\alpha$  where  $0 < \alpha < 1$ .
- If  $Y$  of defensive resources is committed against  $Z$  of aggressive resources, the fraction that  $i$  keeps is

$$\frac{Y^\beta}{Y^\beta + \theta Z^\beta}$$

- where  $\theta$  gives the efficacy of offense relative to defense, and  $\beta \in (0, 1)$  reflects diminishing returns to fighting

# Simple Model

- Both oligarchs simultaneously engaged in all three activities. Then payoff for player 1:

$$\Pi_1 = (X_1)^\alpha \frac{(Y_1)^\beta}{(Y_1)^\beta + \theta(Z_2)^\beta} + (X_2)^\alpha \frac{(Z_1)^\beta}{(Y_2)^\beta + \theta(Z_1)^\beta}$$

- Symmetric Nash equilibrium, then:

$$X_1 = X_2 = \frac{\alpha(1+\theta)}{\alpha(1+\theta) + 2\beta\theta}$$

$$Y_1 = Y_2 = Z_1 = Z_2 = \frac{\beta\theta}{\alpha(1+\theta) + 2\beta\theta}$$

- Efficiency implies  $X_1 = X_2 = 1$  but this is not a NE.
- Note, losses rise with  $\theta$ , when technology favors offense over defense. This is Russia in 1990's with information war
- If  $\beta > 1$  asymmetric corner solution

# Environment in the 1990's

- Excess of ex-KGB agents
  - 11,000 left in 1992 alone, up to 200,000 left the MVD annually during (1992-96)
  - Federal law allows FSB officers to work at enterprises while remaining in service
  - By 1998, private security agencies had employed 50,000 former officers from state security
  - Balance regarding physical violence
- Privatization, especially Loans for Shares, viewed as illegitimate
  - Every oligarch has skeletons to hide
  - Easy to dig up evidence
  - Only protection is to dig up evidence on others
- Mutual interest: keep state weak so no reversal of privatization and no prosecutions can occur

# Consequence

- Bankers' War showed that conflict was intensifying
- Crisis reduced and reshuffled number of oligarchs
- Because offense more effective than defense, likely outcome was battle to the finish
  - Stakes were growing
  - Communists on the way back, so all may be lost



# Solution

- To the oligarchs the solution is to find mechanism to disarm
- Requirements of the mechanism
  - They need an impartial agent who can hold them hostage
  - Normal answer is the state, but they cannot use the state due to fear of capture by a rival
    - Consequence of resource abundance and inverted funnel economy
  - Need an arbiter and enforcer



# Characteristics of the Enforcer

- 3 essential requirements
  1. Completely impartial
    - Arbiter cannot become puppet of a specific oligarch
  2. Not a potential rival
    - Arbiter cannot be a potential oligarch
  3. Possess sufficient power to enforce nonaggression pact
    - Credibility with respect to punishment
- Credibility is crucial
  - If they disarm they need to know they will be protected
  - Need to know that others have disarmed
  - And that others will not rearm in the future

# The Arbiter

- Considering (3) it is clear that oligarchs cannot appoint someone to this position
  - Solution is an equilibrium, but how do you get there?
- Putin walks in and says:
  - “You know, you can stop looking. I promise to be impartial”
    - his remarks in January 2000 about from now on, all oligarchs are "equidistant from power"
  - “I promise not to be your rival”
    - his statement that, contrary to rumor, he was not going to reverse the privatizations.
  - “But, actually, I don't care whether you trust me on those points or not. The main thing is that you don't have to give me enough weapons to punish a violator of the pact. I already have them.”

# The Weapon

- Putin's weapon is a monopoly of financial information that can be used for blackmail
- Powerful because all oligarchs gained wealth and power in ways that can be made to look illegal
- Prior to Putin each oligarch is getting *kompromat* to use on each other
  - Putin has acquired all of this information
    - Also, the monopoly on new information.
      - He has the files, but he also has the sole authority to assemble new files. He shut down or took over all the rival agencies that had been involved in collecting the information (and then selling it to the warring oligarchs)
  - So if oligarch A attacks oligarch B, Putin can release info on oligarch A, wiping out any gain
  - Putin can protect each oligarch against attacks from others, and can credibly threaten any oligarch who breaks his rules

# Protection Rackets

- Classic case is use of physical force, but non-physical threats can also work
- Protection against each other, *and* protection of themselves against re-privatization
- Reminiscent of the end of the Castellammarese War
  - Putin is Lucky Luciano
    - Thus, as Capone had been earlier, Luciano was an external force enlisted to tip the balance in a struggle for power within the relatively narrow confines of the honoured society. Luciano's contacts with the much larger universe of Jewish and Irish organized crime were the key resource that he brought to bear *within* the mafia." John Dickie, *Cosa Nostra: A History of the Sicilian Mafia*. London, Hodder & Stoughton, 2004: 229.
  - Protection Racket is the National Commission



# Counterfactual

- Alternative to information-system would require Putin to have a private army.
  - But then the state and police are a counter to the private army – no monopoly
  - Financial information monopoly easier to obtain → fewer agencies to dominate, but many thugs to hire
- Putin convinces oligarchs to disarm by committing not to become oligarch.
  - He takes their weapons under lock and key. They don't need weapons against each other.
  - Rent dissipation is reduced by disarmament.
    - He is like supra-national authority that has controls over everybody's nuclear weapons.



# Putin's Protection Racket

- PPR is informal
  - Putin cannot bring weapon into the state, risks capture
  - Oligarchs need to know that Putin will control it
    - Zubkov
- State still plays role
  - Prosecute transgressors
    - It is the fear that each of them have that they could be prosecuted, and Putin's promise that they won't unless they violate the rules of the PPR which makes it work.
    - State is his stick.
    - Putin needs to control state to use weapon, but needs weapon to be informal to prevent state capture by oligarchs

# Putin and the State

- Notice Putin benefits from efficient state
  - Well-functioning law enforcement and judicial system
    - well-functioning in the sense that once damning evidence is presented, conviction is automatic.
    - Putin then doesn't have to control or manipulate such a system.
    - He need only feed it with the damning evidence – the financial information.
    - This is more efficient than the alternative of constantly having to intervene and micromanage the judicial system, compelling it to act on false or manufactured evidence, etc.

# Rise of Putin

- The real story then is how did Putin acquire the monopoly of information?
- Starts with Chubais
  - Creates the oligarchs to destroy communism
  - Plan A
    - Wants to create an RMS that can collect taxes and create strong state, but due to funnel economy, he cannot collect taxes
      - Svyazinvest is supposed to create impartial system
    - Bankers' War erupts and eliminates Chubais
      - Makes clear the power of kompromat



# Plan B

- But Chubais also had Plan B
  - Kudrin and then Putin brought to Moscow
    - Kudrin then Putin to GKU
      - 12,000 inspections in 1996
      - VChK gets attention, GKU does work
  - Goal is to concentrate power in GKU
    - Kudrin to Finance Ministry
    - Putin heads Presidential Administration for Work with Regions
    - Patrushev gets GKU

# Plan B (cont.)

- Putin has two rivals to deal with
  - Putin takes over FSB, purges economic crimes department
    - Appoints Patrushev head of newly created Dept of Economic Security of FSB in October 1998
    - August 1999: Putin becomes Acting Prime Minister, Patrushev acting head of FSB
    - Abolishes economic crimes unit of FSB
  - Other key agency is Tax Police
    - Putin replaces head of the Tax Police with his man, Vyacheslav Soltaganov
      - Prior to this Putin made him Deputy Head of GKU in charge of power ministries (from MVD, not KGB)
- Monopoly on financial intelligence established by April 1999

# RFM

- Final step is to set up new agency to administer monopoly on financial information weapon
  - Russian Financial Monitoring Service – Rosfinmonitoring – set up in November 2001
  - Head: Viktor Zubkov, a member of “Kudrin’s team” since 1991
    - (Zubkov hands over St. Petersburg tax agency to his son-in-law, Serdyukov, later head of Federal Tax Service and now RF Defense Minister)
  - Zubkov – master of financial information
- Zubkov given the “black suitcase” in 2001. Still has it.

# Play by the Rules

- Key to system is playing by the rules.
  - Example. Nazdratenko. Governor of Primorsky, Chubais had demanded his resignation for corruption.
    - But when Putin become President, rather than prison, N was appointed first to the lucrative position of head of the State Fisheries Committee and then promoted to deputy secretary of the Security Council.
    - Why? Chubais explains:
      - “This [the treatment of N] is the way that our president was demonstratively explaining the new rules of the game to the elite.’ ... Putin was showing that those who play by the rules (and N did play by the rules, because in the end he agreed to voluntarily retire from Primore) will be treated as one of ours, and we will not touch them. But those who do not agree to play by the rules will be dealt with with the full severity of the law...!”
      - Chubais disclosed further to her that it was personally Putin who “gave the order to the FSB to block all criminal actions against N and to shelve all the *kompromat* found on the Primore governor.”
  - Notice that Chubais uses “we” not “he”
  - Recall that Khodorkovsky was also offered a deal, but he refused it

# The Deal

- Prior to Putin Governors were power source
  - Oligarchs protected themselves by investing in governors
    - Governors were alternative sources of protection, and competed for support
- Putin eliminates Governors as rival by ending direct elections
  - Eliminates incentive for oligarchs to buy Governors, and protects oligarchs from actions by Governors
    - From competitive to monopoly predation

# Putin

- Trained as case officer: “identify, recruit, and run agents”
  - Patient
  - Cultivate sources
  - Wait to exploit information
- Pudrin, Chubais, Zubkov, Medvedev, Sechin go back together to 1990
  - *Siloviki*?
    - Putin is only one with proven *silovik* background - and he was an outsider
    - Sechin? Very low level GRU ... perhaps (Romance languages major)
    - Medvedev: lawyer; Chubais, Kudrin: economists; Zubkov: farm manager

# Protection Racket

- This explains how Putin can leave Presidency and retain power
  - Why he could choose Medvedev rather than Ivanov with no complaints from *siloviki*
- Explains why Putin keeps the oligarchs, and helps them in the crisis
- Explains why anti-corruption drives target lower levels
- Predicts that Putin is indispensable to the regime