*The following is an excerpt from* [*David Hoffman's*](http://www.carnegiecouncil.org/people/data/david_e__hoffman.html)*2004*[*talk*](http://www.carnegiecouncil.org/studio/multimedia/20040121/index.html)*on his book*[*The Oligarchs: Wealth and Power in Russia.*](https://www.amazon.com/Oligarchs-Wealth-Power-New-Russia/dp/1586480014?ie=UTF8&qid=1158867780&ref_=sr_1_1&s=books&sr=1-1&tag=viglink23682-20) *Researched and written during a key time period*—*when the wealth and power of oligarchs was strong and rising and Putin had served only a few years in executive office*—*Hoffman gives a clear look at the rise and sudden fall of the once richest man in Russia, Mikhail Khodorkovsky.*
 **What are capitalists in a land that was hostile to the idea for seven decades? What are criminals in a state without the rule of law?**

When we talk about these oligarchs, these businessmen, we are not talking about people who simply stole, because hundreds, thousands of people stole. In that period after the Soviet Union collapsed, stealing was not a major accomplishment. But building an empire, getting the entire natural resources of a country under your control, for that matter, getting the President of the country under your control--that is what it takes to be an oligarch.

In the Soviet period of shadows and shortages, entrepreneurship was considered criminal. Keep that in mind as we hear the saga of [Mikhail] Khodorkovsky and the question about whether he's a capitalist or a criminal.

The Soviet economic system was faltering in the early 1980s; it could not deliver the same levels for consumers, especially because it was so heavily devoted to the military-industrial complex. In a last-ditch effort to recreate the dream, several members of the Politburo pushed through a resolution that would lead the fight against what they called "unearned incomes." This seemed to be a bad thing if people were earning unearned incomes in systems in which entrepreneurship was criminal.

But people didn't know what unearned incomes were. Was that driving a gypsy [unlicensed] cab? Was that growing your own tomatoes and cucumbers? It was very puzzling when this order came out, but nonetheless the militia went down the street trying to figure out what it meant. They decided that growing your own tomatoes was definitely a crime.

They positioned themselves south of Moscow to watch for people driving up from the south to Moscow bringing vegetables for informal sales as part of the shadow economy. *Nezavisimaia Gazeta*, then a rather probing paper, ran the headline "The Criminal Tomato." Out of sheer embarrassment over this episode, Mikhail Gorbachev began to change. The Communist Party undertook an experiment to allow the first small, private businesses, called the cooperatives.

The system was trying to save itself. Certainly they weren't allowing cooperatives to run steel mills or take over oil refineries, but they allowed people baking pies and doing shoe repair to start small businesses, and they gave the Communist Youth League loopholes in order to do this. It was in this environment of uncertainty, fear, testing and experimentalism that Mikhail Khodorkovsky got his first start. All those involved with cooperatives were considered on the edge of society, hustlers and rather unsavory fellows.

Khodorkovsky's first cooperative was a disaster. He opened a little café in the lobby of the Mendeleev Chemical Institute in Moscow, figuring that when his fellow students were finished with their classes, they would stop for coffee. But nobody did. Undeterred, he continued to develop.

It's very surprising when people first meet Khodorkovsky, because for someone who is a very steel-willed individual, he has a soft and high voice that makes me think, even when I talk to him, that he's about 15. He's also painfully shy. With these characteristics that masked a bit of his ambitions, he set out to start another business, to find a way to take a large amount of non-cash State subsidies which sat in various institutes and factories, oftentimes unused. These institutes and factories needed real cash, real rubles, which existed side by side as another kind of money. Real rubles were rather scarce, and you were supposed to use them only to pay your wages. You couldn't hire a truck or build a shed with real rubles.

Khodorkovsky is a very scheming fellow, and he figured out how, with the permission of the Party, to take the non-cash, worthless accounting subsidies that institutes and industry received from [Gosplan](http://www.fas.org/nuke/guide/russia/agency/gosplan.htm%22%20%5Ct%20%22_blank) [agency for central planning] and from the Center and transform them into real cash, which he then could kick back to the factory director, put in his own bank account, and use for other purposes. How did he do this? He was 25 years old. The Soviet Union still existed, and he discovered a way to churn the Soviet system's own subsidies into real money.

He used a tiny loophole to take the workers in any institution, call them your labor collective temporarily and pay them with this special money. He took people in their own factory, gave them a symbolic designation, and used that loophole to then say, "I have to pay them all in cash," took the subsidies, turned it into cash in the state bank, with permission, and had a lot of that cash left over for himself, for the director, and for other purposes. Soon his little bank, Bank Menatep, began to bulge with real cash, and soon after that he figured out how to take the rubles and turn them into dollars.

This is the beginning of the age of easy money, because he wasn't alone. Take that little trick and multiply it by 100, 200, 1,000. Many people were trying this, and as the Soviet Union came to an end in 1991 and the new Russia began in 1992 and 1993, the age of easy money just exploded, and Khodorkovsky and his pals were everywhere.

First of all, self-interest became legitimate in the age of easy money. We went, in a very short period, from entrepreneurship being criminal to self-interest being legitimate. Secondly, you can have no capitalism—as Boris Yeltsin said he wanted—without capitalists. This brigade of young guys was poised and ready to step into the role of the first capitalists.

The Soviet Union had collapsed. Its laws and rules, which were written for a society in which entrepreneurship was considered criminal, were still on the books, but nobody obeyed them. The State fell apart as a regulatory institution, partly because the laws were inherited from a country that no longer existed.

Many people like Khodorkorsky hustled, and he began to accumulate tens of millions, maybe even 100 million dollars in those first years, just by playing on the weakness of the State. You could bet on tomorrow's ruble-dollar rate today and make tens of millions of dollars. You could become an authorized banker for the state. Khodorkovsky could say, "You have to pay the teachers in Kolymskaja. You have no way to pay the teachers. I'll pay the teachers." There was no treasury in the early days of Russia after the collapse of the Soviet Union, so they used the bankers, who said, "Give me $600 million. I'll pay all the teachers in the country." The State gave them the money.

What did he do with it? He didn't pay the teachers. Some of them came and knocked on the door of the bank in Moscow asking for their pay. Khodorkovsky sent out guys with guns and said, "Step back across the street, please." He understood the time value of money. Six hundred million dollars over three months could reap him a nice profit. The teachers didn't get the money until later, and sometimes he then paid them with…IOUs for money he was supposed to give them.

Finally, the most critical point was the arrival of [voucher privatization](https://en.wikipedia.org/wiki/Voucher_privatization). Khodorkovsky accumulated as many of those vouchers as he could with his tens of millions. He in turn used them to buy interests in 29 different companies: oil, metallurgy, chemicals, food processing.

Anatoly Chubais, who was in charge of this process, had a profound assumption behind this program: If we give all the property away, ultimately the people who get it will succeed or fail on their own wits and wisdom. If we give it to them, those who fail will have to sell; those who succeed will make it to the next generation. And Chubais said, "I don't care who gets it. Let the market work. Let evolution happen, and we'll see after two or three generations that the good owners will be predominant and the bad ones will fail."Interesting question, because Khodorkovsky quickly bought up many of these businesses, and then after the vouchers, in every company, there was 20 percent left over which the state still held.

Chubais and some of his aides were asking, "How can we get rid of this 20 percent?" because they wanted all of the property in private hands. They came up with an ingenious scheme—investment tenders. These were an auction where the person who promised to give the most money in the future for a company's investment won the 20 percent. Property was being auctioned in exchange for a promise to invest in the future. Khodorkovsky used investment tenders, as did every other major participant in privatization at the time, to buy these last 20 percent—very valuable because it often gave them majority ownership. Khodorkovsky bought, for example, a little fertilizer company called Apatit. He promised to invest $238 million in it in the future.

This small group of increasingly powerful oligarchs helped get Boris Yeltsin reelected, and in exchange they got a new round of privatizations, a very small number but a large amount of property. The crown jewels were given out in 1995 and 1996—oil, minerals—and this is when Khodorkovsky gets his Yukos Oil Company, which he had had his eye on for several years.

The loans-for-shares auctions, which was part of this embrace of wealth and power, were rigged in a way in which not even Khodorkovsky could hide, because in the auctioneer was also the winner of the bids. So his bank, Menatep, was the auctioneer, and his bank, Menatep, using a front company, a shell company, was the winner.

They had a very ingenious method to keep all foreigners out, because everybody knew that if British Petroleum or Exxon came in, they would all be history. They paid very low prices. Khodorkovsky got 78 percent of a very big oil company for $300 million. Loans for shares, investment tenders, this entire period of voucher privatization was not individual guys going into a candy store and filching a candy bar. These were actions of the State, which was giving the property away. The State set no rules, but said, "You can have factories for a promise."After Khodorkovsky got this Yukos Oil Company and Yeltsin was reelected, there was a huge boom in Russia in late 1996, 1997, and up to the first part of 1998…

[But] All booms come to an end. The ruble crashed in 1998, and the State was once again there at his side, saying "You don't have to pay back any of your loans. We'll have a moratorium. You guys are all hurting. We sold you these bonds. The bonds collapsed, so don't pay back," and Khodorkovsky was among those who didn't pay back. And in 1999 he became the poster boy for the worst kind of corporate governance abuses that we've seen in post-Soviet Russian history. He defaulted on the three bank loans. He told the banks, "I'm just so poor, I can't pay you back. Please?" Banks have to balance their books every year, and after a while they got tired of waiting. They sent a team in to see if he had any assets they could seize, and the team came back shaking their heads.

Early in 1999 they just figured, "We made a mistake, let's write it off." They took the paper, the 30 percent of Yukos which they held, and they sold it. Guess who bought it? They didn't realize it, but on the secondary market he bought it all back for $100 million. Net gain: $136 million in cold cash by simply defaulting. He also had a series of run-ins with creditors, with minority shareholders. He threatened to take the whole oil company offshore to get out from under certain debts.

Where have we come in the nineties? Yeltsin, in a decision that had profound consequences, decided with the liberal reformers to create maximum freedom first and rules later. So into this vacuum rushed chaotic forces, forces of evil—cheaters, charlatans, hooligans, criminal gangs, corrupt politicians, and oligarchs.

In the enfeebled condition of the Russian state at this time, money bought power. There was an unmistakable sequence to the accumulation of all of this property by the oligarchs and others. They got money from the easy money period. They bought property. Then they came into conflict with each other over that property and had no place to solve those conflicts because the State did not exist as a regulatory institution, so they resolved them on the street with guns. There was a terrible surge of violence in the 1990s. But the cycle was complete. Money ruled.

So what happens next in Russia? Do the robber barons go straight? And why? After becoming the bad boy of Russian capitalism in 1999, Mikhail Khodorkovsky decides he will follow the example of the American robber barons and clean up his act.

First he had to get all of Yukos back. He got 68 percent of it after he finished buying back those loans. The stock was practically worthless. They had stopped trading it on the Russian stock exchange because of his bad behavior. So he forced out the chairman of the Russian Securities Commission. Khodorkovsky said, "What do I do? I've got 68 percent of the company, the stock is worthless, it's not trading, and it has a lot of oil." If he had kept it private and said, "Me and my six pals, it's our company and we'll pump the oil," he might have done very well by himself.

Khodorkovsky said, "If we're going to be the robber barons that went straight, we've got to do it differently." He then began slowly, and against much skepticism, to adopt Western transparent business practices. He kept the company public. He inherited a massive oil windfall when prices went up in 2000. It helped to have a couple of billion in cash. He also issued accounts by U.S. standards. He paid dividends. And now I remind you he owned 68 percent of this company, he's paying dividends to himself, but there is the other 30 percent. For the first time, there was a major move by a Russian company to begin paying dividends.

Yukos' production soared. A lot of oil started going through the pipeline. He invested in equipment so that production would increase. He promised good corporate governance, and guess what happened? This Russian robber baron was rewarded for his good behavior. The stock began to trade and go up, and after a year or two, the stock hit 11 bucks a share. He wasn't finished yet.

I was very skeptical. I had an adversarial relationship with Khodorkovsky, I did a lot of reporting that was very difficult, with a lot of secrecy. When people said, "He's changed, and now he's going to be like J P Morgan," I said, "Right." But over time, we began to see that the metamorphosis and evolution was real, and that it parallels precisely what we think so proudly about our own tycoons.

Khodorkovsky then took another step that no other leading Russian businessman had taken. He revealed the true ownership of his company. Khodorkovsky revealed that he had 38 percent or at that time about $9 billion worth of this Yukos Company. He got it for $300 million. Not bad for a couple of years' work. He began philanthropy at home and abroad. And things began to happen in Russia. British Petroleum announced a $7 billion investment in another Russian oil company, and Khodorkovsky began to publicly talk about selling part of Yukos to Exxon or Chevron.

The metamorphosis was continuing. Why did it happen? It happened because there are certain basic forces of change which are very familiar to us from our own history, even from our day-to-day activities. One of them was greed and self-interest. Another was that when all the property and easy money were exhausted, when ruble-dollar speculation was no longer profitable, people need to move into more legitimate channels to make money. And also, there was an important moment when the owners of these companies began to do exactly what Chubais said. They began to feel like stewards. They had to hire good managers. They had to increase production and pay dividends and issue annual reports.

Where does that leave us today [2004]? Is the guy a capitalist or a criminal? The President of Russia, Vladimir Putin, missed this entire period we were discussing. In part of it he was in Germany, later in St Petersburg, but in my view he never fully understood the chaotic period of the nineties or the evolution that was about to happen and was under way with Khodorkovsky.

Putin said recently, "People are constantly saying that the laws were complex and it was impossible to follow them. Yes, the laws were complex and intricate, but it was definitely possible to abide by them. Everyone who wanted to follow them did so. Just because five, seven, or ten people did not follow the laws, it does not mean that everyone did not abide by them." The truth is that nobody abided by them. The truth is that Russia did not become a rule-of-law state in the 1990s, and he missed that.

Khodorkovsky's fortunes changed abruptly this year (2004). The company came under attack. He was arrested, he was accused of fraud. Some of his partners have been arrested, others have fled, and the market value of the company has gone down. He's not worth $9 billion anymore. He's now in jail.

A capitalist or a criminal? I mentioned that in 1994 the fertilizer company, Apatit, was privatized. There was an investment tender for 20 percent, and Khodorkovsky promised to put in the $283 million investment, but did not. He was not alone.

Where was the State that had set this up? After a period of litigation over Apatit Fertilizer Company, Khodorkovsky finally reached a settlement. He paid the State $15 million last year as a settlement for the promise to invest that he didn't keep. It was a civil settlement in which the criminal prosecutor also sent a letter saying, "I have no further claims."

Now, suddenly, it's the basis of a criminal complaint. Now, suddenly, Khodorkovsky is under fire. This is the core of the case against him. This is not a question of criminal activity because what's happening is something larger. All of privatization is on trial. If the Apatit case was a crime, then pick anybody now in business in Russia and he's a criminal. If you can have arbitrary prosecution, you don't have a rule-of-law state. If you declare that all the nineties' privatization is vulnerable, then watch out, because anybody can be next. Is that where Russia should be going?

What's really behind this? People say, "Oh, it's just politics. Putin's running for election." It's a very good way to run a populist campaign. There's enormous resentment. Millions of Russians suffered in this period.

People also say, "The State needs revenues. These guys have all the billions. Why don't we just get it from them?" There's a way to do that—taxes.

People say, "Oh, Putin's cleaning up. He's going to make it a rule-of-law state." But you can't build a rule-of-law state unless you use rule-of-law methods, and these are not rule-of-law methods. The Kremlin has decided to consolidate power in both politics and the economy, where competition is the real oxygen of democracy, of capitalism. Putin has started to smother competition and capitalism, just as he's smothered it in politics with the governors, the Parliament, and the media.

There are examples around the world of places where state capitalism functions. Take a look at Mexico. Should Russia be like Mexico? Do we want a place where the state controls all the decisions about winners and losers? Is that real market capitalism?

\**Editor’s note: This transcript was from 2004. In 2005, Khodorkovsky—a fierce critic of Vladimir Putin and at one point in time Russia’s richest man--was jailed for eight years for tax evasion, fraud, and embezzlement charges. He was tried again in 2011 on charges of money laundering and embezzlement. He was pardoned in 2013 by Putin on “principles of humanity.” Many see the charges as politically motivated. For more information on Khodorkovsky, please see the* [*BBC’s profile*](http://www.bbc.com/news/world-europe-12082222)*.*