Resource Wealth and Institutional Change:

The Political Economy of Tax Reform in Russia

By

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In Russia, nothing happens in legislation unless it is driven by the oil and gas companies.
--Russian financial analyst, name withheld[1]

Introduction

With few exceptions, scholars and policy-makers alike have been very pessimistic about Russia's prospects for economic reform.[2] Many have also attributed the stagnation or absence of economic reform in Russia to the evils of "insider privatization" and the efforts of these "early winners" to prevent further reforms in order to protect their own economic gains from the initial reforms that took place in the early 1990s (see, e.g., Alexeev, 1999; Black, Kraakman, and Tarasova, 2000; Hellman, 1998; and Sonin, 1999).

Significant reforms in Russia's energy sector and the taxation regime over the past few years, however, seem to challenge both of these prevalent views. The energy sector is not only the leading economic sector in Russia,[3] but also the most notorious for the way in which its industrial leaders acquired private ownership through a pure "asset grab" followed by a "loans for shares" deal (see, e.g., Johnson, 1997 and McFaul, 1995 for details).[4] Yet, by end of 1998, the oil industry was fully privatized, substantially deregulated, and had undergone significant internal restructuring (see Table 1 below). Even more recently, the Russian government has adopted (1998-2000) and enacted (1999-2002) a new Tax Code that by most accounts exceeds Western standards.[5] For example, it introduced a 13 percent flat tax on personal income, capped

[1] Authors' personal communication, Moscow, September 2001.
[2] Shleifer and Treisman (2000) is noteworthy for its balanced evaluation of economic reform in Russia.
[3] The energy sector accounts for approximately 40 percent of Russia's exports and 13 percent of its GDP. See http://www.eia.doe.gov/emeu/cabs/russia.html.
[4] This process mirrored the "spontaneous" or unofficial privatization (a.k.a. "stealing the state") that took place throughout the economy. See Solnick, 1998 for a full description.
[5] The Tax Code consists of two parts. Part I was adopted in July 1998 and enacted in January 1999; it covers administrative and procedural matters, including the introduction of new taxes and the protection of taxpayers' rights. Part II was adopted in August 2000, amended in November and December 2001, and enacted in 2001 and 2002; it includes specifications on various taxes, including the VAT, corporate profits tax, personal incomes tax, and

corporate contributions to the social insurance fund, reduced the profits tax (a.k.a. corporate income tax) rate from 35 to 24 percent, abolished turnover taxes (as of 2003), tied export tariffs directly to the price of oil, and established new accounting procedures that are on par with International Accounting Standards.[6] It has also won the praise of foreign and domestic financial and political analysts for its potentially positive impact on the Russian economy as a whole (see, e.g., Arthur Andersen, 2002; Rabushka, 2002; Authors' personal communications with domestic and foreign financial analysts in Russia, Moscow, September 2001). Moreover, the initial results indicate that tax collection rates have increased since the new code was put into effect (see, e.g., *Pravda*, October 18, 2001; and *Kommersant*, October 19, 2001.[7] How do we explain this apparent puzzle of reform? More specifically, how did this new tax code come about? And, more broadly, how is far-reaching economic reform possible when the most important sector is dominated by early winners? These are the primary questions we address in this paper.

Table 1 about here

What makes the emergence of the new Tax Code even more puzzling is the fact that it represents a sharp break with the status quo equilibrium whereby each side adopted a strategy of risk-dominance (DD) in order to avoid ending up at the worst outcome of unreciprocated cooperation (CD), as in an assurance game. Owing to mutual suspicion and weak enforcement, for most of the 1990s the Russian government's best strategy was to maximize its revenue through a flexible tax policy and the Russian oil companies' (hereafter, ROCs) best strategy was to evade taxes (see Table 2 below). In short, the new Tax Code thus required the Russian

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the social tax. This paper focuses primarily on explaining Part II, although Part I laid the groundwork for the approval and implementation of Part II. For an overview see, OECD, 2001, pp. 115-144

[6] Consider, for example, the fact that this 13 percent flat tax is even lower than the 17 percent advocated by Steve Forbes, and that the 24 percent profits tax is lower than the OECD rate. In addition to these changes, there is also a movement to establish a new mineral production tax as a flat rate pegged to the price of oil (Authors' personal communication with Steven Dashevsky, CFA, Aton Group, September 19, 2001).

[7] German Gref, Minister of Economic Development and Trade, also boasted that "tax collection in the first six months of [2001] exceeded the projected level" (RFE/RL, 2 August 2001).

government and the ROCs to simultaneously abandon their equilibrium strategies of defection and to adopt a much riskier strategy of cooperation. Why did both sides risk a less optimal outcome? What explains this apparent convergence of interests and behavior?

We argue that the new Tax Code is the outcome of a negotiated settlement between the Russian government and the ROCs whereby the former sought to stabilize its revenue stream and the latter sought to stabilize its tax burden. Yet, this is not a simple story of economic interest groups bargaining with a predatory state to receive formal guarantees. Nor is the new Tax Code simply a product of direct foreign pressure (e.g. in the form of foreign consultants or the International Monetary Fund) compelling the Russian government to design a more suitable (i.e. Western-style) tax regime.[8] Rather, it is a story of mutual vulnerability to global markets and the powerful incentives that this can create for desiring formal guarantees at home.

For both the Russian government and the ROCs, the August 1998 financial crisis served as an exogenous shock that caused a profound shift in their perceptions about the value of their current strategy (i.e. defection) and the riskiness of pursuing the alternative strategy (i.e. cooperation), enabling them to realize the mutual gains from cooperation. In short, this crisis magnified their mutual vulnerability to global markets because it threatened the basis for their political and economic survival. In order to recover and to insulate themselves against future effects of global markets, both sides realized the need to establish and abide by formal rules of the game. For the Russian government, fixed tax rates would decrease the level of fiscal uncertainty that was characteristic of the mid-to late 1990s, reduce the costs of tax collection, and thus create a domestic environment in which the government could broaden its tax base and promote long-term economic development beyond the energy sector. For the ROCs, tax

[8] In fact, since 1997 the IMF has been encouraging the Ministry of Finance to raise, not lower, tax rates (Authors' personal communication with Arkady Dvorkovich, Deputy Minister, Ministry of Economic Development and Trade, Moscow, July 5, 2002).

compliance would enable them to invest in modernization and attract Western partners in order to expand their operations at home and abroad, which in turn required increased transparency and corporate governance. They conveyed this change in interests and future behavior through incremental strategic moves to assure the other side that they were committed to reform.

Our findings contribute to the broader understanding of economic reform and institutional change in several ways. First, they bolster our previous claim that privatization offers a potential way for resource-rich countries to escape the so-called "resource curse" because it forces governments to negotiate with domestic actors for revenue (Jones Luong and Weinthal, 2001; Weinthal and Jones Luong, forthcoming). Global markets are unlikely to induce the government's desire for formal rules of the game unless natural resource wealth is privatized because ownership provides states with a more secure revenue stream (or at least the perception that it is more secure). Thus, although states that maintain full ownership may feel the pressure of boom and bust cycles due to fluctuations in world market prices, they will not feel compelled to adopt a formal agreement in response to these cycles. Rather, they are more likely to arbitrarily confiscate profits, increase exports, and/or borrow abroad against future revenue from their resource wealth. In contrast, where domestic private owners exist, they can serve as an engine for economic growth by demanding formal guarantees from the government in response to such crises.[9] Regardless of how the ROCs initially acquired their wealth, due to their desire to access and compete in global markets, these "early winners" have over time become perhaps the most important proponents of economic reform in Russia.

Second, if global markets can indeed foster the desire for formal rules then this both counters the conventional wisdom that resource wealth necessarily leads to myopic decision-

[9] The link between formal guarantees (in the form of property rights and/or political representation) and economic growth is discussed, for example, in North and Weingast, 1979, Olson, 1993, and Weingast, 1993.

making (see, e.g., Karl, 1997; Mahdavy, 1970; Mitra, 1994; and Shafer, 1994) and suggests another benefit of globalization. Whereas the logic behind the classic Prisoner's Dilemma -- that is, that individually rational outcomes can be collectively suboptimal -- is often used to justify government intervention in markets, in this case global markets seem to promote pareto optimal outcomes where government intervention fails.[10] It also points to an alternative mechanism whereby foreign investors and the lure of global markets leads to more stable institutional environments. The new Tax Code is not the product of direct foreign pressure, but of internal bargaining between the government and the ROCs. Nor did the Russian government adopt a new tax regime to attract foreign direct investment, but rather, because ROCs wanted to secure their property rights at home by attracting Western partners.

Finally, our findings clarify the role of exogenous shocks in inducing institutional change. While crises are often invoked as an explanation for political and economic reform (see, e.g., Krasner, 1994; Haggard and Kaufman, 1997) the precise causal mechanisms are rarely specified. The case of the new Tax Code in Russia provides additional support for the argument that exogenous shocks cause fundamental institutional change only when incumbents believe that continuing current policies directly threatens their own survival (Jones Luong, 2002). The question remains, however, as to how this change in perceptions translates into a change in behavior that makes institutional creation or change possible. The answer that we provide is that actors must engage in incremental strategic behavior to indicate and then to assure one another that this change in beliefs and behavior has indeed taken place. This contrasts with the literature in international relations, which finds that a single bold or pre-emptive strategic move by one player is sufficient for cooperation to occur (see, e.g., Jervis, 1978; Maoz and Felsenthal, 1987).

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[10] The classic prisoner's dilemma is part of a broader class of collective action games similar to Hardin's (1968) "tragedy of the commons" and Olson's (1965) "logic of collective action". For an overview, see Ostrom, 1990.

It also suggests an explanation for sustained cooperation after crisis. In short, because it serves to build up trust over time, incremental strategic behavior may produce a more self-enforcing outcome than a unilateral strategic move.

This paper proceeds as follows. First, we describe the central empirical puzzle -- *How did the new Tax Code, which required both the government and the ROCs to reverse their equilibrium strategies of defection in favor of a much riskier strategy of cooperation, come about?* -- in more detail. We then we put forth our explanation, which is based on the incentives that mutual vulnerability to global markets creates for desiring formal guarantees, and thus, promoting cooperation. Third, we briefly consider several alternative explanations. We conclude by discussing several implications of our findings for understanding economic reform, institutional change, and the role of exogenous shocks in inducing both.

The Puzzle: From Defection to Cooperation

Tax policy in Russia for most of the 1990s can best be described as an informal bargaining process whereby economic elites presiding over the country's industrial enterprises as well as regional leaders engaged in on-going negotiations with the government to determine their respective tax burdens.[11] Not surprisingly, the government purposefully targeted the highly lucrative and concentrated industries in the energy sector for revenue extraction. While official tax rates for industry and revenue sharing for regions existed on paper, they were rarely if ever observed and tax collection rates were abysmally low as a result (see, e.g., Gustafson, 1999,

[11] For a more detailed description of this process, see Easter, forthcoming and Weinthal and Jones Luong, forthcoming.

Chapter 9; and Shleifer and Treisman, 2000, Chapter 6).[12] For example, although the statutory tax rate for the oil companies was 53 percent of revenues, the Russian government only managed to collect between 33-35 percent of revenues (Authors' personal communication with Vitaly Yermakov, Research Associate, CERA, June, 2002 and Dvorkovich, op.cit). Moreover, responsibility for determining tax rates in the energy sector was often shared by the Ministry of Fuel and Energy and the Ministry of Finance, which resulted in constant fluctuations in the tax rates, especially pertaining to excise taxes. The Russian oil companies' (ROCs) tax burden was also exacerbated by the tendency of regional and local governments to levy "informal" taxes on the oil companies operating in their regions by forcing them to provide social services and infrastructure investments (Gustafson, 1999, p.207).

This system emerged (and persisted for several years) neither because it was the most optimal nor the most efficient outcome for both parties concerned (i.e. the ROCs and the Russian government).[13] Rather, it resulted from each side failing to realize mutual gains through cooperation as in an assurance game (see Table 2).[14] In general, revenue-seeking governments have three available strategies. They can confiscate revenue arbitrarily, rely on flexible rates that are negotiated with various groups from year to year, or set a lower fixed rate for all taxpayers. Because the Russian government was too weak to be predatory in this regard, however (see, e.g.,

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[12] According to the IMF, even as of January 1, 2000, the value of unpaid taxes at the consolidated level (federal and local governments) was 8.3 percent of GDP. Russian Federation: Selected Issues, IMF Report 00/150, November 15, 2000, 69, 71.

[13] Although regional leaders were also influential in shaping taxation policy in the early 1990s, the ROCs and the Russian government were, however, the most important actors involved in the formulation of the new Tax Code (Authors' personal communication with Alexander Ustinov, Economic Expert Group, Moscow, June 2002). As a result, we frame our assurance game as a two-player game.

[14] In this game with two Nash equilibria whereby neither dominates the other, mutual cooperation (C,C) is the pareto-superior equilibrium. Yet, actors often find themselves at the pareto inferior equilibrium (D,D) because neither side can be assured that the other will also cooperate. For more on assurance games, see Fudenberg and Tirole, 2000 and Dixit and Skeath, 1999. Note that assurance games are often characterized as a form of coordination game.

Jones Luong and Way, 2001),[15] it was left with only the latter two strategies. Taxpayers (in this case the ROCs) also have two available strategies regarding taxation; they can either choose to evade [official] tax rates set by the government or to comply with these rates and "play honest."

Looking at Table 2 below, it is easy to see that in the absence of any credible pre-commitment from the ROCs to play honest and given the high costs of enforcement, the Russian government would always choose to rely on flexible tax rates rather than to attempt to introduce a lower fixed rate because this would maximize its payoff regardless of what the ROCs choose to do. Similarly, the ROCs would always be better off choosing to evade taxes in the absence of a guarantee from the Russian government for a stable tax rate while utilizing their privileged access (formal and informal) to policy-making levers to negotiate a reduced tax burden. Since both players expected the other side to defect owing to a general culture of mutual suspicion, it was thus rational for them to pursue a strategy of risk-dominance (DD) in order to avoid ending up at the worst outcome of unreciprocated cooperation (CD).[16] Thus, the status quo prior to the new Tax Code can be characterized as a coordination failure in which both actors preferred to play a strategy in which "all hare risk-dominates all stag," resulting in a pareto inferior Nash equilibrium.[17]

Table 2 about here

The new Tax Code itself thus presents a striking puzzle because it amounts to both sides making a sharp shift from their equilibrium strategies of defection to a much riskier equilibrium strategy of cooperation. In order for such an agreement to emerge, each side had to willingly incur the risk that the other side would continue to defect, and thus that it would be left worse off

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[15] The origin of this argument comes from Lucan Way's analysis of Ukraine. See Way, 2001.
[16] For more on risk-dominance, see Harsanyi and Selten, 1988; Cooper, 1999; and Carlsson and van Damme, 1993.
[17] This assurance game resembles the Stag Hunt game as described in Jervis, 1978 in which the players' preference ordering is: CC>DC>DD>CD. See also, e.g., Oye, 1986.

-- i.e. with a lower payoff than before. Moreover, the mechanisms that might facilitate cooperation -- such as 1) coercion, 2) a pre-commitment strategy,[18] or 3) social norms (e.g. focal points)[19] -- are clearly absent in this case.

First, in the late 1990s, the Yeltsin administration took a very public stance against tax evasion when both the new Prime Minister Sergei Kiriyenko and the newly appointed head of the State Tax Service, Boris Fyodorov, announced that they would take a much tougher stance toward collecting taxes, particular from the oil companies (see, e.g., *I-Tass Weekly*, June 26, 1998).[20] Yet, its repeated attempts to coerce tax compliance within the energy sector by threatening enterprises with bankruptcy, blocking access to export venues (i.e. trunk pipelines and seaport terminals), and launching criminal investigations against oil companies met with very limited success (see, e.g., *I-Tass Weekly*, June 22, 1998; *RPI*, August 1998; *Moscow Times*, August 28, 1999, and September 2, 1999).

Second, neither party was unilaterally willing to abandon its dominant strategy in order to lower the magnitude of risk generated by CD. Rather, each party continued to pursue independent strategies that only enhanced the risk that the other would defect. For example, even when oil prices were declining in early 1998, rather than easing the tax burden on the ROCs, the government sought to squeeze the ROCs for additional taxes to cover the gaps in the government budget (*RPI*, June/July 1998). Likewise, the ROCs' strategy to exaggerate their losses to obtain tax breaks only added to the level of mutual distrust between the ROCs and the Russian government (*RPI* April 1998).

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[18] A pre-commitment strategy occurs when one player unilaterally makes an extreme strategic move to convince another player that he/she is willing to abandon his/her dominant strategy and change his/her behavior. On pre-commitment strategies, see, e.g., Maoz and Felsenthal, 1987.
[19] On focal points, see Schelling, 1960.
[20] In conjunction with these public statements, on May 22, 1998 Kiriyenko signed Government Ordinance No. 476 – "On measures to enhance the effectiveness of using bankruptcy procedures, and endorsed the provision on accelerated application of bankruptcy procedures" (*RPI*, August 1998).

Finally, as will become clear below, the persistence of the behavioral norms and informal networks that guided elite behavior in the Soviet period actually facilitated the status quo pareto inferior equilibrium, rather than serving as a focal point to achieve the pareto optimal equilibrium.

Adding to this puzzle is the fact that in the absence of such mechanisms, both sides willingly agreed to unilaterally change their strategies and hence “tie their hands” through the formalization of tax obligations. Doing so, moreover, required that both effectively relinquish the primary source of their bargaining power vis-à-vis the other.

Prior to the new Tax Code, the RCOs were able to effectively evade taxation because they could hide their profits through a series of legal and semi-legal schemes. Transfer pricing was the most common form. Because the corporate income tax (or profits tax) was based on trade rather than production, parent companies could reduce their official income by creating trading subsidiaries (often located in a low tax zone within Russia) from which they purchased oil at below market prices and then resold this oil at equally low prices to off-shore Russian intermediaries (often located in a free-trade zone). By some estimates, the oil companies have been able to hide at least 25 percent of their export proceeds through transfer pricing (Authors’ personal communication with Yermakov, op. cit.). As a result of such tax avoidance measures, despite the high statuary tax rates in Russia, the government only received 22 percent of the approximately $30 billion in windfall rent from natural resources sales in 2000 while 78 percent remained in the hands of (largely oil and gas) exporters (Authors’ personal communication with Yermakov, op. cit.). Actual (versus statutory) tax rates on oil were not only lower than they should be, but also differed markedly from company to company (see, e.g., *Novaiia gazeta*, August 7, 2000). Parent companies also devised several schemes to avoid payroll taxes. These included creating offshore subsidiaries to pay their employees, arranging for insurance companies to pay their employees under the guise of large monthly payouts from life insurance policies, and paying higher corporate banking fees so that employees would earn higher interest rates than the market rate on their checking accounts.

Although the Russian government's auditors and the Ministry of Finance could ascertain a close estimate of what the ROCs' actual profits were through export quotas and yearly audits, the prevalence of these legal and semi-legal mechanisms to evade taxation made it extremely costly to catch or to sanction the ROCs for tax evasion (Authors' personal communication with representatives of Russian oil companies and with tax auditors, Moscow, July 2002). Thus, the Russian oil companies' expected utility of tax evasion (EU_E) was greater than their expected utility of playing honest (EU_H) because there was a very low probability of being caught and sanctioned.[21]

Yet, the new Tax Code is deliberately designed to eliminate such loopholes. Transfer pricing, for example, has been rendered less effective through a new tax regime that essentially taxes profits from production rather than trade (Authors' personal communication with Richard Lewis, Ernst and Young, June 2002). In addition, whereas the oil companies earlier paid taxes on their realization price, which was much lower than the market price, the new transfer pricing chapter of the Tax Code forces the oil companies to pay taxes on their exports according to "publicly quoted spot prices in international markets" such that they cannot artificially deflate the selling price (Authors' personal communication with Yermakov, op.cit). The incentive to avoid payroll taxes has also been greatly reduced for both employer and employee by

[21]The expected utility of tax evasion is $EU_E=R-T_E$ which is equivalent to revenue minus taxes after evasion, which depends on the probability of being caught and sanctioned. The expected utility of playing honest is: $EU_H=R-T_H$ where $T_H \geq T_E$.

consolidating and capping the corporate contribution to the social insurance fund and introducing a flat tax on personal income, respectively.

At the same time, ROCs benefited from flexible tax rates because they had privileged access to both formal and informal policy-making channels. Throughout the 1990s, they exerted political influence through two main forms of lobbying. The first and most common form was to influence deputies in the Duma to oppose or support proposed government legislation. The oil companies achieved this by either simply bribing deputies or supporting their own candidates (often former employees) for election to the single-mandate seats. Some analysts claim that whereas the former was the norm for most of the 1990s -- with the exception of representatives from oil and gas regions whose interests were inseparable from the oil and gas lobby -- the latter became the norm as of the 1999 elections (Authors' personal communication with Boris Makarenko, Deputy Director General, Center for Political Technologies, September 19, 2001, and Oleg Vyugin, Chief Economist, Troika Dialogue, September 17, 2001). As regional legislatures have become more important -- e.g. in determining PSAs and granting licenses -- some oil companies have also pursued the strategy of supporting candidates in regional elections (Authors' personal communication with Russian oil company representative, Moscow, September 2001). Overall, lobbying techniques have become more sophisticated over time – prompting one expert to claim that they are "looking more and more like the U.S. Congress" (Authors' personal communication with Makarenko, op. cit.).[22] The second form of lobbying took place through direct, personalized contact with members of the executive branch -- most importantly, the Ministry of Fuel and Energy. Many oil companies used their close relations with key government ministries to block what they considered to be unfavorable legislation, including

[22] As part of their strategy to guarantee more support in the Duma, for example, some companies (most notably Lukoil) have organized trips for deputies out to the Caspian region and organized meetings with the deputies -- e.g., to discuss tax issues.

previous versions of the Tax Code (Authors' personal communication with Mark Urnov, Center for Political Technologies, September 19, 2001).

Different companies have relied on different tactics, depending on resources, and did not seem to coordinate their strategies. Lukoil and Gazprom, for example, relied more on their close government contacts and gained influence in the Duma by supporting candidates and parties, respectively (Authors' personal communications with Vladimir Konovalov, Director, Petroleum Advisory Forum, September 14, 2001, and with Russian oil company representatives, Moscow, September 2001, op. cit.). In contrast, most agree that TNK and YUKOS achieved more influence through bribery.

Regardless of the method, however, the oil and gas lobby was highly effective and thus widely considered to be "one of the strongest and most effective lobbies" in Russia (Authors' personal communication with Vadim Eskin, Cambridge Energy Research Associates (CERA), September 12, 2001).[23] For the latter part of the 1990s, this lobby convinced a sufficient number of deputies and government officials to block tax reform and even to reverse unfavorable changes made by executive decree[24] In March 1997, for example, ROCs persuaded both the Duma and the government to reverse a R15,000 increase in the oil excise tax (from R70,000 to R55,000 per ton of crude) that the Ministry of Finance and the State Tax Service pushed through several months before (*RPI*, March 1997).

By agreeing to the new Tax Code, then, the ROCs forfeited a distinct advantage vis-à-vis the government. The benefits are, of course, a reasonable tax system and stable rules of the game. But there are also costs. In short, the oil companies paid for those benefits by agreeing to

[23] This sentiment was shared by other experts whom the authors interviewed, including Makarenko, op. cit., and Urnov, op. cit..

[24] Although legally (i.e. according to the 1993 Russian Constitution) taxation is under the purview of the legislature, President Yeltsin often implemented tax reform by decree.

full disclosure and strict[er] governmental controls. Once they did this, moreover, they effectively tied their hands; that is, there was no longer an option for them to return to the previous status quo because their profits, along with their accounting and reporting procedures, were made public. To grasp just how risky such a strategy is, consider the fact that if the government were to unilaterally abolish the flat tax or raise the rates to previous levels, the ROCs would be forced to pay much higher taxes on their actual profits -- at least in the short-run (i.e. until they come up with new tax evasion schemes).

The previous system of taxation also had some clear advantages for the Russian government. It was able to collect at least a portion of the revenue it sought by setting exorbitantly high tax rates by decree and threatening to employ different coercive means, such as blocking access to pipelines and export markets. Maintaining high tax rates was in fact the favored strategy within the Ministry of Finance, whose officials consistently believed that this was the best way to replenish the budget despite low compliance rates (see, e.g., *RPI*, March 1996; and Samoylenko, April 1998; Authors' personal communication with Dvorkovich, op.cit.). The Russian government's expected utility of a flexible tax rate (EU_{FlT}) is equivalent to the revenue accrued from the flexible tax rate minus the costs of the flexible tax rate whereby the costs of the flexible tax rate are a function of the proportion of the revenue that leaves the country and the proportion of tax evaders. [25] Given the elaborate legal and semi-legal schemes employed by the ROCs for tax evasion, the best way for the Ministry of Finance to insure a guaranteed income was to set the rate exceptionally high, since the government only expected to receive a proportion of the taxes owed. The government could, moreover, guarantee itself a

[25] More formally, $EU_{FlT} = R_{FlT}$-C_{FlT} where $C_{FlT} = f(P_1, P_2)$. Likewise the expected utility (EU_{FiT}) of a fixed tax rate is equivalent to the revenue accrued from the fixed tax rate minus the costs of the fixed tax rate. The costs of a fixed tax rate are a function of the proportion of the revenue that leaves the country and the proportion of tax evaders. Thus, $EU_{FiT}=R_{FiT}$-C_{FiT} where $C_{FiT}=(P_3,P_4)$.

source of fuel by arbitrarily granting tax arrears to companies in exchange for providing energy to delinquent customers, which often included domestic industries as well as households (Jones Luong, 2001). Thus, by agreeing to the new Tax Code, the Russian government also forfeited its advantage vis-à-vis the ROCs to raise the tax rates arbitrarily, especially if the ROCs fail to comply with the new tax rates or if the government experiences a deficit in its budget revenue, and to confiscate assets when companies cannot pay such exorbitant tax rates. Similar to the RCOs, in adopting the new Tax Code as a law (i.e. rather than a decree), the government effectively tied its hands.[26]

Explaining Cooperation: Shocks, Mutual Vulnerability, and Institutional Change

Russia's new Tax Code thus represents a decisive departure from the previous status quo in which the best strategy for each side was to defect. In short, it required the ROCs and the Russian government to simultaneously abandon their equilibrium strategies of defection and to adopt a much riskier strategy of cooperation. What explains this convergence of interests and behavior?

We argue that the desire to cooperate, and hence the creation of a new Tax Code, was induced by the August 1998 financial crisis. (See Figure 1 below). This crisis served as an exogenous shock to the Russian economy that magnified the mutual vulnerability of both the Russian government and the ROCs to global markets. The immediate effect of the 1998 shock was a change in both actors' perceptions concerning the relative utility of their current risk-dominance strategies (DD). Subsequently, to recover from the shock and shield themselves from future crises of this magnitude, they both realized the need for stable rules, which required

[26] Changing a law is much more difficult than changing a decree because the former must pass through the Duma, which can be both a long and contentious process.

formal guarantees that neither side would unilaterally defect. In particular, the Russian government sought to stabilize its revenue stream while the ROCs sought to stabilize its tax burden through the formalization of the tax code. The shock thus served as a "learning mechanism," whereby each player simultaneously realized the benefit of changing their equilibrium strategies from mutual defection (DD) to mutual cooperation (CC).[27] Their mutual desire for cooperation, however, was not sufficient to cause fundamental institutional change. Rather, both sides had to effectively convey their commitment to tax reform through a series of incremental strategic moves.[28]

Figure 1 about here

Mutual Vulnerability, Change in Beliefs, and the Need to Recover

Although its root causes were much deeper, the Russian government's decision to devalue the ruble and place a moratorium on external debt payments triggered the August 1998 financial crisis that sent shockwaves throughout the Russian economy: real GDP plummeted, inflation and unemployment soared, and commercial banks went bankrupt (see, e.g., OECD, 2000, pp.33-45).[29] At the same time, the August 1998 shock provided the impetus for both the Russian government and the ROCs to seek a compromise in the form of a new tax regime.

As noted in the previous section, by the late 1990s Russia's tax regime had devolved into a vicious cycle whereby the Russian government set exorbitant tax rates that encouraged evasion, which in turn encouraged the government to maintain or increase these rates while engaging in coercive measures to increase compliance. Although the government has attempted to introduce

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[27] Although learning processes and preference change can be endogenous (see, e.g., Zeev and Mor, 2002), in this case, they are the result of an exogenous shock.

[28] We define a strategic move as an expression of changed beliefs intended to create the expectation that commensurate actions will follow.

[29]As of late 1997 and early 1998, the Russian government was facing chronic fiscal imbalances and indebtedness, especially as tax revenue collection was declining and the economy was becoming increasing demonetized (OECD, 2000, p. 35).

new tax legislation since 1995, it was continuously stalled by the oil and gas lobby in the Duma, which the Yeltsin administration attempted to circumvent by issuing new decrees. Even as late as April 1998, the Duma and the government could not reach an agreement concerning tax reform. Rather, the former continued to impede reform by adopting numerous amendments and the latter refused to lessen the tax burden or address procedural issues related to taxpayers rights (see, e.g., Samoylenko, April 1998). Similarly, in addition to blocking tax reform in the Duma, the ROCs continued to exaggerate their losses in order to obtain tax breaks (*RPI*, April 1998, p.10) and to pressure the government to lessen their tax burden.

This situation, however, changed dramatically in the aftermath of the August 1998 financial crisis. The financial crisis, which resulted in enormous losses in profits and tax revenue to the ROCs and government, respectively, revealed the extent to which both the ROCs and Russian government were vulnerable to global markets, and thus, how costly it would be to continue their prior strategies. Specifically, the shock changed the payoff structure for both actors by raising the costs of mutual defection (DD) and individual defection (DC), as illustrated in Table 3 below. For the oil companies, the 1998 crisis was “sobering” as it made them “realize the cumulative negative effects of their previous behavior” (Authors’ personal communication with representative of Russian oil company, Moscow, July 2002). Following the crash in August 1998, many of the oil companies (e.g. YUKOS, Sibneft, and TNK) faced bankruptcy and lacked a cash flow to service their debts. Because many of the ROCs had acquired substantial foreign debt, the Russian government’s decision to devalue the ruble made it even more expensive to repay these loans (*RPI* September 1998, p. 7). Moreover, the ROCs were unable to pay salaries, and many companies (e.g. Sibneft) were forced to shut down their operations for several months or to radically downsize their operations and decrease expenditures (Authors’ personal communications with representatives of Russian oil companies, Moscow, June-July, 2002 and *RPI*, October 1998, p. 17). Similarly, the 1998 financial crisis that ensued after the 1997 Asian economic crisis and the dramatic fall in world oil prices revealed how vulnerable the government was to global markets due to its dependence on oil exports for budgetary revenue. Almost immediately, federal government revenues and expenditures plunged in response to the 1998 crisis.[30] According to the IMF (2000, pp. 60, 63), cash revenues dropped in the third quarter of 1998 to just 7 percent of GDP from 10.5 percent of GDP in the first half of 1998, and cash spending fell in the third quarter to 11 percent of GDP from 16 percent of GDP in the first half of 1998. As a result, according to Sergei Dimitrievich Shatalov, First Deputy Minister of Finance, "[The 1998 financial crisis] created the realization that we needed to change the [current] system of securing revenue" (Authors' personal communication, Moscow, July 2002).

Table 3 about here

Subsequently, both the ROCs and the Russian government also realized that they needed stable rules to abet their recovery as well as to insulate themselves from the effects of future crises. For the oil companies, at a minimum "recovery" required investing in modernization, for which they also needed both greater predictability and more secure property rights. Prior to the 1998 crisis, the ROCs property rights were threatened by frequent tax inspections that resulted in profit losses through indiscriminate taxes and fees (Authors' personal communication with Tom Adshead, Troika Dialog, Moscow, July 2002). The 1998 crisis, furthermore, exacerbated the fear among the ROCs that the government might re-nationalize their assets because many of the ROCs faced bankruptcy (Authors' personal communications with Stephen O'Sullivan, United Financial Group, Moscow, July 2002, and with representatives of Russian oil companies,

[30] In 1998, the oil sector accounted for approximately one-fourth of all government tax revenues (*Russian Economic Trends*, 8 December 1998, p. 6).

Moscow, June-July, 2002). At a maximum, the ROCs' "recovery" required attracting Western partners in order to expand their operations at home and abroad, which in turn required increased transparency (e.g. disclosing information about profits and providing accurate information about profitability to shareholders) and establishing corporate governance. Specifically, the ROCs recognized that strategic partnerships with Western companies would enable them to plan more long-term by giving them access to foreign capital and technology, which was necessary to increase production. At both ends of the spectrum, then, the ROCs could not recover without obtaining formal guarantees from the government that it would not arbitrarily expropriate their assets or the proceeds from these assets through indiscriminate taxation (Authors' personal communications with Russian oil companies and oil and gas analysts, Moscow, June-July 2002). Tax legislation, moreover, would both enhance predictability and require increased transparency, thus providing them with the stability to invest in their assets at home and the credibility to attract Western partners to expand their operations at home and abroad.

For the government, "recovery" required at a minimum budgetary stability. In order to regain their budgetary losses in the short-term and to stabilize the flow of tax revenue from the oil sector, the Russian government needed to give the ROCs a greater incentive to pay their taxes voluntarily. Throughout the 1990s, the Russian government relied heavily on taxing the oil sector to fill its coffers.[31] In addition to exorbitant corporate income tax rates, oil producers were subject to a fixed excise tax rate and stiff export tariffs. Yet, by August 1998, it became clear that this strategy was driving the oil companies into bankruptcy[32] and creating an unreliable revenue stream. At the same time, the Russian government's ability to seize assets to induce tax

[31] For example, in 1997 fuel and pipeline sectors combined contributed approximately 12% of GDP (*Russia Economic Trends*, December 1997, p.3).

[32] The fixed rate excise tax, for example, meant that oil producers, paid approximately 55 rubles per ton (or about $9.00) regardless of the price of oil. When oil prices plummeted in 1998, then, "many of the companies [were driven] to the verge of bankruptcy" (Samoylenko, April 1998, p.3).

compliance was hampered by cumbersome bankruptcy procedures. “Recovery” at a maximum required expanding the tax base and increasing compliance overall so as to reduce the budget’s dependence on the oil sector for revenue. Structural reform aimed at promoting real growth across sectors thus became a top priority for the government, and establishing a stable tax regime was a central component of this strategy (see, e.g., Vasiliev, February 2000; Authors’ personal communications with Dvorkovich, op. cit., and with Shatalov, op. cit.). Within the government, the Ministry of Energy and Fuel initially and later the Ministry of Economic Development and Trade viewed lowering the tax rate and tying export tariffs directly to the price of oil as the means to promote long-term recovery and growth in the oil sector while also serving to stabilize the government’s revenue stream, broaden the tax base, and improve the rate of compliance (Authors’ personal communication with Dvorkovich, op. cit.).

Incremental Strategic Moves and Institutional Change

While key actors within the Russian government and the ROCs came to change their beliefs about the value of their current strategies and to realize the need for stability independently, in order to achieve a formal agreement they needed to demonstrate convincingly to one another that this change in beliefs and realization had actually occurred and would be sustained. They achieved this not through a single strategic move that was unilateral or pre-emptive (see, e.g., Jervis, 1978; Maoz and Felsenthal, 1987), but rather, through a series of incremental strategic moves -- both private and public -- that assured the other side that they were committed to tax reform and would not defect. In sum, the ROCs’ strategic moves included bringing their business activities back on-shore, adopting new international accounting standards, and embracing corporate governance, while the government’s included pledging to honor private ownership of the oil sector and continuing to work with the Duma to pass an acceptable Tax

Code as a law rather than to change the tax system by decree. These assurances were effective not only because they were reciprocated but also because they were consistent -- even as the price of oil rebounded in late 1999[33] and the economy began to recover, resulting in an increase in both the government's tax revenues and the ROCs' profits, they continued.[34]

Shortly after the August 1998 crisis, the ROCs initiated an informal dialogue with the Russian government to convince it to "soften" the tax system -- that is, to become "less aggressive vis-à-vis the oil companies" -- to aid their recovery by making investment in modernization possible (Authors' personal communication with Russian oil company representative, Moscow, July 2002; and with Konstantin Reznikov, Alfa Bank, Senior Oil and Gas Analyst, Moscow, September 2001).[35] Specifically, they lobbied for several features that are embodied in the new Tax Code -- including the flat rate for corporate profits tax,[36] the cap on contributions to the social fund, and export duties based on profits rather than production -- because they were conducive to their newfound desire to invest more capital in domestic production and expansion (Authors' personal communications with representatives of Russian oil companies and with domestic and foreign financial analysts in Russia, Moscow, September 2001 and June-July 2002).[37] The ROCs also pressured the government to introduce a flat rate for the mineral tax, which would be tied directly to the world price of oil so that when the price is

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[33] In January 1998, Russian oil sold for $15.79 on the open market. By January of he following year, it dropped to $10.09, and then rebounded to $23.36 by January 2000. See http://www.eia.doe.gov/emeu/cabs/russia.html .

[34] By September 1999, Lukoil was already reporting profits from the higher price of oil and according to RFE/RL 10 September 1999, Lukoil, recorded profits of $830 million during the first three quarters of 1999, a 207 percent increase over the same period last year. Already in the first half of 1999, there were improvements in tax collection in which tax revenues accounted for 10.6 percent of GDP in comparison to 6.8 percent of GDP during the second half of 1998 (OECD, 2000, p. 61).

[35] This occurred shortly after the chief executives of two major oil companies -- Mikhail Khodorkovsky of YUKOS and Vagit Alekperov of Lukoil -- stated publicly that taxes were too high given declining oil production and that a dialogue with the government was necessary to rectify this situation in October and November 1998, respectively (*Finansovye Izvestia*, 1998; *Rossiyskaya Gazeta*, 1998).

[36]The new corporate profit's tax specifically targets the ROCs, b/c the foreign oil companies still pay taxes abroad, usually at a higher rate (Personal communication Lewis, op.cit.).

[37] In addition, the new Tax Code includes their demands for increased exemptions for investment in infrastructure, new technology and new fields exploration, and compensates companies drilling in older fields.

low, the companies will be assured of a guaranteed amount of cash available for investing and long-term planning (Authors' personal communication with Steven Dashevsky, CFA, Aton Group, Moscow, September 19, 2001).

Several other strategic moves followed that served to assure the Russian government that the ROCs were committed to reform. First, in June 1999 they showed good faith by agreeing to pay all their taxes in cash by December 1999 despite having recently downsized their operations (*Moscow Times*, June 23, 1999). This was a sharp departure from their behavior prior to the August 1998 crisis when the ROCs would often run up huge tax arrears on their exports and then settle their tax liabilities in kind (e.g. barter deals), which made it extremely difficult for the Russian government to estimate how much revenue the oil sector would actually contribute to the budget on an annual basis (Aitken, 2001). Second, at the end of 1999, the ROCs took an even bolder step by beginning to increase their level of domestic investment and increasing their transparency.[38] This trend continued unabated, such that the following year (2000) ROCs' total investment jumped by 95% (Mazalov, 2001, p. 37) and shareholder confidence was being restored (Authors' personal communication with O'Sullivan, op. cit.). In March 2001 at the Second Annual Russian Energy Summit, Lukoil's chief executive Vagit Alekperov emphasized the need for oil companies to enhance the transparency of their operations and adhere to other standards of corporate management and declared his own company's intention to continue to reinvest in its domestic projects. Finally, the ROCs agreed to reveal their profits through their implementation of international accounting methods (i.e. GAAP standards) and corporate governance codes (*RPI* October 2001). Overall, these incremental strategic moves assured the

[38] To ensure their immediate recovery, the ROCs began to invest heavily in increasing production either through fixing old wells (e.g. Yukos' strategy) or through drilling new wells (e.g. Sibneft's strategy).

Russian government that the ROCs were serious about bringing their profits on-shore and no longer hiding them by investing off-shore.

YUKOS has been one of the leaders in demonstrating to the Russian government how the ROCs have changed their beliefs and behavior following the 1998 crisis. It has changed its strategy through aggressively pursuing (1) corporate governance; (2) hiring international management; (3) increasing investments in Russia; and (4) building strategic partnerships with Western companies (Authors' personal communication with company representatives, Moscow, July 2002, and with O'Sullivan, op. cit.).[39] By 2001, approximately 25% of top-level management in YUKOS were foreigners, which is "one of the main reasons for and signs of the change in thinking that is going on at YUKOS" (Authors' personal communication with company representative, Moscow, July 2002).

The RCOs' overtures did not go unrequited. Several key actors within the Russian government simultaneously made incremental strategic moves that were intended to convey its own commitment to reform. First, the Ministry of Energy and Fuel introduced several tax proposals in late 1998 to lower the oil excise tax in order to reduce the tax burden on the ROCs and provide incentives for the ROCs to adopt Western technologies and to establish alliances with foreign partners (*RPI*, September 1998, p. 27). Although there were a few officials in the Ministry of Finance receptive to tax reform in the early to mid-1990s, such as Shatalov, this ministry was generally opposed to such cuts after the crisis for fear that it would lead to further losses to the federal budget.[40] Second, Yeltsin's dismissal of Prime Minister Kiriyenko, who had

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[39] Yukos, for example, was one of the first oil companies to form a strategic partnership with a Western service company – Schlumberger.

[40] According to Shatalov, he sought to push through tax reform in the early 1990s, but he resigned in frustration because prior to the 1998 financial crisis "the Yeltsin administration's was not committed to real tax reform." Only after the Putin administration demonstrated its commitment to tax reform did Shatalov agree to return to the government, at which time the Ministry of Finance also became more receptive to tax reform.

initiated accelerated bankruptcy proceedings against the ROCs in mid-1998 in August 1998, and replacement with Yevgeni Primakov in September conveyed to the ROCs that the Russian government had abandoned its attempts at coercion and was willing to negotiate.[41] It also conveyed that the Yeltsin administration was committed to pursuing the formalization of the Tax Code by working with the Duma on tax reform rather than reverting back to setting arbitrary tax rates by executive decree. While Kiriyenko and "the reformers" lacked a majority coalition in the Duma, Primakov was considered to be acceptable to the large faction of Communists in the Duma (Shleifer and Treisman, 2000, p.177). This was reassuring to the ROCs because they universally considered a law, which required the approval of the Duma, to be more stable (i.e. harder for the government to change arbitrarily) than a decree (Authors' personal communications with Alexander Ustinov, Economic Expert Group, Ministry of Finance, Moscow, June 2002, and with representatives of Russian oil companies, June-July 2002). This commitment was reinforced in December 1998, when the Russian government proposed a package of eight laws to the Duma, which connected tax rates to profitability of the oil wells and then again in January 1999 when Part I of the Russian Tax Code, which introduced a reduction in the profits tax from 35% to 30%, officially went into effect (Vasiliev, 2000).

The government's next set of incremental strategic moves took place under the leadership of Vladimir Putin, who was appointed Prime Minister at the end of 1999 and elected to the presidency in March 2000. First, he established a new ministry to deal precisely with the task of promoting long-term economic growth -- The Ministry of Economic Development and Trade, which began to dominate the debates over tax reform inside the government and to represent the government's position in private negotiations with the ROCs and public debates in the Duma. It

[41] In fact, shortly after his appointment, Primakov met with representatives of the largest ROCs to begin seeking a compromise (*Kommersant*, September 30, 1998, p. 4).

thus effectively replaced the Ministry of Finance, which had spearheaded the government's previous approach to tax reform, thereby undermining its ability to negotiate an acceptable compromise with the Duma (see, e.g., Samoylenko, April 1998, p.2), and which financial analysts and ROCs alike agree was fixated on fulfilling short-term budgetary requirements (Authors' personal communications with representatives of Russian oil companies, Moscow, September 2001, and with domestic and foreign financial analysts in Russia, Moscow, September 2001).

At the end of 2000, Putin supported the formation of a special "working group" composed of government officials, Duma deputies, and the ROCs to discuss the remaining aspects of the Tax Code, especially those that were of special concern for the ROCs, such as the corporate profits tax and the mineral tax (Authors' personal communication with Shatalov, op. cit.). The Ministry of Economic Development and Trade in these discussions advocated dramatic cuts in tax rates as a way to simultaneously stimulate investment in long-term and new oil projects[42] and increase tax compliance across sectors (Authors' personal communication with Dvorkovich, op. cit.). By advocating a flat tax on corporate profits of 24 percent, for example, the government was committing to a much lower share of the oil companies' profits in exchange for the full disclosure of their actual profits. Moreover, the Ministry of Economic Development and Trade unlike the Ministry of Finance supported the flat tax on personal income and corporate profits tax because they believed that it would eventually expand the government's tax base by encouraging investment in other economic sectors (i.e. beyond the oil sector) and reducing the size of the illegal economy (Authors' personal communication with Dvorkovich, op. cit., Reznikov, op. cit., and Vyugin, op. cit.). They were also behind the more recent proposals to

[42] The previous tax system discouraged oil companies from investing in long-term and large new projects (Authors' personal communication with Yermakov, op. cit., and with representatives of Russian Oil Companies, Moscow, June-July 2002).

compensate companies "for losses resulting from adjustment of transfer prices for tax purposes" (Authors' personal communication with Yermakov, op. cit.) and to establish a flat mineral tax pegged to the world market price of oil. The latter in particular was deliberately designed to guarantee a more stable revenue flow to both the ROCs and the government over the long term (Authors' personal communication with Dashevsky, op. cit.). The formation of this group thus conveyed to the ROCs not only that the government remained committed to tax reform, but also that it remained committed to working with the Duma to enact tax legislation. At this time, the Russian government also provided additional assurances to the ROCs that it would not make significant changes to the Tax Code for at least three years after it was adopted in 2001, which is considered to be a fairly long period of time in Russia (Authors' personal communication with Ustinov, op. cit.).[43]

Finally, to reassure the ROCs that the Russian government would cease to arbitrarily expropriate their profits and assets, Putin met with the Russian oligarchs in the middle of 2000 and informed them publicly that "[he] would stay out of business, if [they] stayed out of politics" (Authors' personal communication with O'Sullivan, op. cit., and with Adshead, op. cit; See also, Feifer, 2000). The reaction of the ROCs was universal relief because they viewed this as a credible commitment to respecting their property rights (Authors' personal communications with representatives of Russian oil companies).

Alternative Explanations

There are several possible alternative explanations for why Russia adopted and enacted a Tax Code between 1998 and 2002 that exceeds Western standards. One of the most obvious is,

[43] Rather, the government pledged to introduce only minor amendments to "work out the bugs out of the code" (Authors' personal communication with Ustinov, op. cit.).

of course, that the government pushed through this new tax regime in order to attract foreign investment. Yet, it has been clear since independence that, particularly in the energy sector, Russia has very little interest in bringing in foreign investors. In fact, until very recently, both the executive branch and the Duma have stalled the adoption of production sharing agreements (PSAs), which are universally viewed as the key to further foreign investment in the energy sector (Authors' personal communication with Konovalov, op. cit.). Another related alternative explanation is that the Russian government was responding to direct pressure from international lending agencies to adopt a new tax regime. Yet, this is also not the case. International pressure did play a central role, but indirectly in the form of global markets.

It is also plausible that the steep drop in oil prices in 1998 may have brought the Russian government and the ROCs to the table, but did not in fact fundamentally change their beliefs and mutual desire for formal guarantees. Yet, the new Tax Code itself belies this explanation. Certainly, time will tell whether in fact both sides stick to their agreement not to renege and the tax regime is a self-enforcing equilibrium. The fact that all parties remained at the bargaining table long after the initial "shock" of the August 1998 oil crisis had dissipated and they began to recover, however, indicates that they were not merely interested in finding a short term solution.

The remaining alternative explanations hinge on the balance of power between the Russian government under Putin and the ROCs. On the one hand, the new Tax Code could be understood as yet another example of Putin's ability to unilaterally (re-)define Russia's political climate since his election in June 2000. Certainly, he showed ROCs that he was willing to use force through his treatment of the notorious oligarchs Boris Berezovsky and Vladimir Gusinsky. Yet, if this is what brought the ROCs to the bargaining table it fails to explain why negotiations over a new tax regime began in 1998, under Yeltsin. It is also clear that Putin could not or would not simply impose a new tax regime without at least the tacit approval of the ROCs. Although he could have imposed a new Tax Code by decree, he clearly opted to continue negotiations through the Duma to find an acceptable agreement that could be passed as a law. He also publicly recognized the property rights of the oil industry and pledged his commitment not to re-nationalize (Authors' personal communications with representatives of Russian oil companies, names withheld, September 2001, and with domestic and foreign financial analysts in Russia, Moscow, September 2001). Thus, he seemed to be interested in making a truce with the remaining oligarchs rather than alienating them.

On the other hand, perhaps the new Tax Code just the result of "state capture" -- that is, the ROCs have used their control over the state (or excessive political influence) to lower tax rates for their own benefit (See, e.g., Hellman, Jones, and Kaufman, 2000). Yet, this is an unsatisfactory explanation for several reasons. First, even if the ROCs did have so much control over the state and retained it after the 1998 crisis, this does not explain why they would prefer to establish formal tax regime rather than continuing to benefit from informal networks and influence both to negotiate favorable tax rates and to evade unfavorable taxes. Second, the literature on "state capture" predicts that those who benefit from a "capture economy" will reject institutions that disperse rents (Hellman, Jones, and Kaufman, 2000) or improve the protection of property rights (Sonin, 1999). Yet, by protecting tax payers rights vis-à-vis state agencies, lowering rates for all taxpayers, and endeavoring to increase compliance across sectors and broaden the tax base, the new Russian Tax Code does both. Finally, the Tax Code was the product of intense negotiations and compromises between the Russian government and the ROCs, not the latter imposing its will on the former.

Implications: Privatization, Global Markets and the Role of Exogenous Shocks

In sum, we argue that the new Russian Tax Code is the outcome of an assurance game between the government and the domestic oil companies (ROCs), whereby the former sought to stabilize its revenue stream and the latter sought to stabilize its tax burden. In doing so, they were able to realize the mutual gains from cooperation after several years of iterated play in which the best (risk-dominance) strategy for both sides was defection. This was made possible because the shock of the August 1998 financial crisis simultaneously changed their perceptions of the game's payoff structure such that mutual defection became more costly. This shock not only magnified their mutual vulnerability to global markets, but also led them to realize the need for formal rules in order to recover from the present crisis and sustain future crises. They conveyed this change in perceptions and the desire for formalization through incremental strategic moves that, over time, effectively assured each side that the other was committed to reform and would not defect. These findings further our understanding of economic reform and institutional change in Russia, resource-rich states, and beyond.

First, they emphasize the direct and positive impact that privatization to domestic actors can have on economic reform and institutional change via the revenue bargain between governments and domestic interests -- regardless of how domestic owners initially acquired their property. Both the recent literature on economic reform in post-communist states and the long held conventional wisdom on resource-rich states predict that Russia will fail to develop the necessary institutions to promote economic growth, particularly a stable and/or comprehensive tax regime.

Concerning the former literature, "insider privatization" (or privatization policies that deliberately favor insiders) is cast as the primary evil on the stage of successful transition to a market economy, either because it enriches a few agents who prefer to maintain insecure property rights so that they can exploit their privileged access to social assets (Sonin, 1999) or creates “early winners” who block subsequent reforms that would threaten their ability to continue to reap the benefits of their ill-gotten gains (Hellman, 1998). More specifically, Russia’s inability to develop a viable tax regime has also been attributed to this elite “redistribution of power resources” following the Soviet collapse (Easter, forthcoming). The new Russian Tax Code, however, demonstrates not only that the ability of economic elites to derail the economic reform process is more limited that these pessimistic accounts suggest but also that, under certain conditions, these “insiders” or “early winners” can in fact serve as the engine of further reform. If Russia’s oil sector had been state-owned rather than privatized in August 1998, the financial crisis would not have had the same effect on perceptions and behavior. First, the Russian state would not have felt the same degree of vulnerability to oil price fluctuations that induced its desire to formalize revenue extraction because it would have the option to either arbitrarily confiscate profits, increase exports, and/or borrow abroad against future revenue from their resource wealth. The existence of private firms, however, meant that seizing assets required complicated and costly legal procedures. Second, the ROCs would have neither been in a position to pressure the government to establish formal guarantees against arbitrary expropriation of its assets nor felt the need for such an agreement. They could have turned to the government instead to subsidize their recovery, for example, through foreign loans.

In the vast literature on the "resource curse," a weak (or non-existent) tax regime is viewed as perhaps the most prevalent negative outcome of resource wealth due to state leaders' myopic thinking and heavy reliance on external (i.e. rather than internal) sources of revenue (see, e.g., Callaghy, 1988; Chaudry, 1989; Karl 1997; Mahdavy, 1970; Mardon, 1990; Mitra, 1994;

and Shafer, 1994). The lack of a viable tax regime has also been consistently identified in this literature as impeding broad economic growth and the development of democracy (see e.g. Karl, 1997).[44] The emergence of a viable Tax Code in Russia, therefore, seems to be a striking anomaly. Yet, this is only because the literature on the resource curse shares a common assumption that natural resource wealth is always and necessarily state-owned. In contrast, we argue that privatization encourages, rather than discourages, institution-building in resource-rich states, particularly with regard to taxation, because it disperses ownership over key assets, such that the government can benefit only indirectly from its resource wealth -- the resource allocation effect (RAE) -- and facilitates the development of economic interests outside the state that lobby for formal guarantees -- the political influence effect (PIE) (for details, see Weinthal and Jones Luong, forthcoming). The new Tax Code in Russia demonstrates the independent effect of both these causal mechanisms.

Thus, Russia's new Tax Code both demonstrates how transition economies can move beyond the supposed deadlock created by "insiders" or "early winners" and confirms our hypotheses developed elsewhere that privatization offers a potential way for resource-rich countries to escape the so-called "resource curse" because it forces governments to negotiate with domestic actors for revenue (Jones Luong and Weinthal, 2001).

Secondly, by creating mutual vulnerability among the government and key economic actors, global markets can foster the desire for formal rules. Whereas the logic behind the classic Prisoner's Dilemma -- that is, that individually rational outcomes can be collectively suboptimal -- is often used to justify government intervention in markets, in this case global markets seem to promote pareto optimal outcomes where government intervention fails. It also points to an

[44] Conversely, the development of a viable tax regime is often cited in the broader literature in comparative politics as facilitating transitions to democracy, economic development, and state capacity (see e.g. Bates and Lien, 1985; Levi, 1988).

important, albeit indirect, mechanism whereby foreign investors and the lure of global markets leads to more stable institutional environments. The new Tax Code is not the product of direct foreign pressure, but of internal bargaining between the government and the ROCs. Nor did Russia adopt a new tax regime to attract foreign direct investment, but rather, because ROCs wanted to secure their property rights at home by attracting Western partners.[45]

Finally, our findings in the case of Russia clarify the role of exogenous shocks in inducing institutional change more broadly. While crises are often invoked as an explanation for political and economic reform (see, e.g., Krasner, 1994; Haggard and Kaufman, 1997), the precise causal mechanisms are rarely specified. For example, contrary to the conventional wisdom, debt crises in the 1980s throughout Latin America also did not result in immediate policy change. Rather, "the typical pattern was for governments to respond to crisis by tightening their restrictions" -- that is, by returning to previous policies (Rodrik, 1996, p. 25). Nor have the general conditions under which we can expect crises to result in fundamental institutional or policy change been specified. Yet, we know that it is often not the case empirically that shocks -- even of such magnitude as, for example, the Asian economic crisis -- cause countries to alter their political and/or economic system. This same global crisis seems to have had a profound impact, for example, on state-business relations and economic policy in some countries, such as Russia and Indonesia, and yet very little impact in other countries such as Malaysia and Brazil (see, e.g., Krugman, 2000, for details).

The case of the new Tax Code in Russia provides some insight into both the conditions under which we should expect shocks to induce fundamental institutional change and the

[45] Most believe that strategic partnerships with Western partners would prevent the Russian government from unilaterally changing the Tax Code or expropriating their assets because doing so would cause an international incident at the very time when Russia is aiming to integrate into the world economy (Authors' personal communication with O'Sullivan, op.cit.)

mechanisms through which shocks result in such change. In short, the three conditions are: 1) that the shock threatens the survival of the key political and economic actors in a given country, 2) that the structural context limits these actors' options for recovery such that neither can recover without the cooperation of the other, 3) that actors effectively convey their desire for change; and the causal mechanisms are 1) a change in beliefs and 2) a series of incremental strategic moves, or expressions of changed beliefs intended to create the expectation that commensurate actions will follow.

Tax reform in Russia provides additional support for the argument that exogenous shocks result in fundamental institutional change only when incumbents believe that continuing current policies directly threatens their own survival (Jones Luong, 2002). The 1998 financial crisis threatened the political and economic survival of both the Russian government and the ROCs because it hit both sides where it hurt them most. They felt vulnerable following the shock because they could no longer rely on their primary source of economic, and hence, political power -- revenue from oil production and export. Despite low tax compliance across the oil sector, until the 1998 crisis the Russian government was satisfied that it could squeeze the major oil companies to fill its coffers and make up for budgetary shortfalls. The ROCs faced the loss of their most valued assets -- their primary "cash generating commodity"[46] -- through bankruptcy or re-nationalization. Moreover, their possible responses to the crisis were limited by structural conditions -- in particular, the privatization of the oil sector -- for the reasons outlined above. This feeling of vulnerability thus translated into a desire for a cooperative outcome in the form of a stable Tax Code.

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[46] The major ROCs used rents from oil production and export to finance all of their other business activities (Authors' personal communication with O'Sullivan, op. cit.).

Their mutual change in beliefs and desire for cooperation, however, were necessary but not sufficient to bring about fundamental institutional change in the form of a new Tax Code. In order for this change in beliefs and desire for cooperation to result in fundamental institutional change (i.e. the new Tax Code), it had to be accompanied by a change in behavior. In particular, both sides had to engage simultaneously in incremental strategic behavior that effectively assured one another that this change in beliefs and behavior had indeed taken place. For the ROCs, these consisted bringing their business activities back on-shore, adopting new international accounting standards, and embracing corporate governance. For the government, they included pledging to honor private ownership of the oil sector and continuing to work with the Duma to pass an acceptable Tax Code as a law rather than to change the tax system by decree.

The idea of incremental strategic moves as a mechanism for facilitating cooperation not only contrasts with the literature in international relations, which finds that a bold strategic move by one player is sufficient for cooperation to occur (see, e.g. Jervis, 1978 and Maoz and Felsenthal, 1987), but also suggests an explanation for sustained cooperation after crisis. In short, because it serves to build up trust over time, incremental strategic moves may produce a more sustainable outcome than a single strategic move. Although it is much too soon to evaluate the long-term stability of the Tax Code or its positive effects, the fact that the new equilibrium is yielding higher payoffs for both sides -- i.e. higher revenues through tax compliance for the Russian government and higher shareholder value and access to international capital for the ROCs -- will also contribute to its sustainability.

Table 1: Stages of Reform in the Russian Energy Sector, 1992-1998

	Stage I (1992-93)	Stage II (1995-96)	Stage III (1997-98)
Brief Description	Ownership Restructuring into Combination of Holding Companies & Subsidiaries (VICs); Some Privatization with Strict Regulation	More Privatization (“Loans for Shares”) and Partial Deregulation	Full Privatization and Full Deregulation; Internal Restructuring
Ownership Structure	**State Ownership Maintained** • Ownership rights in Holding Companies (50+% shares) and majority interest (38%) in VICs	**State Ownership Reduced** • Largest banks acquire state shares as collateral for loans. • HC Rosneft partially privatized & shares in several VICs sold • BUT several companies still protected from full privatization	**State Ownership Relinquished** • In 1997, the government relinquished ownership rights in a large number of companies; held majority shares in less than 1/2 and no shares in almost 1/3rd • Rosneft and Transeft privatized.
	Foreign Ownership Restricted • Limited to between 5 and 15%	**Foreign Ownership Restricted** • Limited to between 5 and 15%	**Foreign Ownership Opened** • Federal/Official limit abolished • Duma adopts PSA law in 1998
Regulation	**Strict Price Controls** • Oil prices set at 5% of world level	**Price Controls Eliminated** • Prices liberalized: domestic & intern’l prices near parity by mid-95	
	Strict Export Controls • Quota & licensing system -- some designated “states needs” exporters • Greater restrictions for JVs	**Export Controls Relaxed** • Trade liberalized: export quotas abolished; export duties reduced in 1995, then abolished in mid-1996 • BUT “state needs” program remained	**Export Controls Eliminated** • “state needs” export program greatly scaled back, then eliminated
	Domestic Requirements • Delivery despite non-payments • Internal restructuring limited	**Domestic Requirements** • Delivery despite non-payments • Internal restructuring limited	**Domestic Requirements Relaxed** • Shut-offs increasingly common • Workforce reduced, investment curtailed, and mergers discussed

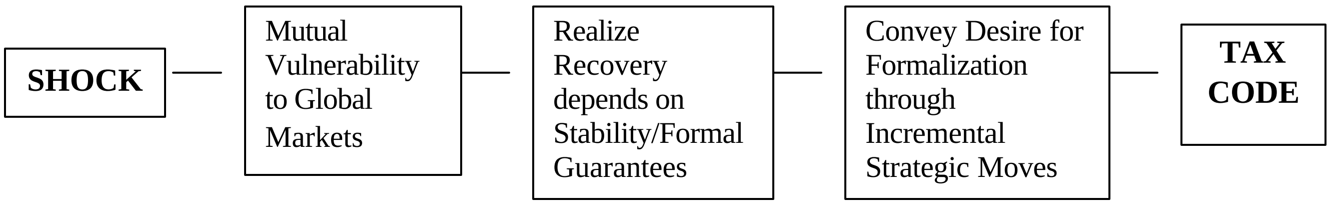
Table 2: Equlibrium Strategies

	(II) ***Domestic Owners' Strategies***	
	Play Honest (Cooperate)	**Evade Taxes (Defect)**
Fixed Tax Rate (Cooperate)	9,9 (New Tax Code)	4,7
(I) ***Government's Strategies***		
Flexible Tax Rate (Defect)	7,4	6,6 (Status Quo)

Table 3: Impact of the Shock on Payoffs

	(II) *Domestic Owners' Strategies*	
	Play Honest (Cooperate)	**Evade Taxes (Defect)**
(I) *Government's Strategies* **Fixed Tax Rate (Cooperate)**	9,9 (New Tax Code)	4,5
Flexible Tax Rate (Defect)	5,4	1,1 (Status Quo)

Figure 1: From the Shock to Institutional Change



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